

ARTICLES

TAXING PUBLICLY TRADED ENTITIES

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Abstract

Publicly traded entities are generally treated as corporations for U.S. tax purposes. Under various exceptions, however, publicly traded entities may obtain special treatment if they earn predominately certain specified types of qualifying income. This Article examines potential rationales for granting special tax treatment to certain publicly traded entities. As the analysis in this Article will show, many of the potential rationales are unconvincing. In addition, to the extent that some rationales may be persuasive, the current rules are not designed in a way that best comports with these potential justifications. Therefore, reform is needed.

To reform the current system, this Article proposes narrowing the scope of what may be classified as qualifying income so that special tax treatment is bestowed upon publicly traded entities only when warranted by underlying policy justifications. Specifically, this Article proposes that income that is classified as qualifying income under current law should not be classified in that manner unless it is earned by holding a publicly traded asset. In addition, current law grants favorable treatment to all income earned by a publicly traded entity if and only if the entity earns predominately qualifying income. This Article assesses whether tax law should, instead, grant special tax treatment to only qualifying income earned by a publicly traded entity, but with the special treatment applying regardless of whether the entity earns predominately qualifying income. Ultimately, this Article concludes that, on balance, concerns about complexity justify continuation of a regime under which beneficial treatment applies to all income earned by a publicly traded entity if and only if the entity earns predominately qualifying income, provided that the scope of what may be classified as qualifying income is narrowed in the manner proposed by this Article.

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I. INTRODUCTION

Publicly traded entities are generally treated as corporations for tax purposes. Under various exceptions, however, publicly traded entities may obtain special treatment if they earn predominately certain specified types of qualifying income.¹ Recently, the use of sophisticated tax structuring techniques has precipitated an expansion in the universe of entities that obtain special tax treatment.

This phenomenon has caught the attention of the popular press. On August 9, 2014, for instance, the New York Times published an article, “A Corporate Tax Break That’s Closer to Home,” highlighting a recent trend--a growing number of businesses reduce their tax liability by organizing themselves as real estate investment trusts (“REITs”).² Likewise, on April 22, 2013, an article titled “Restyled as Real Estate Trusts, Varied Businesses Avoid Taxes” occupied the front page of the New York Times.³ The article contained additional discussion of this recent trend.⁴ Although businesses that primarily earn income from real estate have long been formed as REITs, increasingly businesses that have earnings other than traditional real estate income make use of the tax benefits of the REIT structure.⁵ The New York Times article from April mentioned several examples of this new generation of REITs, including a company that owns and operates prisons and a company that owns casinos. Likewise, the Wall Street Journal published an article, “More Firms Enjoy Tax Free Status,” on January 10, 2012. That article featured another current development--a surge in the number of publicly traded partnerships that avoid entity-level tax by predominately earning certain types of qualifying income (typically investment income).⁶ Although nothing is new about the ability of publicly traded partnerships to avoid entity-level tax when they mainly earn investment income, the Wall Street Journal article focused on new publicly traded partnerships that are decidedly different. Unlike their traditional counterparts, these new publicly traded partnerships manage to avoid entity level tax notwithstanding the fact that they earn substantial amounts of non-qualifying income. The Wall Street Journal article provided several examples of this new breed of publicly traded partnerships, including a publicly traded firm that specializes in running cemeteries and publicly traded

¹ Under current law, publicly traded entities that earn more than a small amount of non-qualifying income are not the only types of entities that are automatically treated as corporations for tax purposes. See Treas. Regs. §§ 301.7701-2(b)(1), (3)–(8) (describing entities that must be treated as corporations). For instance, under current law, an entity is automatically treated as a corporation for tax purposes if it is organized under a federal or state statute that describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic. See Treas. Regs. §§ 301.7701-2(b)(1). Therefore, an incorporated publicly traded entity is automatically treated as a corporation regardless of the type of income that it earns in most cases. Consequently, this Article’s discussion of special treatment granted to certain publicly traded entities that earn primarily qualifying income is, for the most part, focused on unincorporated publicly traded entities. However, an incorporated entity that met various eligibility requirements could qualify as a real estate investment trust (a “REIT”) for tax purposes. See I.R.C. § 856(a)(3). Therefore, this Article’s discussion of publicly traded REITs could include incorporated entities.

² Gretchen Morgenson, *A Corporate Tax Break That’s Closer to Home*, N.Y. TIMES, Aug. 9, 2014.

³ Nathaniel Popper, *Restyled as Real Estate Trusts, Varied Businesses Avoid Taxes*, N.Y. TIMES, Apr. 22, 2013, at A1.

⁴ *Id.* For additional discussion, see, e.g., *Telecom Firm Announces Latest Tax-Free REIT Spin-Off Transaction*, 2014 TAX NOTES TODAY 146-1 (Jul. 30, 2014); Lee A. Sheppard, *Can Any Company Be a REIT?*, 2013 TAX NOTES TODAY 160-2 (Aug. 19, 2013).

⁵ *Id.*

⁶ John D. McKinnon, *More Firms Enjoy Tax Free Status*, WALL STREET JOURNAL, Jan. 10, 2012.

partnerships that share in the income earned by private equity fund sponsors, such as Blackstone Group, L.P. and KKR & Co., L.P.⁷

The growing number of REITs and publicly traded partnerships that avoid entity-level tax has troubled the IRS. The increasing prevalence of non-traditional REITs prompted an IRS working-group study to examine the topic of REIT classification.⁸ The IRS also called a temporary halt to issuing private letter rulings involving publicly traded partnerships in order to further study the topic.⁹ At the same time, in May 2014, the Treasury proposed regulations that would expand the definition of what constitutes real property for purposes of the REIT qualification rules, making the regulations consistent with guidance that has been issued by the IRS in private letter rulings.¹⁰

These trends have also attracted congressional attention. Recently, for instance, the Committee on Ways and Means proposed reforms under which publicly traded partnerships would only qualify for exemption from entity-level tax if they primarily earned income from activities related to mining and natural resources.¹¹ That proposal was not the first congressional proposal that would have limited the circumstances in which publicly traded partnerships can avoid entity-level tax.¹² In addition to addressing publicly traded partnerships, the Committee on Ways and Means proposed measures that would make it more difficult for existing businesses to restructure themselves as REITs, and that would hinder the ability of taxpayers to use tax structuring techniques to obtain REIT qualification.¹³

In order to place these recent trends in context, this Article examines potential rationales for granting special tax treatment to certain publicly traded entities that earn predominately qualifying income. As the analysis in this Article shows, many of the potential rationales are unconvincing. In addition, to the extent that some rationales may be persuasive, the current rules are not designed in a way that best comports with these potential justifications. For instance, legislative history suggests that special treatment is granted to qualifying income because owners of the publicly traded entity could earn qualifying income directly.¹⁴ Based on this rationale, the scope of what currently constitutes qualifying income is much too broad because many types of income that

⁷ *Id.*

⁸ See, e.g., Amy S. Elliott, *Companies Report IRS May Have Suspended REIT Conversion Rulings*, 2013 TAXNOTES TODAY 111-4 (Jun. 10, 2013).

⁹ See, e.g., Tax Analysts, *IRS Has Stopped Ruling on Publicly Traded Partnership Qualifying Income*, 2014 TAXNOTES TODAY 61-4 (Mar. 31, 2014).

¹⁰ Reg-150760-13. For further discussion, see Willard B. Taylor, *Closing the Gap Between Private Letter Rulings and Regulations*, 144 TAXNOTES 597 (Aug. 4, 2014).

¹¹ Committee on Ways and Means, Tax Reform Act of 2014, Discussion Draft, Section-by-Section Summary, Section 3620, available at http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

¹² For instance, Senators Max Baucus and Charles Grassley proposed legislation in 2007 that would have limited the scope of the Exempt Publicly Traded Partnership rules. S. 1624, 110th Cong. (2007). For further discussion of the legislation, see Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 104-20 (2008). For further discussion of lawmakers' consideration of reform to the tax treatment of large partnerships, see, e.g., Martin A. Sullivan, *Economic Analysis: Why Not Tax Large Passthroughs as Corporations*, 131 TAXNOTES 1015 (2011).

¹³ Committee on Ways and Means, Tax Reform Act of 2014, Discussion Draft, Section-by-Section Summary, Sections 3631, 3635 available at http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

¹⁴ See *infra* Part III.B.

owners of a publicly traded entity could not earn directly are classified as qualifying income. Therefore, reform is warranted.

To reform the current system, this Article proposes narrowing the scope of what may be classified as qualifying income so that special tax treatment is bestowed upon publicly traded entities only when warranted by underlying policy justifications. Specifically, this Article proposes that income that is classified as qualifying income under current law should not be classified in that manner unless it is earned by holding a publicly traded asset.¹⁵ Furthermore, income earned by a publicly traded entity that is “carried interest” should never constitute qualifying income.¹⁶ As discussed below, “carried interest” is a percentage of the profits generated by a private equity fund, real estate fund, or hedge fund that is earned by the fund’s sponsor.

In addition to containing an overly broad definition of “qualifying income,” current law grants favorable treatment to all income earned by a publicly traded entity if and only if the entity predominately earns qualifying income. This Article assesses whether tax law should, instead, grant special tax treatment to only qualifying income earned by a publicly traded entity, but with the special treatment applying regardless of whether the entity earns predominately qualifying income.¹⁷ Ultimately, the Article concludes that, on balance, concerns about complexity justify continuation of a regime under which beneficial treatment applies to all income earned by a publicly traded entity if and only if the entity predominately earns qualifying income, provided that the scope of what may be classified as qualifying income is narrowed in the manner proposed by this Article.

The reforms proposed by this Article would create a more rational system than what currently exists. Furthermore, these reforms would have the additional benefit of eliminating the effectiveness of the wasteful, elaborate tax structuring techniques employed by the new generation of REITs and publicly traded partnerships recently featured in the popular press.

This Article proceeds as follows. Part II describes the current state of law. It discusses how publicly traded entities are treated for tax purposes, it describes the special tax treatment granted to certain publicly traded entities, and it explains the new tax structuring techniques used by entities to qualify for special tax treatment. Part III explores potential justifications for current law. Part IV highlights some troubling

¹⁵ For discussion of this proposal in the context of the publicly traded partnership rules, see Emily Cauble, *Redefining Qualifying Income for Publicly Traded Partnerships*, 145 TAX NOTES 107 (2014).

¹⁶ For discussion of this proposal in the context of the publicly traded partnership rules, see Cauble, *supra* note 15, at 46.

¹⁷ This question has been raised briefly in earlier work. See Emily Cauble & Gregg D. Polsky, *The Problem of Abusive Related-Partner Allocations* 16 FLA. TAX REV. 479, 518 (2014) (“While a full ventilation of this broader concern is left for another day, it is worth noting that the critical issue appears to be whether the tax system should, in the context of publicly traded entities (1) *always* tax qualifying income at the entity level, (2) *never* tax qualifying income at the entity level, or (3) *sometimes* tax qualifying income at the entity level depending on the amount of non-qualifying income earned by the entity—a factor that is sometimes within the entity’s control if it avails itself of sophisticated tax planning. Our current system can be described as using the third approach, which seems to be the worst of the three options”); Emily Cauble, *Was Blackstone’s Initial Public Offering Too Good To Be True?: A Case Study in Closing Loopholes in the Partnership Tax Allocation Rules*, 14 FLA. TAX REV. 153, 202-203 (2013) (mentioning the possibility that Congress could enact a rule for publicly traded partnerships that would, in all cases, subject only non-qualifying income to corporate-level tax). This Article builds upon that earlier work by undertaking a thorough analysis of this question in the context of considering rationales for granting special tax treatment to certain entities.

aspects of the current taxation of publicly traded entities, illustrating how current law is not well suited to achieve any of the conceivable rationales for granting special treatment to certain publicly traded entities. Part V describes and evaluates the reforms proposed by this Article.

II. CURRENT TAXATION OF PUBLICLY TRADED ENTITIES

Although many business entities can elect to be treated as partnerships or corporations for tax purposes, certain entities must be treated as corporations.¹⁸ For example, entities that are publicly traded typically must be treated as corporations for tax purposes.¹⁹ An entity that is listed on an established securities exchange, like the New York Stock Exchange, is publicly traded.²⁰ In addition, even if interests in an entity are not traded on an exchange, if, given all the facts and circumstances, owners are readily able to buy, sell, or exchange their interests in a manner that is economically comparable to trading on an established securities market, the entity generally will be treated as a corporation for tax purposes.²¹

If an entity is treated as a corporation for tax purposes, generally the entity itself will be subject to tax (“entity-level tax”).²² Furthermore, owners of the entity may be subject to tax when they sell ownership interests in the entity or receive certain distributions from the entity.²³ If an entity is treated as a partnership for tax purposes, the entity will not be subject to tax. Instead, any items of tax income, gain, loss, or deduction recognized by the entity will be passed through to the entity’s owners for the owners to

¹⁸ Treas. Regs. §§ 301.7701-3(a) (providing ability to elect tax classification to many entities); 301.7701-2(b)(1), (3)–(8) (describing entities that must be treated as corporations). Because this Article is focused on publicly traded entities, it uses the term “corporation” to refer to an entity that is treated as a C corporation for tax purposes. Certain closely held entities can opt for treatment as S corporations, which would lead to tax treatment different from the treatment of corporations described in this Article.

¹⁹ I.R.C. § 7704.

²⁰ I.R.C. § 7704(b)(1).

²¹ I.R.C. § 7704(b)(2); Treas. Reg. § 1.7704-1(c). Transfers that are not recognized by the entity and certain other transfers will be disregarded when determining whether the entity is publicly traded. *See* Treas. Reg. §§ 1.7704-1(d), 1.7704-1(e). Furthermore, the Treasury Regulations provide safe harbors, and an entity that is not traded on an established securities market and that qualifies for a safe harbor will be deemed to not be publicly traded. The safe harbors include the private placement safe harbor and the lack of actual trading safe harbor. The private placement safe harbor applies to an entity if interests in it are issued in a transaction that need not be registered under the Securities Act of 1933 and the entity does not have more than 100 owners at any time. *See* Treas. Reg. § 1.7704-1(h). An entity resides within the lack of actual trading safe harbor if not more than two percent of the total interests in the entity are transferred during any given year. *See* Treas. Reg. § 1.7704-1(j).

