

“Blockers,” “Stoppers,” and the Entity Classification Rules

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I. Introduction

Tax lawyers often refer to “blockers” or “stoppers”—what are these? Generically, a blocker or stopper is an entity inserted in a structure to change the character of the underlying income or assets, or both, to address entity qualification issues, to change the method of reporting, or otherwise to get a result that would not be available without the use of more than one entity. One example, discussed further below, would be a case where a regulated investment company (RIC) organizes a foreign subsidiary to invest in commodities or otherwise makes investments that could not be made by the RIC directly without jeopardizing its qualification, and thus converts “bad” assets and income into assets (*i.e.*, shares of the foreign subsidiary) and income (*i.e.*, dividends, subpart F inclusions, and gains from sales of the shares) that are “good” for RIC qualification purposes. The structures vary in significance from, for example, changes in the taxable base to less consequential changes in the way the taxable base is reported. Some are innocent, in the sense of being blessed by the statute (such as the use of a taxable subsidiary of a real estate investment trust (REIT)), but others may require a leap of faith.

What follows is more of a compilation of these situations than a paper that takes a position on whether specific structures are appropriate or not. One reason for this lack of decisiveness is that the results can also be achieved by synthetic ownership structures or instruments¹—so the use of the entity classification rules for this purpose cannot be judged apart from the judgments passed on those structures and instruments. Moreover, while the whole point of blockers and other tiered structures, as well as some synthetic ownership structures, is to undercut statutory restrictions (for example, on what is “good” income for a RIC or on the kind and number of shareholders that an S corporation may have), it is nonetheless difficult to conclude that the use of tiered entities is invariably “bad” or “abusive” because in a significant number of cases the structures are expressly sanctioned by rulings or regulations, or explicitly or implicitly by the statute.

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¹For example, the availability of investments in exchange-traded instruments that provide exposure to underlying assets and income that could not be owned directly without adverse tax consequences, or the use by foreign investors of “barrier” and other options or notional principal contracts to achieve synthetic ownership.

What, then, is the point of laying all of this out? What the examples show, at least to me, is the huge contribution made to the complexity of the tax law by the number of differently treated entities that exist and the differences in the way they are treated for tax purposes. The examples also show that the use of the entity classification rules, although not constrained by the need for “economic substance,”² is in many cases indistinguishable from what tax professionals refer to as “structured” or “financial” products. The structures are, to differing degrees, structurally induced tax distortions, to use more broadly a term developed by the Joint Committee in its analysis of tax expenditures.³ The complexity is not limited to the federal income tax but inevitably, because many states and localities use the federal tax base as a starting point for the state or local income tax base, spills over into state and local income taxes.⁴ And the contributions to complexity described in this Paper do not fully take into account the additional contribution that check-the-box regulations have made to the complexity of the rules relating to foreign investment, both “inward” and “outward”;⁵ or the future complexity that will no doubt result from the development of so-called “cell” companies.⁶ The relative decline in the use of “C” corporations exacerbates the issue.

The uses of the entity classification rules illustrated in this Paper make, at least in my judgment, a persuasive case for fundamentally revising the rules.

²“Economic substance” does not constrain the choice of one legal entity rather than another to carry on business activities and certainly does not constrain elections to treat that entity as an S corporation, a C corporation, a RIC or a REIT, or otherwise.

³See STAFF OF J. COMM. ON TAX’N, 110TH CONG., A RECONSIDERATION OF TAX EXPENDITURE ANALYSIS (Comm. Print 2008); see also STAFF OF J. COMM. ON TAX’N, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 2–3 (Comm. Print 2008).

⁴Consider, for example, the extensive use of captive REITs to reduce state income taxes. The structures, now to a large degree dealt with by statutory changes, relied on the federal dividends-paid deduction (sometimes in combination with a dividends-received deduction) to eliminate state taxes. Many were successfully challenged. See, e.g., *Bridges v. Autozone Props., Inc.*, 900 So. 2d 784 (La. 2005); *Sam’s E., Inc. v. Hinton*, 676 S.E.2d 654 (N.C. Ct. App. 2009); *Wal-Mart Stores E., Inc. v. Hinton*, 676 S.E.2d 634 (N.C. Ct. App. 2009); see also *BankBoston Corp. v. Commissioner*, 861 N.E.2d 450 (Mass. App. Ct. 2007); *HMN Fin., Inc. v. Commissioner*, 2009 Minn. Tax Lexis 13 (Minn. Tax Ct. 2009). But see *Commonwealth v. Autozone Dev. Corp.*, 2007 Ky. App. Lexis 401 (Ky. Ct. App. 2007).

⁵These include (a) the treatment of payments to and by hybrid entities for withholding tax and other purposes, now addressed by regulations under section 894; (b) the unsuccessful effort to deal with hybrid branch payments in Notices 1998-11, 1998-1 C.B. 33, and 1998-35, 1998-2 C.B. 34 (which at one point was part of the Administration’s tax proposals); (c) the now-abandoned Proposed Regulations (Prop. Reg. § 301.7701-3(h), 64 Fed. Reg. 66, 591 (1999)) addressing certain “extraordinary transactions”; (d) the concept of “indirect use” of losses in the dual consolidated loss regulations; (e) the definition of a “person” for purposes of the conduit-financing regulations; and (f) the special foreign tax credit rules for taxes imposed on the income of “reverse hybrids” (which may be expanded by the enactment of the new rule on the separation of income and the foreign taxes on the income).