²² *See* I.R.C. § 11. This discussion assumes that the entity is not an S Corporation, a justifiable assumption within the realm of publicly traded entities because an entity with more than 100 owners cannot qualify as an S Corporation. I.R.C. § 1361(b)(1)(A).

²³ *See* I.R.C. § 301 (addressing distributions from corporations); I.R.C. § 1001 (regarding gain from sale of ownership interests). Certain owners may not be subject to tax as a result of distributions or sale of interests in the entity. For instance, assuming the ownership interest held is not debt-financed, tax-exempt owners generally would be exempt from tax on any dividend income and capital gain income resulting from distributions or sale of interests in the entity. I.R.C. §§ 512(b)(1), 512(b)(5), 514. In addition, in most cases, non-U.S. owners would generally be exempt from U.S. tax on any capital gain income resulting from distributions or sale of interests in the entity. A non-U.S. individual or corporation is generally only subject to U.S. tax on capital gain income if the income is effectively connected with a U.S. trade or business. I.R.C. §§ 871(b)(1), 882(a)(1). Income from trading in stocks and securities for a taxpayer’s own account is generally not treated as effectively connected to a U.S. trade or business. I.R.C. § 864(b)(2)(A)(ii). U.S. withholding tax might apply to dividend income paid to non-U.S. owners, but, depending on the facts, the rate of tax may be reduced by treaty.

take into account directly when computing their own taxable income.²⁴ Thus, treatment as a corporation generally involves two levels of tax--both an entity-level tax and an owner-level tax.²⁵ By contrast, treatment as a partnership involves only one level of tax, the tax imposed at the owner level.²⁶ For example, assume a business earns \$100 of pre-tax income.²⁷ If the business were conducted through an entity treated as a partnership for tax purposes, the entity would bear no entity-level tax, and the individual owners of the business could bear total tax liability of 40% of \$100, or \$40. Thus, after tax, \$60 of income would remain. If, instead, the business were conducted through an entity treated as a corporation for tax purposes, the entity would incur tax liability of 35% of \$100, or \$35. When the entity distributed the remaining \$65, the individual owners would incur total tax liability of 20% of \$65, or \$13, leaving only \$52 of after-tax income (less than the \$60 amount that remained in the case of the partnership).

A. Exempt Publicly Traded Partnerships

As discussed above, typically a publicly traded entity must be treated as a corporation for tax purposes, treatment that subjects its income to two levels of tax. However, certain entities (“Exempt Publicly Traded Partnerships”) can be treated as partnerships for tax purposes notwithstanding the fact that the entities are publicly traded. In order to constitute an Exempt Publicly Traded Partnership, the entity must predominately earn certain types of “qualifying income.”²⁸ In particular, at least 90 percent of the entity’s gross income must be “qualifying income.”²⁹ “Qualifying income” includes dividend income, interest income, capital gain income, and certain other types of investment income.³⁰ In addition, “qualifying income” includes income from activities related to mining and natural resources.³¹ Certain types of income are excluded from the definition of “qualifying income” if they are earned in particular ways. For instance, interest is not qualifying income if it is derived in the conduct of a financial or insurance

²⁴ See I.R.C. § 701. Tax-exempt owners generally would be subject to tax on the income only if the underlying income earned by the partnership is unrelated business taxable income. See I.R.C. § 512(c). Non-U.S. investors would be subject to U.S. tax if the underlying income earned by the partnership was effectively connected with a U.S. trade or business or was U.S. source income of certain types, but, in other cases, non-U.S. investors would generally be exempt from U.S. tax.

²⁵ See *supra* notes 22-23 and accompanying text.

²⁶ See *supra* note 24 and accompanying text.

²⁷ This example also assumes that the underlying income earned by the business is ordinary income, all the individual owners of the business are subject to a tax rate of 40 percent on ordinary income, all the individual owners of the business are subject to a tax rate of 20 percent on dividend income, and the corporate tax rate is 35 percent.

²⁸ See I.R.C. § 7704(c). In order to obtain partnership classification, the entity also must not be automatically classified as a corporation under certain other provisions. See Treas. Regs. §§ 301.7701-2(b)(1), (3)–(8) (describing entities that must be treated as corporations).

²⁹ I.R.C. § 7704(c).

³⁰ I.R.C. § 7704(d).

³¹ Specifically, the term “qualifying income” also includes “income and gains derived from the exploration, development, mining or production, processing, refining, transportation . . . , or the marketing of any mineral or natural resource . . .” I.R.C. § 7704(d)(1)(E).

business.³² In addition, interest and rent that are contingent upon profits do not constitute qualifying income, subject to certain exceptions.³³

Because an Exempt Publicly Traded Partnership is treated like a partnership for tax purposes, it avoids entity-level tax. Instead of subjecting income to tax at the entity level, any items of tax income, gain, loss, or deduction recognized by the entity will be passed through to the entity's owners for the owners to take into account directly when computing their own taxable income.³⁴

B. Real Estate Investment Trusts

A publicly traded entity can also avoid subjecting its income to two levels of tax if the entity achieves classification as a real estate investment trust (a "REIT"). A REIT is generally treated as a corporation for tax purposes. However, unlike an ordinary corporation, a REIT is entitled to deduct dividends that it pays to its shareholders for purposes of computing the REIT's income that is subject to tax at the REIT level.³⁵ Therefore, unlike an ordinary corporation, a REIT can avoid entity-level tax by distributing all of its income to its owners.³⁶

³² See I.R.C. § 7704(d)(2)(A). Regarding this carve-out, legislative history accompanying the adoption of the publicly traded partnership rules states that "interest is not treated as passive-type income if it is derived in the conduct of a financial or insurance business. Thus, for example, interest income from the conduct of a banking business is not treated as passive-type income, as deriving interest is an integral part of the active conduct of the business." H.R. REP. NO. 100-391 (1987).

³³ See I.R.C. §§ 7704(d)(2)(B), 7704(d)(3). Regarding these limitations on the definition of "qualifying income," legislative history accompanying the adoption of the publicly traded partnership rules states that "[i]nterest or rent (or other amounts) contingent on profits involves a greater degree of risk, and also a greater potential for economic gain, than fixed (or even a market-indexed) rate of interest or rent, and thus is more properly regarded as from an underlying active business activity." H.R. REP. NO. 100-391 (1987).

³⁴ See I.R.C. § 701. Certain owners may not be subject to tax on the income allocated to them. Tax-exempt owners would not be subject to tax if the underlying income earned by the partnership is not debt-financed and constituted dividend income, interest income, capital gain income, or other types of income generally excluded from the scope of unrelated business taxable income. In 1993, Congress repealed a rule under which income allocated to a tax-exempt partner from a publicly traded partnership was always unrelated business taxable income. Following the repeal, it appears that publicly traded partnerships that are treated as partnerships for tax purposes receive the same treatment as other partnerships. In general, income allocated to a tax-exempt partner by a partnership is unrelated business taxable income only if the underlying income earned by the partnership is unrelated business taxable income. See I.R.C. § 512(c). Non-U.S. investors would be subject to U.S. tax if the underlying income earned by the partnership was effectively connected with a U.S. trade or business or was U.S. source income of certain types, but, in other cases, non-U.S. investors would generally be exempt from U.S. tax.

³⁵ See I.R.C. § 857(b).

³⁶ U.S. owners of the REIT that are not tax-exempt will generally be subject to tax on the dividend income. Tax-exempt owners of the REIT, however, will generally be exempt from tax on the resulting dividend income as long as their ownership interests in the REIT are not debt-financed. See Rev. Rul. 66-106, 1966-1 C.B. 151. Notwithstanding the fact that tax-exempt owners would generally be exempt from tax, a pension plan that owned a large stake in a REIT whose stock was overly concentrated in the hands of pension plans would be subject to tax on distributions to the extent that the REIT's underlying income would be unrelated business taxable income if earned directly by the pension plan. See I.R.C. § 856(h). A public REIT is not likely to be pension-held. Non-U.S. owners will not be subject to U.S. tax on gain recognized from selling interests in a REIT as long as either: (1) ownership of the REIT is sufficiently concentrated in the hands of U.S. persons to make the REIT domestically controlled or (2) the REIT is publicly traded and the non-U.S. owner owns 5 percent or less of the REIT. See I.R.C. § 897(h)(2), (c)(3). U.S. withholding tax could apply to dividend distributions by the REIT to non-U.S. owners, but the rate of tax may be reduced by treaty.

In order to obtain REIT status, an entity must pass two income tests and an asset test, in addition to complying with other requirements.³⁷ The first income test requires that at least 75 percent of the entity's gross income must consist of rent from real property, interest on obligations secured by mortgages on real property or on interests in real property, and other enumerated types of income related to real estate.³⁸ The second income test requires that the entity derive at least 95 percent of its gross income from dividends, interest, rents from real property, and other specified types of investment income.³⁹ An entity passes the asset test if at least 75 percent of the value of its assets is represented by real estate assets, cash and cash items (including receivables), and government securities.⁴⁰

C. Recent Expansion of Exempt Publicly Traded Partnerships and Real Estate Investment Trusts

As described above, while most publicly traded entities are subjected to corporate tax treatment, publicly traded entities that earn predominately specified types of qualifying income benefit from potentially more favorable tax treatment. In particular, special treatment is bestowed upon Exempt Publicly Traded Partnerships and REITs.⁴¹ Although publicly traded entities that predominately earn qualifying income have long availed themselves of the ability to achieve Exempt Publicly Traded Partnership status, entities that earn substantial amounts of non-qualifying income increasingly utilize sophisticated tax structuring techniques to achieve the same status. Likewise, entities that earn more than traditional real estate related income are increasingly achieving REIT classification through use of similar techniques.

Figure 1 below illustrates the structure increasingly used by publicly traded entities to maintain Exempt Publicly Traded Partnership status despite earning significant amounts of non-qualifying income.⁴²

³⁷ For other requirements, see I.R.C. §§ 856-57.

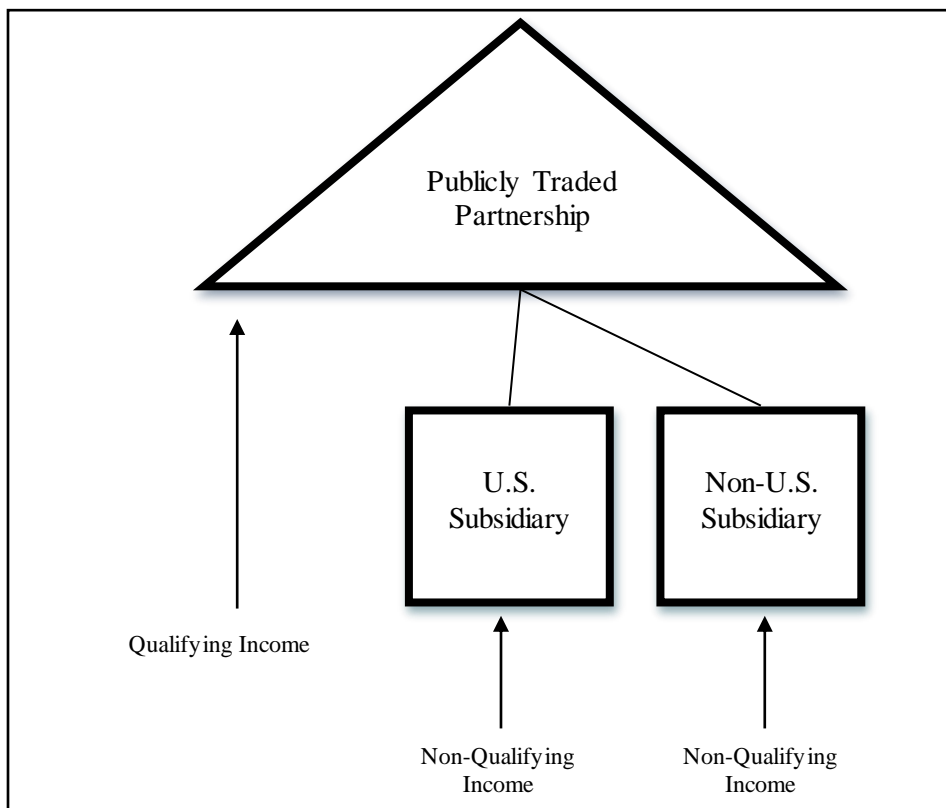
³⁸ I.R.C. § 856(c)(3).

³⁹ I.R.C. § 856(c)(2).

⁴⁰ I.R.C. § 856(c)(4)(A).

⁴¹ Special treatment is also bestowed upon other specialized types of entities. For instance, entities that meet certain requirements can elect to be treated as Regulated Investment Companies ("RICs") for tax purposes. I.R.C. § 851. Similar to a REIT, a RIC can deduct the dividends that it pays to its shareholders. I.R.C. § 852(b)(2). Full discussion of RICs is beyond the scope of this Article. However, it should be noted that, at least in the case of RICs that earn much of their income from investing in publicly traded assets, the proposal made by this Article is not inconsistent with the fact that special tax treatment is granted to those RICs.

⁴² For further discussion of this structure, see, e.g., Cauble, *supra* note 17 at 159-69; Cauble & Polsky, *supra* note 17; Fleischer, *supra* note 12 at 101-03.

Figure 1: Exempt Publicly Traded Partnerships

In this structure, the Publicly Traded Partnership is an entity that is traded on an established securities market. In order to maintain classification as an Exempt Publicly Traded Partnership, at least 90 percent of the Publicly Traded Partnership's gross income must be qualifying income.⁴³ In order to ensure that the Publicly Traded Partnership meets this test, only qualifying income is earned directly by the Publicly Traded Partnership or allocated directly to the Publicly Traded Partnership by subsidiary partnerships.⁴⁴ Because this income is allocated directly to or earned directly by the Publicly Traded Partnership, it retains its original character, and thus, all income the Publicly Traded Partnership directly receives is qualifying income.⁴⁵

Any non-qualifying income is earned by either "U.S. Subsidiary" (an entity formed in the United States) or "Non-U.S. Subsidiary" (an entity formed outside of the United States).⁴⁶ Both of these entities are treated as corporations for U.S. tax purposes, and each of these entities is wholly owned by the Publicly Traded Partnership. Because they are corporations, when these entities distribute cash, the Publicly Traded Partnership

⁴³ See *supra* Part II.A.

⁴⁴ For further discussion of this structure, see, e.g., Cauble, *supra* note 17 at 159-69; Cauble & Polsky, *supra* note 17; Fleischer, *supra* note 12 at 101-03.

⁴⁵ "Character" of income refers to the type of income. For instance, if a subsidiary partnership earned dividend income and allocated such income to the Publicly Traded Partnership, the Publicly Traded Partnership would recognize dividend income.

⁴⁶ For further discussion of this structure, see, e.g., Cauble, *supra* note 17 at 159-69; Cauble & Polsky, *supra* note 17; Fleischer, *supra* note 12 at 101-103.

recognizes dividend income or capital gain income.⁴⁷ Dividend income and capital gain income are types of qualifying income.⁴⁸ Thus, non-qualifying income earned by U.S. Subsidiary and Non-U.S. Subsidiary is converted into qualifying income before it reaches the Publicly Traded Partnership, and U.S. Subsidiary and Non-U.S. Subsidiary are interposed in the structure solely to achieve the result of converting non-qualifying income into qualifying income.⁴⁹

As a result, the Publicly Traded Partnership earns 100 percent qualifying income because its income consists of qualifying income earned directly (or through partnerships), dividend income received from U.S. Subsidiary or Non-U.S. Subsidiary, and capital gain income earned as a result of owning interests in U.S. Subsidiary or Non-U.S. Subsidiary.⁵⁰ Consequently, regardless of the mix of qualifying and non-qualifying income earned in any particular year, the Publicly Traded Partnership will always qualify for the exception from corporate tax treatment because at least 90 percent of its income (in this case, 100 percent of its income) will be qualifying income.⁵¹

Finally, U.S. Subsidiary will pay entity-level tax on the income it earns (which is the non-qualifying income that is funneled through U.S. Subsidiary). Therefore, entity-level tax is not completely avoided. However, in order to reduce U.S. Subsidiary's tax liability, the Publicly Traded Partnership likely loans funds to U.S. Subsidiary and charges U.S. Subsidiary interest.⁵² As a result, U.S. Subsidiary can deduct this interest expense, reducing its taxable income.⁵³ Moreover, the interest income received by the Publicly Traded Partnership from U.S. Subsidiary is qualifying income and, consequently, does not jeopardize its ability to earn predominately qualifying income.⁵⁴ There are limits on the extent to which U.S. Subsidiary's taxable income can be reduced by interest deductions. If the Publicly Traded Partnership charged an interest rate that was higher than a market rate, for instance, the loan from the Publicly Traded Partnership to U.S. Subsidiary could be re-characterized, for tax purposes, as an equity interest in U.S. Subsidiary. Accordingly, the payments made by U.S. Subsidiary would not be

⁴⁷ In particular, to the extent that the distribution does not exceed the corporation's available earnings and profits, the Publicly Traded Partnership will recognize dividend income. I.R.C. §§ 301(c)(1), 316. If the distribution does exceed earnings and profits, the Publicly Traded Partnership could potentially recognize gain from the sale of stock in the corporation, which would be capital gain income. I.R.C. § 301(c)(3)(A). The tax treatment of a shareholder of a non-U.S. corporation could differ from what is described in the text if the non-U.S. corporation earned passive income. In such a case, special "anti-deferral" rules could apply. However, assuming only active income is allocated to Non-U.S. Subsidiary, the anti-deferral rules would not apply to the Exempt Publicly Traded Partnership structure.

⁴⁸ I.R.C. § 7704(d).

⁴⁹ *See id.*

⁵⁰ *See supra* notes 44-49 and accompanying text.

⁵¹ For further discussion of this structure, see, e.g., Cauble, *supra* note 17 at 159-69; Cauble & Polsky, *supra* note 17; Fleischer, *supra* note 12 at 101-03.

⁵² For further discussion, see, e.g., Cauble, *supra* note 17 at 165; Cauble & Polsky, *supra* note 17; Fleischer, *supra* note 12 at 102.

⁵³ *See* I.R.C. § 163 (providing for an interest deduction).

⁵⁴ *See* I.R.C. § 7704(d)(1)(A). It is worth noting that certain other payments that would be deductible by the U.S. Subsidiary would not be treated as qualifying income if paid to the Publicly Traded Partnership. Specifically, rent received from a related taxpayer is treated as non-qualifying income except in certain circumstances. I.R.C. § 7704(d)(3) (defining rent by reference to Section 856(d) with certain modifications) and I.R.C. § 856(d)(2)(B) (providing that rent excludes amounts received from related taxpayers except in certain circumstances).

respected as deductible interest payments for tax purposes.⁵⁵ Nevertheless, subject to certain restrictions, interest deductions can reduce U.S. Subsidiary's tax liability.

Non-U.S. Subsidiary pays no entity-level tax on the non-qualifying income it earns. Non-U.S. Subsidiary, as a non-U.S. corporation, is subject to U.S. tax only on U.S. source-income and income effectively connected with a U.S. trade or business.⁵⁶ Non-U.S. Subsidiary only earns income that is neither U.S. source nor effectively connected with a U.S. trade or business.⁵⁷ As a result, Non-U.S. Subsidiary incurs no U.S. tax liability. Thus, although U.S. Subsidiary pays entity-level tax on the non-qualifying income it earns after reducing the amount of that income by allowable interest deductions, no entity in the structure pays entity-level tax on the qualifying income earned directly by the Publicly Traded Partnership, and Non-U.S. Subsidiary pays no entity-level tax on the non-qualifying income it earns. By contrast, if the Publicly Traded Partnership did not employ this structure, less than 90 percent of its gross income would be qualifying income, and it would be treated as a corporation for tax purposes.⁵⁸ As a result, all of its income (qualifying and non-qualifying) would be subject to entity-level tax.

For one concrete example of the use of this technique, consider the structure utilized by Blackstone Group L.P. Blackstone is a private equity firm that sponsors various real estate funds, hedge funds, and private equity funds (Blackstone, the fund sponsor, is referred to below as "the Blackstone Firm").⁵⁹ As a fund sponsor, the Blackstone Firm receives management fees and a percentage of the profits generated by each fund (referred to as "carried interest"). Blackstone Group L.P. is entitled to receive a share of whatever the Blackstone Firm receives—by way of management fees or carried interest—from the various funds that it sponsors.⁶⁰ Blackstone Group L.P. is a publicly traded partnership listed on the New York Stock Exchange.⁶¹ Blackstone Group L.P. utilizes a structure similar to the one shown in Figure 1 to ensure that at least 90 percent of its gross income constitutes qualifying income so that it obtains exemption from mandatory corporate tax treatment.⁶²

Some of the carried interest earned by Blackstone Group L.P. currently constitutes qualifying income. For instance, assume the Blackstone Firm sponsors a private equity fund that sells stock in a portfolio company, generating gain that is

⁵⁵ Likewise, if U.S. Subsidiary were too thinly capitalized, some of the debt could be recast as equity for tax purposes. Furthermore, Section 163(j) could limit the amount of interest deductible by U.S. Subsidiary if the owners of the Publicly Traded Partnership are not subject to tax on the interest.

⁵⁶ I.R.C. §§ 881–882.

⁵⁷ For further discussion, see, e.g., Cauble, *supra* note 17 at 165-66; Cauble & Polsky, *supra* note 17.

⁵⁸ See *supra* Part II.A.

⁵⁹ The Blackstone Group L.P., *Registration Statement (Form S-1)* at 1 (Mar. 22, 2007), <http://www.sec.gov/Archives/edgar/data/1393818/000104746907002068/a2176832zs-1.htm> (hereinafter Blackstone S-1).

⁶⁰ *Id.* at 10.

⁶¹ *Id.* at 17.

⁶² *Id.* at 202 ("We intend to manage our affairs so that we will meet the Qualifying Income Exception in each taxable year. We believe we will be treated as a partnership and not as a corporation for U.S. federal income tax purposes. Simpson Thacher & Bartlett LLP will provide an opinion to us based on factual statements and representations made by us, including statements and representations as to the manner in which we intend to manage our affairs and the composition of our income, that we will be treated as a partnership and not as an association or publicly traded partnership (within the meaning of Section 7704 of the Code) subject to tax as a corporation for U.S. federal income tax purposes.").

classified as capital gain. As a result of this transaction, some of the carried interest allocated to the Blackstone Firm will receive capital gain treatment.⁶³ Therefore, some of the income earned by Blackstone Group L.P. will be classified as capital gain and thus constitutes qualifying income.⁶⁴ Any carried interest to which Blackstone Group L.P. is entitled that is already qualifying income will be earned by Blackstone Group L.P. through pass-through entities so that the income retains its classification as qualifying income (just as qualifying income is earned directly by the Publicly Traded Partnership in Figure 1).⁶⁵

Blackstone Group L.P. is entitled to receive some non-qualifying income. For instance, management fees are non-qualifying income. In addition, some carried interest earned by Blackstone Group L.P. is non-qualifying income if, for instance, the Blackstone Firm sponsors a fund that earns income from providing services and allocates some of that income to the Blackstone Firm as carried interest. Rather than earning non-qualifying income directly or through pass-through entities, Blackstone Group L.P. earns any non-qualifying income through subsidiaries that are treated as corporations for U.S. tax purposes (just as the Publicly Traded Partnership in Figure 1 earns any non-qualifying income through U.S. Subsidiary and Non-U.S. Subsidiary).⁶⁶ Because these subsidiaries are corporations for U.S. tax purposes, when Blackstone Group L.P. receives distributions from the subsidiaries, Blackstone Group L.P. recognizes qualifying income in the form of dividend income or capital gain.⁶⁷ Thus, by funneling any non-qualifying income through these subsidiaries, Blackstone Group L.P. effectively converts what would otherwise be non-qualifying income into qualifying income.

Some of the corporate subsidiaries are formed in the United States and, thus, are treated as U.S. corporations for tax purposes (like U.S. Subsidiary in Figure 1).⁶⁸ These subsidiaries are subject to corporate-level tax on the income they earn. However, Blackstone Group L.P.'s offering documents leave open the possibility that Blackstone Group L.P. could loan funds to these subsidiaries and charge them interest.⁶⁹ The interest

⁶³ Carried interest is structured as a partnership interest that entitles its holder to receive profits earned by a partnership. Consequently, the person or entity that holds the right to carried interest will be allocated a share of income earned by the partnership. Moreover, because the character of income allocated to a partner depends on the character of income earned by the partnership, the character of carried interest depends on the type of underlying partnership income allocated to the person or entity that receives carried interest. I.R.C. § 702(b).

⁶⁴ I.R.C. § 7704(d)(1)(F) (defining qualifying income to generally include capital gain).

⁶⁵ Blackstone S-1, *supra* note 59 at 203 (stating that the subsidiaries of Blackstone Group L.P. that are treated as disregarded entities for tax purposes – Blackstone Holdings III GP L.P. and Blackstone Holdings IV GP L.P. – “will invest directly or indirectly in a variety of assets and otherwise engage in activities and derive income that is consistent with the qualifying income exception”).

⁶⁶ *Id.* at 202–04 (stating that Blackstone Group L.P. intends to meet the Qualifying Income Exception in each taxable year, and that Blackstone Group L.P. owns interests in certain subsidiaries that are treated as U.S. corporations for tax purposes--such as Blackstone Holdings I GP Inc. However, Blackstone Group L.P., as the holder of Blackstone Holdings I GP Inc.'s common stock, “will not be taxed directly on earnings of entities [it] hold[s] through Blackstone Holdings I GP Inc.” Rather, when Blackstone Holdings I GP Inc. makes distributions, Blackstone Group L.P. will recognize dividend income and, potentially, capital gain.).

⁶⁷ *Id.* Also, as long as the subsidiary that is formed outside the United States does not earn income that would constitute subpart F income, the subpart F regime will not apply to income earned through the non-U.S. corporate subsidiary.

⁶⁸ *Id.* at 202-03 (describing two corporate subsidiaries that are formed in the United States-- Blackstone Holdings I GP Inc. and Blackstone Holdings II GP Inc.).

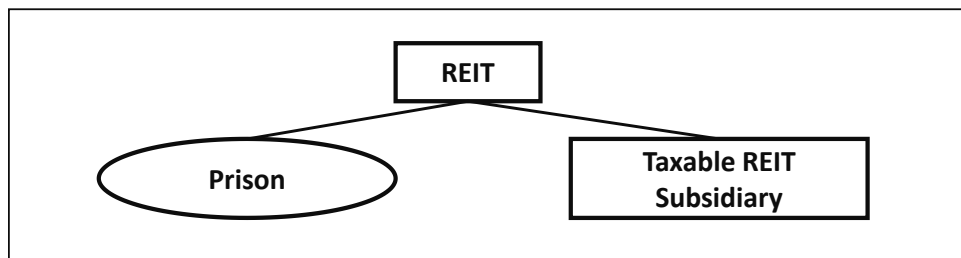
⁶⁹ Or, perhaps a disregarded entity owned by Blackstone Group L.P. could loan money to a corporate subsidiary, with the same tax effect as a direct loan from Blackstone Group L.P. *See id.* at 61

received by Blackstone Group L.P. would be qualifying income and thus, would not jeopardize its ability to qualify for exemption from corporate tax treatment.⁷⁰ At the same time, the subsidiaries can deduct the interest when computing their taxable income, reducing the amount of non-qualifying income earned by the subsidiaries that is subject to corporate-level tax.⁷¹

One of the corporate subsidiaries is formed outside of the United States and thus, is treated as a foreign corporation for U.S. tax purposes (like Non-U.S. Subsidiary in Figure 1).⁷² It appears that this subsidiary earns any non-qualifying income that is not U.S. source income and is not effectively connected with a U.S. trade or business.⁷³ As a result, the non-U.S. subsidiary is not subject to U.S. corporate-level tax on any of the income that it earns.⁷⁴

Figures 2 and 3 below illustrate structures increasingly used by entities seeking REIT classification. In particular, Figure 2 depicts a structure used by REITs that own and operate prisons, and Figure 3 portrays a structure used by REITs that own casinos.⁷⁵

Figure 2



In the structure depicted in Figure 2, the REIT owns prison buildings and grants to government entities the right to use the prison buildings to house inmates.⁷⁶ In exchange, the government entities pay the REIT a fee calculated on a per-day, per-inmate basis.⁷⁷ In private letter rulings, the IRS has ruled that this fee will be treated as rent from real property and, therefore, is qualifying income for purposes of both REIT income tests.⁷⁸ In exchange for a fee paid by the government entities, the Taxable REIT

(“The wholly-owned subsidiaries of The Blackstone Group L.P. will concurrently with the Reorganization and may from time to time thereafter enter into intracompany lending arrangements with one another.”). This statement may or may not refer to using debt to reduce corporate-level tax paid by the U.S. corporate subsidiaries.

⁷⁰ I.R.C. § 7704(d)(1)(A) (defining qualifying income to generally include interest).

⁷¹ See I.R.C. § 163 (providing for an interest deduction). The ability to deduct interest would be subject to certain limitations. For example, if a corporate subsidiary were too thinly capitalized, some of the debt could be recast as equity for tax purposes. Likewise, if Blackstone Group L.P. charged an interest rate that was higher than a market rate, the debt could be recast as equity for tax purposes. Furthermore, Section 163(j) could limit the amount of interest deductible by the corporate subsidiary if the owners of the Blackstone Group L.P. are not subject to tax on the interest.

⁷² Blackstone S-1, *supra* note 59 at 204.

⁷³ *Id.* at 204 (“Blackstone Holdings V GPL.P. is taxable as a foreign corporation for U.S. federal income tax purposes. Blackstone Holdings V GPL.P. is expected to be operated so as not to produce ECI. Its income will not be subject to U.S. federal income tax to the extent it has a foreign source and is not treated as ECI.”).

⁷⁴ *Id.*

⁷⁵ For additional discussion of these structures, see Cauble & Polsky, *supra* note 17.

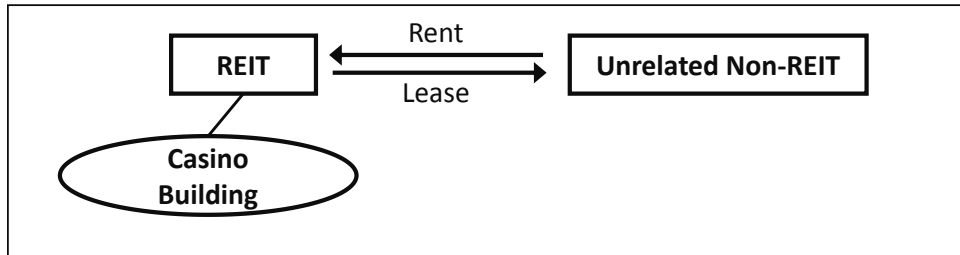
⁷⁶ PLR 201320007.

⁷⁷ *Id.*

⁷⁸ See, e.g., PLR 201320007.

Subsidiary (the “TRS”) provides various services such as security, food services for inmates, medical and dental care for inmates, and inmate transportation.⁷⁹ The TRS is taxed at an entity level on the income it earns, but it can earn income that would be non-qualifying income if earned directly by the REIT without jeopardizing the REIT’s ability to pass the income tests. In order to ensure compliance with the REIT qualification tests, the REIT’s interest in the TRS cannot exceed 25 percent of the value of the REIT’s assets.⁸⁰

Figure 3



In the case of a REIT that owns a casino, as portrayed in Figure 3, the REIT owns a casino building and leases the building to a Non-REIT (an unrelated company).⁸¹ The Non-REIT operates the casino and pays the REIT rent that is in part fixed and in part based on revenues earned from operating the casino. The rent received by the REIT is qualifying income.⁸² Leasing the casino to an entity that is unrelated to the REIT ensures that the payments under the lease are treated as rent for purposes of the REIT income tests, because amounts paid by lessees that are related to a REIT are not treated as rent, unless certain requirements are met.⁸³

Following a spin-off of its copper and fiber-optic lines into a separate, publicly traded REIT, a structure similar to that shown in Figure 3 will be used by Windstream Holdings, Inc. (a publicly traded telecom company).⁸⁴ The REIT will lease the assets back to Windstream so that it can continue to use them in its operations. Virtually any company that holds significant real estate assets could use a similar approach.

In summary, publicly traded entities increasingly use elaborate tax structuring techniques to obtain classification as Exempt Publicly Traded Partnerships or REITs.

⁷⁹ *Id.* In some cases, the charge for services is not separately stated, so the government pays the entire amount to the REIT, and the REIT pays the TRS a fee for providing the services.

⁸⁰ I.R.C. § 856(c)(4)(B)(ii).

⁸¹ This structure is similar to the structure used by Penn National Gaming Inc. after engaging in a spin-off. For a description of the spin-off and the private letter ruling obtained by Penn National Gaming Inc., see Robert Willens, *Analyzing Penn National Gaming’s Groundbreaking IRS Ruling*, 2013 TAX NOTES TODAY 239-10 (Sept. 16, 2013).

⁸² Rent from real property does not include an amount that depends on the income or profit derived from property by any person; however, an amount will not be excluded from rent solely because it is based on a fixed percentage or percentages of receipts or sales. I.R.C. § 856(d)(2)(A). Furthermore, Penn National Gaming received a private letter ruling stating that the amount paid by the non-REIT would be treated as rent from real property. See Willens, *supra* note 81.

⁸³ See I.R.C. § 856(d)(2)(B) (setting forth the general rule that payments from related persons are not treated as rent); I.R.C. § 856(d)(5) (providing that constructive ownership rules will apply when determining whether a person is related to a REIT); I.R.C. § 856(d)(8) (describing limited circumstances in which amounts received from a related person can be treated as rent).

⁸⁴ For additional discussion of this transaction, see, e.g., Thomas Gryta & Ryan Knutson, *Windstream Cleared to Cut Taxes by Forming a REIT; IRS Allows Firm to Classify Its Phone Lines as Real Estate*, WALL STREET JOURNAL ONLINE (July 30, 2014).

Although the structuring techniques used vary from case to case, they have a common theme. In order to maintain the entity's desired classification, the entity does not directly earn any non-qualifying income, but instead this income is earned by a corporate subsidiary or by an unrelated corporation.

III. POTENTIAL JUSTIFICATIONS FOR CURRENT TAXATION OF PUBLICLY TRADED ENTITIES

As described above, recent years have witnessed an expansion of the universe of publicly traded entities that employ tax structuring techniques in order to benefit from special tax treatment traditionally reserved for entities that earn predominately qualifying income. This trend has not gone unnoticed. The popular press, the IRS, and members of Congress have each given the matter attention, sometimes calling for reforms that would halt the current expansion or otherwise limit the ability of publicly traded entities to escape corporate tax treatment.⁸⁵

In order to place the recent trends in context and evaluate the wisdom of enacting reform, this section will examine potential rationales for the current state of the law. In particular, this section will first address the question of why publicly traded entities are generally subject to corporate tax treatment. Next, this section will discuss rationales that might justify granting special tax treatment to publicly traded entities that earn predominately qualifying income.

A. Why Public Trading?

Fundamentally, explaining why publicly traded entities are generally subject to corporate level tax is a difficult task because there is no consensus regarding why the corporate tax system exists at all or why only some business entities are subject to it.⁸⁶ Indeed, legal scholars, economists, and others have long advocated for reform to the corporate tax system that would integrate the entity-level tax and the tax that applies to shareholders, eliminating the double tax system.⁸⁷ However, starting with the premise that, as a practical matter, the corporate tax system will continue to exist and that only some business entities will be subject to it, some scholars have explained the establishment of public trading as the boundary between business entities that must be subject to the corporate tax system and other business entities by noting that taxpayers have a difficult time avoiding the public trading boundary.⁸⁸

⁸⁵ See *supra* notes 3-12 and accompanying text.

⁸⁶ See, e.g., Sullivan, *supra* note 12 ("What should be the dividing line between businesses subject to corporate tax and those that should be exempt? That's not an easy question given that there is no economic justification for the corporate tax in the first place.").

⁸⁷ A discussion of the arguments in favor of corporate tax integration is beyond the scope of this Article. For some discussion of this topic, see, e.g., Joseph M. Dodge, *A Combined Mark-to-Market and Pass-through Corporate-Shareholder Integration Proposal*, 50 TAXL. REV. 265, 269 (1995); R. Glenn Hubbard, *Corporate Tax Integration: A View From the Treasury Department*, 7 J. ECON. PERSP. 115, 117-19 (1993); Charles E. McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532, 540-41 (1975); Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 725 (1981).

⁸⁸ See, e.g., Calvin H. Johnson, *Replace the Corporate Tax with a Market Capitalization Tax*, 117 TAXNOTES 1082, 1084 (2007); Fleischer, *supra* note 12 at 107 ("Searching for a coherent normative justification for taxing publicly traded entities as corporations is not a satisfying endeavor. . . . When Congress enacted the PTP rules in 1987, it concluded that PTPs that conduct an active business look enough like corporations to be treated as such for tax purposes. Broadly speaking, the rules tend to operate under a benefit theory: In exchange for accessing public equity markets, one must pay a corporate-level tax on profits. Because the normative case for having a corporate tax at all is rather weak, the line drawing in this

Taxpayers cannot easily avoid the public trading boundary because the demand for public trading is based on strong non-tax considerations. Thus, entities may be unlikely to forgo public trading in order to avoid entity-level tax.⁸⁹ Entities that are publicly traded tend to be businesses that benefit from economies of scale, so that large businesses have an advantage over small businesses.⁹⁰ Large businesses benefit from widely dispersed equity ownership, and widely dispersed equity owners of large businesses benefit from liquidity. Widely dispersed equity ownership is necessary to raise the amount of capital required by a large business, assuming that any given shareholder does not want to invest a large amount. Any given shareholder will want to hold a diverse pool of investments and therefore will not want to invest a large amount in any given company.⁹¹ Further, widely dispersed equity owners of large businesses benefit from liquidity because, being unable to effectively monitor business decisions made by a large business in which they own a small stake, equity owners demand the security afforded by the ability to easily exit the business by selling their shares.⁹² In addition, liquidity helps equity holders maintain a diverse portfolio, because liquidity allows an equity holder to easily rebalance his or her portfolio if changes in the share price of one corporation results in the company representing an undesirably large portion of the equity holder's overall portfolio.⁹³

Because equity holders have strong non-tax reasons to demand liquidity, entities cannot easily abandon public trading in order to avoid corporate tax treatment. Selecting a feature as a trigger for imposing corporate tax, like public trading, which is difficult to forgo potentially serves two underlying goals. First, the corporate tax system will raise more tax revenue if taxpayers cannot easily avoid it. Indeed, fear that taxpayers would conduct businesses through entities treated as partnerships for tax purposes rather than corporations, leading to erosion of the corporate tax base, was the primary reason why Congress enacted legislation providing that publicly traded partnerships are generally

area tends to be pragmatic, not principled.”); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1629-30 (1999) (“The check-the-box regulations eliminated the four-factor test and moved the line between partnerships and corporations to public trading. . . . The argument for abandoning the four-factor test is that it was enormously inefficient. It merely caused people to shift their organizational structures without collecting any tax. The check-the-box regulations try to draw a line--public trading--that is more difficult to avoid. Because fewer taxpayers will change their behavior to avoid the new line, it is potentially more efficient. . . . Regardless of the merits of this argument (a subject that will be explored in greater depth below), what is important about the check-the-box regulations is that they drop traditional doctrinal concerns and instead focus on efficiency.”).

⁸⁹ See, e.g., Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 986 (1989) (“It is the value of liquid equity as perceived by the market that justifies a double tax. Liquidity attracts investors who value the exit rights or the financial strategies that can be pursued with liquid equity ownership.”); *id.* at 1103-06 (discussing value of liquidity to shareholders).

⁹⁰ See, e.g., Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 19-20 (2003).

⁹¹ See, e.g., Jane G. Gravelle & Laurence J. Kotlikoff, *The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good*, 97 J. POL. ECON. 749, 757 (1989) (“[G]iven that some enterprises are large, why should they have more than a very small number of owners? The answer here appears to involve a number of factors: diversification of risk, the desire to limit liability, information costs of becoming fully informed about all the activities of a large enterprise, and liquidity.”).

⁹² See, e.g., Rudnick, *supra* note 89 at 1121-22 (explaining that a market for liquid shares helps owners to monitor managers more effectively).

⁹³ See, e.g., Rudnick, *supra* note 89 at 986, 1103-06, 1114-15.

treated as corporations for tax purposes.⁹⁴ Second, selecting public trading as the boundary for the corporate tax system may distort taxpayers' decisions less significantly than selecting a boundary that is easier to avoid, which could improve the efficiency of the tax system.⁹⁵ However, selecting public trading as the boundary does not necessarily lessen the extent to which the tax system distorts taxpayers' decision making. On the one hand, because entities have strong non-tax reasons to maintain liquidity for their owners, they are unlikely to relinquish public trading in order to avoid corporate tax. On the other hand, if an entity does forgo public trading, the change in that entity's behavior will be quite drastic. Thus, the public trading line is less likely to cause distortions than a more easily avoided line, but when it does cause distortions, those distortions will be more severe.⁹⁶

In summary, if some but not all business entities will be subject to corporate tax, some test must be selected to sort between entities that will and will not be subject to corporate tax. Adopting public trading as the test may be justified on the grounds that taxpayers have strong non-tax reasons to demand public trading. Therefore, taxpayers cannot easily circumvent the test.⁹⁷

B. Why Qualifying Income?

As discussed above, Congress opted to impose the corporate tax system on publicly traded entities; however, Congress provided exceptions for certain publicly traded entities that predominately earn qualifying income.⁹⁸ For instance, special treatment is bestowed upon Exempt Publicly Traded Partnerships and REITs, and, in order to obtain classification as an Exempt Publicly Traded Partnership or a REIT, an entity must predominately earn certain types of qualifying income.⁹⁹

⁹⁴ See H.R. REP. NO. 100-391, pt. 2, at 1065 (1987) ("The recent proliferation of publicly traded partnerships has come to the committee's attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base. To the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.").

⁹⁵ See, e.g., Weisbach, *supra* note 88 at 1630 ("The check-the-box regulations try to draw a line--public trading--that is more difficult to avoid. Because fewer taxpayers will change their behavior to avoid the new line, it is potentially more efficient.").

⁹⁶ See, also, Weisbach, *supra* note 88 at 1669-70 ("[W]e cannot simply interpret the models as suggesting that lines in the tax law should be made harder to avoid. A line can be too hard to avoid, at least from an efficiency perspective. This can happen because there are two components in the deadweight loss triangles (or marginal deadweight loss trapezoids): the width (reflecting elasticity) and the height (reflecting the size of the tax). Taxing a low-elasticity item too high is not optimal. We can think of these dimensions as the number of taxpayers that shift their behavior (the width) and the social cost (loss of consumer surplus) for each shift (the height). If a line is too hard to avoid, there may be few shifts, but each shift will have a large cost.").

⁹⁷ Imposing the corporate tax system on publicly traded entities has also been justified on the grounds that applying a pass-through tax regime to publicly traded entities would be too difficult. See, e.g., H.R. REP. NO. 100-391 (1987) ("[B]ecause of the trading in interests, these partnerships present unique administrative difficulties and enforcement concerns if the tax law relating to partnerships is applied to them. The partnership tax rules under present law contemplate an entity in which the identity of the investors is known and transfers of interests are easily identifiable, and public trading in partnership interests does not conform to this model."). For further discussion of this concern, see, e.g., Karen C. Burke, *Passthrough Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329, 1342-43 (2013).

⁹⁸ See *supra* Parts II.A. and II.B.

⁹⁹ See *supra* Parts II.A. and II.B.

Justifying the special treatment afforded to entities that predominately earn qualifying income is a challenging exercise. As others have observed, given the lack of a convincing justification for the corporate tax system, we should not be particularly surprised by the lack of a clear rationale for the rules governing when it applies.¹⁰⁰ The difficulty of rationalizing the exceptions for entities that mainly earn qualifying income is further exacerbated by the fact that there is no consistent definition of qualifying income that applies for all purposes--for instance, income that is qualifying for purposes of the Exempt Publicly Traded Partnership rules may not be qualifying for purposes of the REIT rules and vice versa.¹⁰¹ Furthermore, in some cases, the special tax treatment granted to certain publicly traded entities may merely represent unprincipled giveaways to politically powerful interest groups. For instance, recently proposed reforms that would have narrowed the scope of the Exempt Publicly Traded Partnership rules nevertheless maintained an exception for publicly traded entities that predominately earned income related to mining and natural resources.¹⁰² Along similar lines, perhaps reflective of the lack of a principled policy justification, the House Report that accompanied the adoption of the Exempt Publicly Traded Partnership rules explained exceptions for certain types of income as rooted merely in tradition. In particular, the report stated:

[C]ertain types of natural resources and rental real estate activities have commonly or typically been conducted in partnership form, and the committee considers that disruption of present practices in such activities is currently inadvisable due to general economic conditions in these industries. The committee does not intend to treat tax benefits from such activities more favorably than under present law, but at the same time considers it inappropriate to subject net income from such activities to the two-level corporate tax regime to the extent the activities are conducted in forms that permit a single level of tax under present law.¹⁰³

¹⁰⁰ See, e.g., Fleischer, *supra* note 12, at 111 (“Blackstone’s strongest argument is to push for a principled distinction between firms that are subject to the corporate tax and firms that are not. It can argue that the exceptions swallow the rule. Oil and gas and other natural resources firms often qualify as PTPs despite conducting some active business activities. The policy rationale is unclear Similarly, many real estate firms operate without paying a corporate-level tax, either through the PTP rules (which allow certain rental activities to qualify as passive income) or the REIT rules. Congress created a special rule for REITs, § 856(i)(1), which allows them to ‘cleanse’ small amounts of ‘bad’ income through a taxable REIT subsidiary, much like the blocker entity in the flow-through structure. Insurance companies, cooperatives, and other industry groups have their own methods of managing corporate tax liability. Why not Blackstone? There is no normatively satisfying answer to this question.”); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999) (“The nature-of-income limitations for RICS, REITs, REMICs, FASITs, and publicly traded partnerships may simply be part of the tax law’s condition for permitting such publicly traded entities to obtain pass-through treatment Because there is no consensus regarding why the income of public firms should be taxed twice, it is not surprising that the exact nature of these restrictions cannot be explained from first principles. Instead, one might simply conclude that a limitation may be needed in order to maintain the integrity of the double tax system as applied to public firms, whether such a system can be justified or not.”).

¹⁰¹ Willard B. Taylor, “Blockers,” “Stoppers,” and the Entity Classifications Rules, 64 TAXLAW. 1 (2010) (suggesting the development of a single definition of qualifying income for REITs, PTPs and other purposes); Willard B. Taylor & Diana L. Wollman, *Why Can’t We All Just Get Along: Finding Consistent Solutions to the Treatment of Derivatives and Other Problems*, 53 TAXLAW. 95 (1999) (containing further discussion regarding the idea of a unified definition of qualifying income).

¹⁰² See *supra* note 11 and accompanying text.

¹⁰³ H.R. REP. NO. 100-391, pt. 2, at 1066 (1987). The report does not articulate this concern in terms of mere tradition but instead describes continued favorable treatment of publicly traded entities in

Although many of the exceptionally beneficial tax rules governing particular publicly traded entities may be based merely on political considerations, legislative history also suggests three potential policy justifications for granting special tax treatment to entities that earn predominately qualifying income. Ultimately, though the existing rules are a poor fit for each of the three justifications, and more accurately targeted rules could better serve the goals articulated by legislative history.

Regarding the first justification, the House Report that accompanied the adoption of the Exempt Publicly Traded Partnership rules mentions that dividend income is treated as qualifying income because dividend income is received from an entity treated as a corporation for tax purposes that may, itself, be subject to corporate-level tax.¹⁰⁴ Thus, dividend income may be included on the list of types of qualifying income to prevent subjecting the same income to an additional level of tax. This rationale, however, is not a convincing explanation for the special tax treatment granted to publicly traded partnerships that predominately earn qualifying income. If the publicly traded entity receiving the dividend income were treated like a corporation for tax purposes, a more narrowly crafted rule could exempt the dividend income from an additional level of tax. In particular, in certain circumstances, Internal Revenue Code Section 243 allows a corporation that receives dividend income to deduct all or a portion of the dividend income when computing the recipient corporation's taxable income.¹⁰⁵ If Congress wanted to entirely exempt dividend income from an additional level of tax, Congress could modify Section 243 so that, when it applied, the recipient corporation could take a deduction equal to the entire amount of dividend income that it received.¹⁰⁶ The existing rules regarding qualifying income, which encompass much more than dividend income, are an overly broad and, therefore, inaccurate mechanism for achieving the objective of exempting dividend income from an additional level of tax.

Regarding the second justification, the House Report that accompanied the adoption of the Exempt Publicly Traded Partnership rules states:

In general, the purpose of distinguishing between passive-type income and other income is to distinguish those partnerships that are engaged in activities commonly considered as essentially no more than investments,

certain industries as necessary to avoid "disruption of present practices" given general economic conditions. However, any change to tax law could have economic consequences for those affected by the change. Thus, this concern could be raised in connection with any tax reform proposal.

¹⁰⁴ *Id.* at 1068 ("[T]he rationale for imposing an additional corporate-level tax on investments in publicly traded partnership form is less compelling, because . . . the income has already been subject to corporate-level tax, in the case of dividends. . . .").

¹⁰⁵ I.R.C. § 243 (2012). Furthermore, by contrast to the qualifying income rules, Section 243 is more precisely targeted at the objective of preventing the imposition of an additional level of tax on dividend income paid by an entity that is subject to entity-level tax. First, Section 243 is more precise because it is limited to dividend income and does not apply to other types of income (such as interest, rent, etc.) that have not already been taxed. Second, not all dividend income is received from an entity that is, itself, subject to corporate-level tax, and restrictions on the dividends received deduction are intended to limit it to dividend income paid by an entity that is subject to tax. See, e.g., I.R.C. § 243(a) ("In the case of a corporation, there shall be allowed as a deduction an amount equal to the following percentages of the amount received as dividends from a domestic corporation which is subject to taxation under this chapter.").

¹⁰⁶ Currently, Section 243 allows the recipient corporation to deduct 70 percent of the dividend income, unless the recipient corporation owns a large stake in the corporation from which the dividend income is received, in which case the recipient corporation can deduct a larger percentage of the dividend income, up to 100 percent in some cases. I.R.C. § 243 (2012). If Congress wanted to entirely exempt dividend income from an additional level of tax, Section 243 could be modified to expand the circumstances in which the recipient corporation can deduct 100 percent of the dividend income it receives.

and those activities more typically conducted in corporate form that are in the nature of active business activities. In the former case, the rationale for imposing an additional corporate-level tax on investments in publicly traded partnership form is less compelling, because purchasers of such partnership interests could in most cases independently acquire such investments.¹⁰⁷

This statement suggests that qualifying income ought to include only passive-type income that owners of the publicly traded partnership could earn directly, rather than indirectly by purchasing interests in a publicly traded entity. Granting special tax treatment to qualifying income for this reason may be based on the notion that, if the owners did earn the income directly, it would not be subject to corporate-level tax. Therefore, according to this rationale, it should not be subject to corporate-level tax when the owners earn it indirectly through a publicly-traded entity.¹⁰⁸ This rationale may be convincing in the case of income that owners of the publicly traded entity could, in fact, earn directly. However, the current definition of “qualifying income” is much broader than what this rationale warrants because it includes many types of income that owners of an entity could not earn directly, as discussed in more detail below.¹⁰⁹

The legislative history accompanying the adoption of the REIT rules suggests a third rationale that may explain granting more beneficial tax treatment to certain publicly traded entities. In particular, the legislative history suggests that Congress wanted to provide small investors with an avenue to invest in real estate without holding the real estate through an entity that was subject to corporate-level tax.¹¹⁰ Given that an individual who is not particularly wealthy can afford to own only a small interest in real estate, such an individual can only invest in real estate through a publicly traded entity. Thus, without the special REIT provisions, such an individual could only invest in real estate through an entity that was subject to entity-level tax. By contrast, a wealthy individual who can afford to own a large stake in real estate could invest, along with a small number of other wealthy individuals, in a real-estate-owning entity treated as a partnership for tax purposes. The REIT provisions result in greater parity between the tax treatment of partnerships that own real estate (a vehicle that is functionally available to only the very wealthy) and publicly traded entities that own real estate (a vehicle that is accessible to individuals other than the very wealthy).

This rationale, however, is only convincing if individuals of modest means do, in fact, invest in publicly traded REITs to a significant extent, which is doubtful.¹¹¹

¹⁰⁷ H.R. REP. NO. 100-391, pt. 2, at 1068 (1987).

¹⁰⁸ More precisely, given the manner in which the rules are implemented, the income is not subject to corporate tax when earned indirectly through a publicly traded entity as long as the entity earns primarily qualifying income.

¹⁰⁹ See *infra* Part IV.A.

¹¹⁰ H.R. REP. NO. 2020, 86th Cong., 2d Sess. 3 (1960) (“[R]eal estate investment trusts . . . constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.”). For more detailed discussion of the debate surrounding the adoption of the REIT rules, see Bradley T. Borden, *REIT Reform Alternatives*.

¹¹¹ This is particularly doubtful because, to the extent that ordinary individuals hold investments in publicly traded REITs, they likely do so through pension plans or other tax-exempt vehicles. Thus, if the REIT were treated like a regular corporation for tax purposes, only one level of tax would be incurred currently--the entity-level tax. A tax-exempt investor, like a pension plan, would generally not be subject to

Furthermore, the objective of offering more tax-favorable investment opportunities to individuals of modest means would be better served by reform targeted at such individuals. For instance, introducing more graduated tax rates on capital gain income would do more to assist individuals of modest means than granting special tax treatment to REITs, particularly given that many wealthy investors avail themselves of the tax benefits of the REIT vehicle. Thus, despite statements in the legislative history about providing more equal access to tax-favored investments in real estate, the REIT rules, in reality, seem to do a poor job of achieving equality for investors with modest resources but a much better job of simply favoring the real estate industry.¹¹²

In summary, it is not entirely clear why publicly traded entities that earn predominately qualifying income receive more favorable tax treatment than other publicly traded entities. The political influence of certain industries doubtlessly provides part of the explanation.¹¹³ Some rationales offered by legislative history would be better served by more precisely targeted measures. For instance, concerns about subjecting dividend income to an additional level of tax could be addressed, and to some extent already are addressed, by provisions limited to dividend income. Likewise, the REIT rules are a very imprecise mechanism for providing tax-favored investment opportunities to individuals of modest means. One potential rationale remains – the notion that corporate-level tax should not be imposed upon income that owners of the publicly traded entity could earn directly. This rationale may have merit. However, it would be better served by differently designed rules, as proposed in Part V below.

IV. TROUBLING ASPECTS OF CURRENT TAXATION OF PUBLICLY TRADED ENTITIES

As discussed above in Part II, although most publicly traded entities are subject to the corporate tax system, current law grants special treatment to publicly traded entities that earn predominately qualifying income. The potential policy justifications for this special treatment were explored in Part III, leading to the conclusion that only one potentially convincing explanation exists--the idea that corporate-level tax should not be imposed on income that owners of the publicly traded entity could earn directly. Given this analysis, there are several troubling features of the current taxation regime applicable to publicly traded entities.

First, the current definition of qualifying income is far too broad—it includes much income that owners of a publicly traded entity could not earn directly.

Second, current law grants special treatment to all income earned by a publicly traded entity if and only if the entity earns predominately qualifying income. Under the publicly traded partnership rules, for instance, if at least 90 percent of a publicly traded partnership's gross income consists of qualifying income, the partnership may obtain classification as an Exempt Publicly Traded Partnership so that it avoids entity-level tax on all of its income. By contrast, if only 89.99 percent of the publicly traded partnership's gross income was qualifying income, the same partnership would be subject

tax as a result of receiving distributions from the corporation or selling stock in the corporation. See *supra* note 23. Thus, at the time the income is earned and distributed by the publicly traded entity, the ordinary individual's investment through a pension plan into a corporation leads to one level of tax, and one level of tax would also be incurred if a wealthy individual held real estate through a partnership.

¹¹² See also, Morgenson, *supra* note 2 (“An expanding REIT universe may not seem that troubling. But it is a prime example of what’s so bad about our tax code: special rules that favor certain taxpayers over others.”).

¹¹³ See *supra* notes 102-103 and accompanying text.

to entity-level tax on all of its income. Thus, the current rules result in what is sometimes called a “cliff effect” in that small non-tax changes can result in drastic tax changes.¹¹⁴ This cliff effect is problematic because it causes the tax treatment of publicly traded entities to be somewhat arbitrary, and this arbitrary treatment encourages wasteful tax planning.

Third, as discussed above, publicly traded entities are increasingly engaging in sophisticated tax planning strategies in order to qualify as Exempt Publicly Traded Partnerships or REITs. This has transpired because the current tax rules are easily manipulated, and, thus, they invite wasteful, elaborate tax structuring. Each of these problematic features of current law is discussed in more detail below.

A. Overly Broad Definition of Qualifying Income

As discussed above, the only convincing justification articulated by legislative history suggests that qualifying income ought to include only income that owners of the publicly traded entity could earn directly. The current definition of “qualifying income” is much more expansive than what is warranted by this justification.¹¹⁵ In particular, in many cases, the current definition mischaracterizes as “qualifying income” items that could not be earned by the owners of a publicly traded entity directly.

To illustrate the overly broad nature of the current definition of qualifying income, consider the income earned by Blackstone Group L.P. As discussed above, the Blackstone Firm is a firm that sponsors various hedge funds, private equity funds, and real estate funds.¹¹⁶ In exchange, the Blackstone Firm receives management fees and carried interest (a percentage of the profits earned by each fund). Blackstone Group L.P. is a publicly traded partnership that is entitled to receive a portion of the management fees and carried interest earned by the Blackstone Firm.¹¹⁷

Some of the carried interest is classified as qualifying income under the current, overly broad definition of that term, despite the fact that owners of Blackstone Group L.P. could not earn the income directly.¹¹⁸ When a private equity fund sponsored by the Blackstone Firm acquires a portfolio company, the Blackstone Firm’s management will often dedicate much time and effort to making decisions about how the portfolio

¹¹⁴ For criticism of cliff effects in tax generally, see Lily L. Batchelder, *What Should Society Expect from Heirs? The Case for a Comprehensive Inheritance Tax*, 63 TAX L. REV. 1, 91 n.303 (2009); Karen C. Burke & Grayson M.P. McCouch, *Death Without Taxes?*, 20 VA. TAX REV. 499, 531 (2001); Glenn E. Coven, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145, 174-75 (1989); Deborah L. Paul, *The Taxation of Distressed Debt Investments: Taking Stock*, 64 TAX LAW. 37, 40 (2010); Clinton G. Wallace, *The Case for Tradable Tax Credits*, 8 N.Y.U. J.L. & BUS. 227, 234 (2011); Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 59 (2000); Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 416-17 (1993). For further discussion of gradual versus discontinuous rules, see, e.g., Andrew Blair-Stanek, *Tax in the Cathedral: Property Rules, Liability Rules, and Tax*, 99 VA. L. REV. 1169 (2013).

¹¹⁵ For additional discussion of the overly broad nature of the definition of “qualifying income” in the publicly traded partnership context, see, Cauble, *supra* note 15. For ease of discussion, I refer to one definition of “qualifying income” in the text. In reality, there are multiple definitions as the term is defined in the publicly traded partnership context in a different way from the manner in which it is defined in the REIT context.

¹¹⁶ See *supra* note 59 and accompanying text.

¹¹⁷ See *supra* notes 60–61 and accompanying text.

¹¹⁸ See also Fleischer, *supra* note 12, at 109–10 (“Public investors cannot independently acquire a general partnership investment in a Blackstone fund or a share in Blackstone’s deal advisory or restructuring business. This indicates that Blackstone is not merely acting as a conduit, but rather is conducting active business activities.”).

company should be restructured in order to increase the return the fund can earn from selling the company.¹¹⁹ There is no reason to believe that the owners of Blackstone Group L.P. would have the ability or the inclination to devote similar time and efforts on their own. Therefore, the owners of Blackstone Group L.P. could not earn, directly, the carried interest generated from sale of the portfolio company.

Even if we disregard the Blackstone Firm's management's active involvement in restructuring a portfolio company, it is also true that funds sponsored by the Blackstone Firm can acquire non-publicly traded assets that require large investments, such as ownership interests in privately held portfolio companies. Owners of Blackstone Group L.P. could not have acquired these non-publicly traded assets directly given that they, individually, invest only small amounts. Therefore, owners of Blackstone Group L.P. could not directly earn the carried interest attributable to sale of a privately held portfolio company.

Finally, even in the case of any carried interest that may be attributable to a fund's sale of publicly traded stock, owners of Blackstone Group L.P. could not have earned the carried interest directly. If the underlying stock is publicly traded, owners of Blackstone Group L.P. could acquire a direct interest in the underlying stock. However, carried interest represents the Blackstone Firm's entitlement to profits earned by a fund that are not attributable to the Blackstone Firm's capital investment. Therefore, an owner of Blackstone Group L.P. could not simply purchase a small interest in the underlying publicly traded stock owned by a fund in order to mimic the economic consequences of holding, indirectly, a share of a profit's interest in the fund. Purchasing a small interest in the underlying stock would allow the individual to earn the profits generated by the stock, but holding a direct interest in the underlying stock would also expose the individual to the risk of losing the capital invested unlike holding a right to carried interest generated from sale of the stock. Stated differently, although owners of Blackstone Group L.P. could, directly, acquire an interest in the underlying publicly-traded stock owned by a fund sponsored by the Blackstone Firm, they could not directly acquire a share of the Blackstone Firm's right to carried interest, which is the asset that they, in fact, own indirectly through Blackstone Group L.P.¹²⁰

Blackstone Group L.P. and other publicly traded partnerships in the same industry are not the only publicly traded entities earning income that is classified as qualifying income despite the fact that owners of the entity could not earn the income directly. Rather, Blackstone Group L.P. and similar publicly traded partnerships merely represent the most recent wave of publicly traded entities that benefit from the overly broad definition of qualifying income. Many, more traditional publicly traded entities also avail themselves of the advantages of the qualifying income definition's excessive scope. For example, publicly traded partnerships that earn income from energy-related operations and mining engage in activities characterized by economies of scale. Thus, these publicly traded partnerships invest in assets that require large capital outlays--assets

¹¹⁹ For further discussion of active involvement by private equity fund sponsors, see, e.g., Steven M. Rosenthal, *Private Equity is a Business: Sun Capital and Beyond*, 140 TAX NOTES 1459 (2013).

¹²⁰ See also Cauble, *supra* note 15, at n.46; Fleischer, *supra* note 12, at 109-10 ("Public investors cannot independently acquire a general partnership investment in a Blackstone fund or a share in Blackstone's deal advisory or restructuring business. This indicates that Blackstone is not merely acting as a conduit, but rather is conducting active business activities.").

that owners of the publicly traded partnership could not acquire directly.¹²¹ Likewise, publicly traded partnerships that invest in real estate and REITs use their vast resources to acquire ownership interests in real estate that owners of the publicly traded entity could not acquire directly.

B. Arbitrariness

Even if the definition of qualifying income were properly limited to include only the types of income that owners of a publicly traded entity could earn directly, the current rules are flawed in another respect. In particular, as discussed above, the current design of the rules governing publicly traded entities results in a cliff effect—a small change in the amount of non-qualifying income earned by a publicly traded entity can result in a large change to the entity's tax consequences. Thus, for instance, if 90 percent of a publicly traded partnership's gross income is qualifying income, the partnership receives very different tax treatment than an otherwise identical partnership that earns slightly less qualifying income. If a publicly traded entity earns \$100 million in taxable income, for instance, a slight change in the percentage of qualifying income earned by the entity could make the difference between the entity owing \$35 million or \$0 in entity-level tax, assuming a 35% corporate tax rate.

Mandating that extreme tax changes follow from minor non-tax changes results in arbitrariness,¹²² and this arbitrariness is problematic because it undermines any underlying goals that the tax rules might serve.¹²³ Whatever policy goals might have

¹²¹ The legislative history surrounding the adoption of the publicly traded partnership rules seems to acknowledge that the special treatment granted to energy and mining partnerships cannot be justified based on the principle that owners could earn the income directly. The legislative history explains the treatment of these partnerships as, instead, based merely on tradition. *See supra* note 103 and accompanying text. This explanation, however, is not satisfactory as a policy matter.

¹²² One might argue that treating a publicly traded entity differently from a non-publicly traded entity is also arbitrary. To some extent, this may be true. However, as discussed above, public trading is a significant feature for non-tax reasons. *See supra* Part III.A. Therefore, there are significant non-tax differences between an entity that is publicly traded and one that is not.

¹²³ Rules that create cliff effects might also be criticized for distorting taxpayers' decisions. Consider, for instance, the following example. A publicly traded partnership has earned \$899 of qualifying income and \$100 of non-qualifying income in a given year. The partnership will earn one more dollar of income before the year closes. If the additional dollar is non-qualifying income, the partnership will not obtain classification as an Exempt Publicly Traded Partnership because less than 90 percent of its gross income will be qualifying income. If the additional dollar is qualifying income, then the partnership may obtain classification as an Exempt Publicly Traded Partnership, resulting in significant tax savings. Assuming a tax rate of 35 percent and assuming that the partnership has no available deductions, classification as an Exempt Publicly Traded Partnership results in the partnership owing \$0 in tax liability rather than \$350 in tax liability. In this example, the partnership has a very strong tax motivation to earn one dollar of qualifying income rather than one dollar of non-qualifying income. This strong tax incentive could encourage the taxpayer to earn one dollar of qualifying income even when there are good non-tax reasons to engage, instead, in the activity that would generate non-qualifying income. Although rules that produce cliff effects can distort taxpayers' decisions, it is not clear that gradual rules would distort decisions to a lesser extent overall. Under a gradual rule that provides that all non-qualifying (and no qualifying income) is subject to entity-level tax, the decisions of a partnership under the facts of the example just described will be less subject to distortion than such decisions would be under current law. Under current law, the taxpayer incurs \$350 of tax liability by earning one dollar of non-qualifying income so tax consequences almost certainly will dissuade the taxpayer from engaging in the activity that generates that income. By contrast, under a gradual rule, the taxpayer would only incur an additional thirty-five cents of tax liability and thus might still undertake the activity despite the tax consequences. However, compared to current law, a gradual rule could cause even greater distortions in the decisions of partnerships that earn well over 90 percent qualifying income, for example. Under current law, such partnerships can earn one dollar of non-qualifying income or one dollar of qualifying income without incurring any entity-level tax. Thus, tax consequences

prompted Congress to grant special tax treatment to entities that earn predominately qualifying income, it is highly unlikely that these goals are best served by granting extremely different treatment to two entities when the only difference between the entities is that qualifying income represents 90 percent of the gross income of one entity but 89.99 percent of the gross income of the other entity.¹²⁴

Hence, the goal of granting special treatment to income that owners of the publicly traded entity could earn directly would be served better by less arbitrary rules. Even if qualifying income were defined appropriately to include only income that owners of the entity could earn directly, this justification suggests that qualifying income earned by any publicly traded entity ought to be exempt from the corporate tax system regardless of the amount of qualifying income earned by the publicly traded entity. Consider, for instance, a publicly traded entity that earns interest income from investing in U.S. Treasury securities--income that owners of the entity could earn directly because they have ready access to the U.S. Treasury securities through the public markets. The fact that the owners of the entity could earn this income directly becomes no more true if the income is earned by a publicly traded entity that earns mainly qualifying income rather than by a publicly traded entity that earns mainly active business income.

Publicly traded partnerships that earn income that is close to the 90 percent threshold likely will be sufficiently sophisticated to monitor the amounts of income earned to ensure that the 90 percent test is met. Furthermore, if a publicly traded entity earns qualifying income in an amount large enough to justify the structuring costs, it can earn the non-qualifying income through a corporate subsidiary or unrelated corporation so that its qualifying income escapes corporate-level tax. For instance, if a publicly traded entity earns 60 percent qualifying income and 40 percent non-qualifying income, it can set up a corporate subsidiary through which it will funnel the non-qualifying income so that its qualifying income can maintain exemption from corporate-level tax, similar to the structure used by the new wave of Exempt Publicly Traded Partnerships discussed above.¹²⁵ Therefore, the arbitrariness of the rules ultimately might not affect the tax consequences experienced by publicly traded entities.¹²⁶ However, the arbitrariness is problematic because it induces taxpayers to engage in costly tax planning to exempt qualifying income from corporate-level tax.¹²⁷ The tax planning could be costly for a

will not distort the decision between the two types of income. Under a gradual rule, such partnerships could earn one dollar of qualifying income without incurring any entity-level tax but would incur thirty-five cents of entity-level tax as a result of earning one dollar non-qualifying income. Thus, as compared to current law, a gradual rule could cause greater distortions in the decisions made by partnerships with well over (or well under) 90 percent qualifying income. For a similar discussion, see David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 873-74 (1999).

¹²⁴ It could be that Congress adopted a 90 percent threshold for reasons of administrative convenience. As discussed below, additional complexity would arise under a system in which qualifying income is always subject to one level of tax while non-qualifying income earned by a publicly traded entity is subject to two levels of tax. See *infra* Part V.B.1.

¹²⁵ See *supra* Part II.C.

¹²⁶ Furthermore, if a publicly traded partnership did miss the 90 percent threshold by a narrow margin, as a practical matter, the publicly traded partnership nevertheless might not face corporate tax treatment because the IRS might not enforce the tax consequences mandated by I.R.C. § 7704. For discussion of the IRS's unwillingness to enforce the harsh consequences mandated by tax rules that cause cliff effects, see Andrew Blair-Stanek, *Tax in the Cathedral: Property Rules, Liability Rules, and Tax*, 99 VA. LAW REV. 1169, 1205-06 (2013).

¹²⁷ For further discussion of the wastefulness of tax planning, see, e.g., David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAXL. REV. 215, 222-25 (2002). For discussion of this concern in the context of the tax structuring utilized by publicly traded partnerships to channel their non-qualifying income through

variety of reasons. For instance, there may be cases in which a publicly traded entity could function more efficiently if one entity handled both the operations that generate qualifying income and those that generate non-qualifying income. In order to achieve favorable tax consequences, however, the entity must sacrifice some operational efficiency to ensure that the non-qualifying income is earned by a subsidiary corporation or an unrelated corporation.

C. Manipulability

Under current law, the tax treatment of a publicly traded entity depends critically on whether the entity earns predominately qualifying income. If the entity is willing to engage in elaborate tax structuring, the amounts of qualifying and non-qualifying income earned by the entity are often within its control because the entity can convert non-qualifying income into qualifying income by earning the income through a subsidiary corporation, or the non-qualifying income could be earned by an unrelated corporation. Thus, the current test is easy to manipulate as long as the entity engages in tax structuring.¹²⁸

The arbitrariness and manipulability of the current rules work hand in hand to encourage elaborate, potentially costly tax structuring. The arbitrariness of the rules provides the incentive for the tax structuring, and the manipulability of the rules enables it.

V. PROPOSED REFORMS

As discussed above, only one potentially convincing justification explains why more favorable tax treatment is bestowed upon publicly traded entities that earn predominately qualifying income -- namely, the notion that corporate-level tax should not be imposed on income that owners of the publicly traded entity could earn directly. Given this justification, the current definition of qualifying income is far too broad -- it includes much income that owners of a publicly traded entity could not earn directly.

Therefore, Congress should amend the definition of "qualifying income" to provide that income that would otherwise be classified as qualifying is no longer classified in that manner unless it is earned by holding an asset that was publicly traded during the publicly traded entity's entire holding period for the asset.¹²⁹ Furthermore,

corporate subsidiaries, see, e.g., Bradley T. Borden, *Notable Partnership Articles from 2013*, 143 TAX NOTES 1513 (2014) ("Others might be troubled by the structure because tax law appears to require a partnership to create a complicated ownership structure and jump through several unnecessary and inefficient hoops to obtain tax treatment that the law seems to condone.").

¹²⁸ This is not, of course, the only context in which taxpayers utilize tax structuring. Even some of the techniques used by publicly traded partnerships and REITs are similar to techniques used in other contexts. For instance, just as a publicly traded partnership might earn non-qualifying income through a U.S. corporate subsidiary to convert the non-qualifying income into qualifying income, a tax-exempt organization might earn income that would otherwise be unrelated business taxable income through a blocker corporation to convert the income into capital gain income or dividend income. However, at least in the tax-exempt context, rules exist that limit the ability for the tax-exempt organization to loan funds to the subsidiary, charge the subsidiary interest that reduces the subsidiary's corporate tax liability, and earn interest income that the tax-exempt organization claims is not unrelated business taxable income. In particular, if a tax-exempt organization receives a specified payment (defined to include any interest, annuity, royalty, or rent) from a controlled entity, the tax-exempt organization must treat the payment as unrelated business taxable income to the extent that the controlled entity can deduct the payment against income that would be unrelated business taxable income if earned by the tax exempt organization. I.R.C. § 512(b)(13) (2012).

¹²⁹ For additional discussion of this proposal in the context of publicly traded partnerships, see Cauble, *supra* note 15. In the case of income allocated to a publicly traded entity from a partnership (or through several tiers of partnerships), whether or not the income is generated by holding a publicly traded

income earned because of a publicly traded entity's (or a subsidiary partnership's) right to carried interest should never be qualifying income.¹³⁰

Restricting the definition of qualifying income in this manner would better align the definition of qualifying income with the goal of granting special treatment to income that owners of the publicly traded entity could earn directly. This is true because owners of the publicly traded entity could earn income directly only when the asset that generates the income is, itself, publicly traded and only if the income is not carried interest.¹³¹

asset would be determined by looking to the asset held by the lowest tier partnership from which the income was allocated.

¹³⁰ For discussion of this proposal in the context of the publicly traded partnership rules, see Cauble, *supra* note 15 at n. 46. Given that rights to receive carried interest are not publicly traded, this additional restriction might, at first, appear redundant once qualifying income is defined to exclude any income that is not earned by holding a publicly traded asset. However, the additional restriction is necessary given the manner in which carried interest is treated under current law. Current law treats the right to receive carried interest from a partnership as a partnership interest. Assume, for example, that the Blackstone Firm sponsored a hedge fund that earned capital gains from a sale of publicly traded stock, and the Blackstone Firm received, as part of its carried interest, a share of those gains. As a result, Blackstone Group L.P. could earn capital gains income from a sale of the underlying publicly traded stock that was allocated to it through several tiers of partnerships. The lowest tier partnership from which the income was allocated would be the hedge fund itself, and the asset held by the hedge fund that generated the gains would be publicly traded stock. Thus, if the definition of qualifying income included capital gains earned from sale of a publicly traded asset, this income would constitute qualifying income even under the revised definition, given that, in the case of income allocated to a publicly traded entity from a partnership (or through several tiers of partnerships), whether or not the income was generated by holding a publicly traded asset would be determined by looking to the asset held by the lowest tier partnership from which the income was allocated. See *supra* note 129. Thus, to ensure that this income is not treated as qualifying income, the definition of qualifying income should be further restricted by providing that income earned because of a publicly traded entity's (or a subsidiary partnership's) right to carried interest can never be qualifying income.

¹³¹ Even when an asset is publicly traded, if the publicly traded entity holds a diversified pool of investments, an owner of the publicly traded entity could not, without incurring significant transaction costs, achieve the same level of diversification through direct acquisition of interests in the underlying assets. Thus, even a publicly traded entity that owned publicly traded assets would still allow its owners to achieve something they could not achieve, as easily, through direct ownership. In this way, a publicly traded entity that invests primarily in liquid securities serves a function similar to the purpose served by many regulated investment companies ("RICs"). It is also true that, even if an asset is publicly traded, owners of the publicly traded entity might lack the financial expertise to engage in the same investment strategies used by the entity, without obtaining potentially prohibitively costly expert advice. The same could be said of investors in RICs, and RICs obtain exemption from entity-level tax. Thus, in these two ways (allowing less costly diversification and allowing owners to benefit from the financial expertise of a shared adviser), publicly traded entities that invest primarily in liquid securities allow their investors to earn income that they could not, as a practical matter, earn directly. Nevertheless, publicly traded entities that invest primarily in liquid assets ought to receive exemption from corporate-level tax for at least two reasons. First, some practical limitations on the owners' ability to earn the same income directly can be ignored in order to develop an administrable test of what can constitute qualifying income. Second, publicly traded entities that allow owners to hold a diversified pool of investments in liquid securities provide their owners with a cost-effective way to diversify their investment portfolios. Providing a means of easy diversification is a worthwhile policy objective that warrants exemption from corporate-level tax even if, once every practical factor is considered, the owners could not earn the income directly. It could be argued that REITs serve the same function of allowing diversification and that this function justifies their special tax treatment. However, the current REIT rules do not require that an entity hold a diversified pool of real estate assets in order to qualify as a REIT. There are some requirements that ensure that a REIT does not hold an overly concentrated share of its assets in certain securities. See I.R.C. §§ 856(c)(4)(B)(i)-(iii) (2012). However, there are no comparable requirements related to a REIT's real estate holdings. As an alternative to adopting the reforms proposed by this Article that would effectively preclude publicly traded entities from qualifying as REITs, the REIT rules could be reformed to better ensure that they serve the purpose of facilitating diversification. For instance,

Stated differently, unless the underlying asset owned by a publicly traded entity is, itself, publicly traded, individuals who invest small amounts in the publicly traded entity lack the financial resources to obtain a direct interest in the underlying asset and, therefore, lack the ability to directly earn the resulting income. Likewise, individuals who invest small amounts in a publicly traded partnership that is entitled to a portion of the carried interest earned by a private equity fund sponsor are not able to acquire, directly, rights to carried interest.

Restricting the definition of qualifying income in the manner proposed by this Article is also consistent with the idea that corporate tax is imposed on publicly traded entities because taxpayers, for non-tax reasons, cannot easily relinquish public trading given that liquidity has value.¹³² In particular, if a publicly traded entity earns income from holding a publicly traded asset, then the publicly traded entity does not add any value by providing liquidity with respect to that asset; owners of the publicly traded entity can already hold liquid interests in the asset directly. If the publicly traded entity were subject to entity-level tax on income earned from holding such an asset, owners of the publicly traded entity could avoid the entity-level tax by simply holding the asset directly. In other words, because the entity is not providing liquidity in any meaningful sense, its owners might hold direct interests in its underlying assets in order to avoid corporate-level tax. By contrast, if a publicly traded entity earns income from holding a non-publicly traded asset, then the entity is adding value by providing liquidity that could not already be obtained by holding the asset directly. In that case, imposing entity-level tax upon the entity would be less likely to induce its owners to no longer hold interests in the entity.

Adopting the proposed, restricted definition of qualifying income would cause a loss of exemption from the corporate tax system for many publicly traded entities.¹³³ For instance, publicly traded partnerships that earn income primarily from energy-related activities, mining, or real estate would no longer qualify for exemption from corporate-level tax. In addition, most entities that are currently designated as REITs could no longer qualify for REIT treatment. Furthermore, the new definition of qualifying income would have significant effects on publicly traded partnerships like Blackstone Group L.P., as discussed in more detail in Part V.A.

Better aligning the definition of qualifying income with underlying policy goals addresses one of the troubling aspects of the current tax rules applicable to publicly traded entities--the overly broad scope of the current definition of qualifying income.¹³⁴ This Part will proceed by demonstrating that the proposed revision to the definition of qualifying income would also address an additional troubling aspect of the current state of the law by making the rules less susceptible to manipulation by taxpayers. Finally, this Part will conclude with an analysis of whether additional reform should be instituted to make the rules less arbitrary.

REITs could be subject to a diversification requirement. Furthermore, some of the recent expansions in the definitions of what constitutes qualifying income for REIT purposes could be reversed.

¹³² For further discussion, see *supra* notes 88-96 and accompanying text.

¹³³ Indeed, given that this proposal potentially allows so few publicly traded entities to maintain exemption from corporate-level tax, administrative convenience might weigh in favor of simply providing that all publicly traded entities are subject to corporate-level tax unless they qualify for exemption under the RIC rules or other regimes. Any entities that would have continued to receive exemption from corporate-level tax under the new definition could, perhaps, instead be covered by the RIC rules (or, more accurately, a modified version of the RIC rules that would accommodate the entities).

¹³⁴ For discussion of this problem, see *supra* Part IV.A.

A. The Proposed Reforms Better Guard Against Easy Manipulation by Taxpayers

Under current law, if an entity is willing to engage in elaborate tax structuring, the amounts of qualifying and non-qualifying income earned by the entity are often within its control because the entity can convert non-qualifying income into qualifying income by earning the income through a subsidiary corporation, or an unrelated corporation could earn non-qualifying income. This technique is exemplified by the structure used by Blackstone Group L.P., discussed above.¹³⁵

Under the revised definition of qualifying income, taxpayer manipulation would be less likely. Consider the case of Blackstone Group L.P. Under the revised definition, all of the carried interest earned by Blackstone Group L.P. would become non-qualifying income. Once all of its income is non-qualifying income, Blackstone Group L.P. can no longer benefit from the tax structuring currently used.¹³⁶

Consider, instead, the case of a publicly traded partnership that invests in publicly traded securities and privately placed debt or equity securities. Under current law, this entity can obtain exemption from corporate-level tax. Under the proposed reforms, the income earned from privately placed debt or equity securities becomes non-qualifying income.¹³⁷ If this income is more than an insignificant portion of the entity's income, the entity will become subject to corporate-level tax.¹³⁸

¹³⁵ See *supra* Part II.C.

¹³⁶ It is worth noting that the proposed reforms would affect the current owners of Blackstone Group L.P. and not the principals of the Blackstone Firm who sold their rights to carried interest and management fees in the initial public offering. However, the proposed reforms would also prevent similar private equity firms from benefiting from the use of similar structures in connection with future public offerings.

¹³⁷ Capital gains from sale of stock in privately held portfolio companies would be non-qualifying income even if the gain was recognized by taking the portfolio company public. For the income to constitute qualifying income, the asset generating the income must have been publicly traded during the publicly traded entity's entire holding period. This requirement is warranted because only when this requirement is met could owners of the publicly traded entity have made the same investment and earned the same gains directly.

¹³⁸ This result is justified because the entity is providing its owners with liquid access to otherwise illiquid assets. In addition, given that many of its assets are not publicly traded, owners of the entity who may, individually, invest small amounts could not earn the income directly. Therefore, imposition of corporate-level tax is warranted. Imposing corporate-level tax in the case of equity securities becomes potentially problematic only if they represent equity interests in entities treated as corporations for tax purposes so that imposing the tax raises the possibility of subjecting the same income to corporate-level tax more than once. This concern, however, is better addressed by means other than treating the income as qualifying income. After all, treating the income as qualifying income does nothing to address the concern unless the entity earning the income earns primarily qualifying income, which will not always be the case. Other means of addressing this concern could include, in the case of dividend income, a tool such as the dividends received deduction in I.R.C. § 243. If Congress wanted to entirely exempt dividend income from an additional level of tax, I.R.C. § 243 could be modified to expand the circumstances in which the recipient corporation can deduct 100 percent of the dividend income it receives as discussed above. See *supra* notes 105-106 and accompanying text. Some income might also be subject to more than one level of corporate tax as a result of the publicly traded entity that is treated as a corporation earning capital gains from selling shares of corporate stock. It should be noted that this possibility exists under current law, and this Article's proposal exacerbates the pre-existing problem only because it treats gains from sale of stock in a privately held corporation as non-qualifying income. Most entities that are privately held need not be treated as corporations for tax purposes, at least if they are organized as unincorporated entities. Therefore, if the publicly traded entity that holds stock in the privately held company is treated as a corporation for tax purposes, any additional duplicative corporate-level tax resulting from this proposal's change to the definition of qualifying income could be avoided by treating the privately held company as a partnership for tax purposes. There may be reasons why the other owners of the company want to form it as an incorporated

A publicly traded partnership that invested in publicly traded securities and privately placed securities might attempt to manipulate income classification by funneling non-qualifying income through corporate subsidiaries, using a structure similar to that used currently by some Exempt Publicly Traded Partnerships, shown above in Figure 1. However, doing so would not achieve the results obtained by these Exempt Publicly Traded Partnerships under current law. In particular, under the revised definition of qualifying income, dividend income and capital gains income earned as a result of receiving distributions from the non-publicly traded corporate subsidiaries (like U.S. Subsidiary and Non-U.S. Subsidiary in Figure 1) would become non-qualifying income.¹³⁹ In addition, if the publicly traded partnership earned interest income paid on debt issued entirely to it by a corporate subsidiary (like U.S. Subsidiary in Figure 1), the interest would not be interest on publicly traded debt, and, therefore, would be non-qualifying income under the new definition.

The revised definition would not, of course, put an end to all tax planning. However, it would put an end to some of the aspects of the current structuring that are the most troubling. Following adoption of the revised definition of qualifying income, a publicly traded partnership that invested in publicly traded securities and privately placed debt or equity securities might use a different structure. In particular, rather than forming one publicly traded partnership that owned publicly traded assets and privately held assets, taxpayers might form and offer interests in two entities. The first entity, a publicly traded partnership, would earn income from publicly traded assets. As a result, the first entity could maintain exemption from corporate tax treatment even under the new definition of qualifying income. The second entity would own privately placed debt and equity securities, and, as a result, the second entity would not obtain exemption from mandatory corporate tax treatment and would be subject to corporate-level tax on all of its income. In order to reduce its tax liability, this second entity might issue debt to the public so that it incurred deductible interest expense.

To some extent, the tax consequences resulting from formation of these two entities would mimic the result achieved by the structuring available under current law (funneling non-qualifying income through corporate subsidiaries, along the lines of what is done by some Exempt Publicly Traded Partnerships as shown in Figure 1). However, results of the new structure are importantly different in two respects. First, under current law, more income constitutes qualifying income and therefore escapes corporate-level tax, due to the overly broad current definition of qualifying income. For instance, capital gains income, dividend income, and interest income earned from privately placed debt and equity securities are classified as qualifying income under current law but as non-qualifying income under the proposed reforms. Second, in the structure used following adoption of the proposed reforms, the debt issued by the entity that earns non-qualifying income is issued to the public, whereas, in the structure currently used, a publicly traded

entity or want to hold interests in an entity treated as a corporation for tax purposes. Their goals could still be achieved. In particular, an incorporated entity owned by the other owners of the business could form an entity treated as a partnership for tax purposes that owned and operated the business. The incorporated entity and the publicly traded entity treated as a corporation for tax purposes could own interests in this operating partnership. Through this structure, the other owners of the business achieve their goal of investing through an incorporated entity treated like a corporation for tax purposes, and income that is earned by the publicly traded entity treated as a corporation for tax purposes is not subject to more than one level of corporate tax.

¹³⁹ Assuming that the income earned through any non-U.S. corporate subsidiary is not subpart F income, the publicly traded entity could, nevertheless, defer paying tax on the income until the subsidiary made distributions to it.

entity, like the Publicly Traded Partnership in Figure 1, may hold debt that is issued by its wholly-owned corporate subsidiary. In the revised structure in which the debt is publicly traded, market forces ensure that a market rate of interest dictates the interest paid on the debt, and thus, the interest expense deducted by the corporation. This is not the case with debt issued to a publicly traded entity by its wholly-owned subsidiary.¹⁴⁰

B. Should The Rules Also Be Made Less Arbitrary?

As proposed above, the definition of qualifying income should be modified so that income is only qualifying income if it would constitute qualifying income under current law and it is earned by holding a publicly traded asset. Furthermore, carried interest should never constitute qualifying income. This reform better aligns the definition of qualifying income with the goal of granting special treatment to income that the owners of a publicly traded entity could earn directly. In addition the revised definition would be less susceptible to taxpayer manipulation.

If, however, tax law continued to grant special treatment to all income earned by a publicly traded entity if and only if the entity earned predominately qualifying income (within the meaning of the new definition), then tax law would still result in arbitrary consequences. A small change in the amount of non-qualifying income earned by a publicly traded entity could still cause a drastic change in the entity's tax consequences.

To make the results less arbitrary, tax law could instead grant special tax treatment to only qualifying income earned by a publicly traded entity, but the special treatment would apply regardless of whether the entity earned predominately qualifying income.¹⁴¹ This section will explore how such a system might be implemented. The discussion reveals that the complexity of the system likely warrants maintaining the current regime under which beneficial treatment applies to all income earned by a publicly traded entity if and only if the entity earns predominately qualifying income, provided that the scope of what may be classified as qualifying income is narrowed in the manner proposed by this Article.

¹⁴⁰ Under current law, if the debt is issued entirely to the Publicly Traded Partnership and if the rate of interest is higher than a market rate on debt, the IRS could re-characterize the debt as equity and disallow an interest deduction. Achieving that result, however, requires the IRS rather than the market to take action. Furthermore, to ensure that the debt must truly be publicly traded in order for interest to constitute qualifying income, anti-abuse rules could be adopted in connection with the new definition of qualifying income that provided, for instance, that an asset would not be treated as publicly traded unless the asset was widely held.

¹⁴¹ Under current law, publicly traded entities that earn more than a small amount of non-qualifying income are not the only types of entities that are automatically treated as corporations for tax purposes. *See* Treas. Regs. §§ 301.7701-2(b)(1), (3)–(8) (describing entities that must be treated as corporations). The extent to which the reform considered in this Part V.B would affect the taxation of existing entities would depend, in part, on whether other modifications were made to the list of entities automatically treated as corporations for tax purposes (and on whether the reform considered in Part V.B would apply to these entities). For instance, under current law, an entity is automatically treated as a corporation for tax purposes if it is organized under a federal or state statute that describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic. *See* Treas. Reg. §§ 301.7701-2(b)(1). If this continued to be the case and if all income earned by such entities was subject to the corporate tax system, then many existing entities would be subject to the current corporate tax system notwithstanding implementation of the reform considered in Part V.B. For the reform considered in Part V.B to have broader effects, incorporated entities could be removed from the list of entities automatically treated as corporations for tax purposes so that income earned by an incorporated entity would be subject to double tax only if the entity was publicly traded and only if the income was non-qualifying.

I. How to Implement an Alternative Regime

A system that subjected all qualifying income earned by a publicly traded entity to one level of tax and all non-qualifying income earned by a publicly traded entity to two levels of tax could be implemented in at least three different ways.¹⁴² None of the three methods is simple.

Under the first method, any qualifying income earned by the entity would be taxed under a pass-through regime (so that the entity itself would not be subject to tax on the income but the owners of the entity would be taxed on the income directly) while any non-qualifying income would be taxed under a corporate tax regime (so that the income would be taxed at the entity level and the owner level). The design of the first method is not completely unprecedented. In the context of U.S. tax rules applicable to non-U.S. corporations, for instance, a similar design is employed. In particular, if a non-U.S. corporation is a “controlled foreign corporation,” some, but not all, of the corporation’s income will be taxed under a pass-through regime.¹⁴³ Therefore, existing rules could be used as a baseline for designing new rules in the publicly traded entity context. However, the controlled foreign corporation rules only apply in a situation in which the ownership of a corporation is fairly concentrated in the hands of a small number of owners.¹⁴⁴ This makes application of the rules mechanically simpler in the context in which they are currently used, compared to a context in which an entity is widely held and its ownership changes frequently.

Under the second method, a publicly traded entity would be subject to entity-level tax on all of its income. However, the publicly traded entity would be entitled to a deduction for dividends paid but only to the extent that the dividends were attributable to qualifying income earned by the entity.

Under the third method, a publicly traded entity would be subject to entity-level tax on all of its income. However, the owners of the publicly traded entity would be exempt from tax on dividends paid, but only to the extent that the dividends were attributable to qualifying income.

Under either the second or third method, in order to determine the extent to which a dividend was attributable to qualifying income or non-qualifying income, the new regime might assume that the amount of the dividend paid from qualifying income would equal the same proportion of the entity’s income that was qualifying income over some period of time. Alternatively, the new regime might assume that qualifying (or non-qualifying) income was always distributed first.

Any of the three methods would involve significant mechanical complexity. Furthermore, even though large publicly traded entities might be well equipped for handling mechanical complexity, the new regime’s complexity would also burden the IRS given that it would need to monitor for compliance with the new rules.¹⁴⁵

¹⁴² The choice among these three different methods is not trivial. For instance, the tax consequences for non-U.S. investors or tax-exempt investors that hold interests in the publicly traded entity could vary depending on which method was utilized.

¹⁴³ Any U.S. shareholder in the corporation pays tax under a pass-through regime with respect to any subpart F income earned by the corporation. *See* I.R.C. § 951 (2007).

¹⁴⁴ *See id.*; I.R.C. § 957 (2004).

¹⁴⁵ Furthermore, if each publicly traded entity would continue to have the ability to elect to be treated as a corporation for tax purposes, and if this election continued to result in the entity paying corporate-level tax on all of its income, the availability of this election would address taxpayer complaints and alleviate taxpayer concerns about complexity because taxpayers who judged the mechanics of the new

Given the complexity of the new regime, it should not be adopted. First, it is unclear that the new regime would eliminate the negative effects of arbitrariness, and second, limiting the scope of the definition of qualifying income, as proposed by this Article, ameliorates, to some degree, the negative effects of arbitrariness, even if special treatment is only granted to qualifying income if an entity earns primarily qualifying income. Each of these two observations is discussed in more detail below.

2. *The New Regime Would Not Necessarily Eliminate the Negative Effects of Arbitrariness*

As discussed above, because publicly traded entities are sophisticated, the main negative consequence of granting special treatment to qualifying income only when an entity earns primarily qualifying income is that the regime induces entities to engage in costly, wasteful tax planning. For instance, an entity might sacrifice operational efficiency by implementing a structure in which all non-qualifying income was earned by an unrelated entity so that the entity's qualifying income could obtain exemption from corporate-level tax. Even if Congress adopted a new regime under which beneficial treatment was always bestowed upon qualifying income, regardless of whether an entity earned more than insubstantial amounts of non-qualifying income, taxpayers could still have some incentive to earn non-qualifying income through a separate corporation, depending on how the regime was implemented. For instance, earning non-qualifying income through a separate corporation could ensure that, when the corporation issued debt to the public and incurred interest expense, the interest expense would be deducted from non-qualifying income only. If qualifying and non-qualifying income were earned by the same entity, some of the tax benefit of any interest expense might be lost if the entity deducted some of it from qualifying income.¹⁴⁶

3. *The New Definition of Qualifying Income Partially Mitigates the Negative Effects of Arbitrariness*

As discussed above, beneficial treatment is only bestowed upon qualifying income once the amount of qualifying income earned by a publicly traded entity crosses an arbitrary threshold. In the context of rules that affect sophisticated taxpayers, the primary negative effect of this arbitrary feature may be the fact that it encourages taxpayers to engage in wasteful tax planning. However, even if this arbitrary feature remains, narrowing the scope of qualifying income as proposed by this Article may address the concern about wasteful tax planning in two ways. First, as discussed in Part V.A, under the new definition of qualifying income, taxpayers will have a more difficult time manipulating the characterization of income as qualifying income or non-qualifying

regime to be too onerous could opt for treatment under existing law. The availability of the election would not, however, alleviate complexity faced by the IRS when monitoring compliance with the new regime.

¹⁴⁶ Whether this would occur would depend, in part, on how the new regime was implemented. Furthermore, other mechanical aspects of the new regime could affect whether taxpayers continued to have an incentive to segregate qualifying income from non-qualifying income. For instance, assume the regime was implemented by using either the second or the third method described above in Part V.B.1. Further, assume that the amount of any dividend paid from qualifying income was determined either by considering the proportion of the entity's income that was qualifying income over some period of time or by assuming that non-qualifying income was always distributed first. In addition, assume that a taxpayer intends to currently distribute its qualifying income but may retain its non-qualifying income for some period of time. Given those assumptions, earning exclusively qualifying income through one entity would have tax benefits. In particular, it would ensure that all dividends paid by that entity were treated as attributable to qualifying income so that all dividends received favorable tax treatment.

income. Therefore, some of the existing avenues for engaging in wasteful tax planning will be available no longer. Second, once the scope of what constitutes qualifying income is narrowed, it may be the case that fewer publicly traded entities earn sufficient amounts of qualifying income to justify the costs they would incur to engage in tax structuring.

In summary, the complexity inherent in an alternative system as well as the fact that an alternative system might not eliminate the incentives to engage in tax planning likely warrant maintaining the current regime under which beneficial treatment applies to all income earned by a publicly traded entity if and only if the entity earns predominately qualifying income. This is particularly true because, if the scope of what may be classified as qualifying income is narrowed in the manner proposed by this Article, the rules will become less susceptible to manipulation. Under current law, the arbitrariness and manipulability of the applicable rules work hand in hand to encourage elaborate, wasteful tax structuring. The arbitrariness of the rules provides the incentive for the tax structuring, and the manipulability of the rules enables it. By making the rules less susceptible to manipulation, the adoption of a narrower definition of qualifying income would prevent taxpayers from engaging in wasteful tax structuring, even if the arbitrariness of the rules still provides some incentive to engage in such tax structuring.

VI. CONCLUSION

Under current law, publicly traded entities are generally subject to the corporate tax system unless they earn predominately qualifying income, in which case all of their income is exempt from corporate-level tax. The only convincing policy justification for granting special treatment to qualifying income suggests that qualifying income should include only income that owners of the publicly traded entity could earn directly. Yet, the current definition of qualifying income grants special treatment to much income that owners of a publicly traded entity could not earn directly. This system is difficult to justify on policy grounds and invites taxpayers to engage in elaborate tax structuring in order to transform non-qualifying income into qualifying income. To address these problems, this Article proposes that income that is classified as qualifying income under current law should not be classified in that manner unless it is earned by holding a publicly traded asset. In addition, carried interest should not constitute qualifying income.