⁶See Stephen B. Land, *Entity Identity: The Taxation of Quasi-Separate Enterprises*, 63 TAX LAW. 99 (2009).

The entity classification rules are, to state the obvious, simply the product of a tortured 70-plus year history. The RIC rules were enacted in 1936 in response to the Court's interpretation in *Morrissey* of an "association" taxable as a corporation,⁷ and permit the elimination of entity-level tax through the deduction allowed for dividends paid. Common trust funds, also a response to *Morrissey*, were enacted at the same time.⁸ REITs followed in 1960 as "mutual funds" for real estate. The S corporation rules were enacted in 1958, before there were limited liability companies or wide-spread use of limited partnerships, to deal with the tax penalty imposed on small businesses that sought limited liability and, under then prevailing state law, were forced to incorporate to achieve that goal. After the Service, in the context of doctors and other professionals, changed its mind about what was an "association" and in 1960 adopted the *Kintner* regulations,⁹ the classification rules that applied to domestic unincorporated entities became formulaic.¹⁰ The publicly traded partnership rules were enacted in 1987 to save the corporate tax base in response to this and the resulting spread of publicly traded limited partnerships—which began in the early 1980s.¹¹ The 1987 enactment in turn facilitated the 1996 adoption of the check-the-box regulations. "Fixed investment trusts" followed from the dicta in *Morrissey* that there would be no "association" in the case of a trust set up to hold investments, collect income, and make distributions, since, although not an "ordinary" trust created by will or *inter vivos* declaration, such a trust was not "created and maintained as a medium for the carrying on of a business enterprise and sharing its gains" if the trustee had no power to vary the investments of the trust other than in the capacity of a trustee.¹²

⁷*Morrissey v. Commissioner*, 296 U.S. 344 (1935).

⁸Now defined in, and treated as pass-through entities, by section 584.

⁹So called after *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954).

¹⁰See Marvin Lyons, *Comments on the New Regulations on Associations*, 16 TAX L. REV. 441 (1961). The agony in the tax profession on the appropriate response to *Kintner* was, with the benefit of hindsight, remarkable. See Boris I. Bittker, *Professional Service Organizations: A Critique of the Literature*, 23 TAX L. REV. 429 (1967–1968).

¹¹I.R.C. § 7704(g).

¹²Fixed investment trusts are trusts described in Regulation section 301.7701-4(c). With respect to the evolution of the rules and the prohibition on a power to vary the trust's investments, see, in addition to *Commissioner v. Chase Nat'l. Bank of New York*, 122 F.2d 540 (2d Cir. 1941) (holding that, where there was no power to vary the underlying investments, "the application of the principles set forth in *Morrissey* . . . leads to the conclusion . . . that the trust property was to be held for investment and not to be used as capital in the transaction of business for profit like a corporation organized for such a purpose. . . . [T]here was no exercise by the trustee, the depositor, or both combined of 'any powers beyond those which are necessary incidents to the preservation of trust property, the collection of income therefrom and its distribution to the holders of trust shares.'"), and *Commissioner v. N. Am. Bond Trust*, 122 F.2d 545 (2d Cir. 1941) (reaching the opposite conclusion when the trustee had the power to change the underlying investments).

Would there be separate rules for S corporations, publicly traded partnerships, common trust funds, fixed investment trusts, RICs, and REITs, had the future been visible when *Morrissey* was decided in 1935?

Real estate mortgage investment conduits (REMICs), and the related rules for “taxable mortgage pools,” were enacted in 1986 at the beginning of the mortgage securitization euphoria¹³—would that happen today? Their only purpose was to permit the cash flow from pools of mortgages to be infinitely divided into separate instruments (IOs, POs, PACs, TACs, etc.) that are treated as debt for tax purposes and have different maturities and risks of prepayment or default, or both. Some of these are substantively derivatives—for example, “interest only” (IOs), which are essentially bets on interest rates similar to interest rate swaps.¹⁴ It is not clear to what extent this was understood by Congress or the Treasury at the time the REMIC rules were enacted.¹⁵ Enactment was, very simply, the product of the mortgage securitization lobby.¹⁶ No tax policy was involved—to the contrary, a REMIC allows noneconomic allocations of taxable income to the “residual interests” (the so-called phantom income produced by the “regular interest” rules) and then seeks, nonsensically and with only partial success, to solve that prob-

¹³FREDDIE MAC, PRODUCT OVERVIEW: REMIC PROGRAM (Jan. 2008), available at www.freddiemac.com/mbs/docs/fs_remicprogram.pdf.

¹⁴The complexity of the REMIC rules has plainly not been worked through. See, e.g., Announcement 2004-75, 2004-2 C.B. 580 (relating to interest-only regular interest in REMICs); *Glick v. United States*, 96 F. Supp. 850 (S.D. Ind. 2000) (holding that the loss sustained on account of faster than expected prepayments was a capital loss allowed only at maturity). Comments in response to the Announcement have generally recommended that negative amounts resulting from a prepayment assumption catch-up (PAC) be allowed as current deductions and included in the income of the holder of the residual interest. See David C. Garlock, *ECY Comments on Proposed Regs on Interest-Only Interests in REMICs*, 2005 TAX NOTES TODAY 75-12 (Mar. 25, 2005); David P. Hariton, *NYSBA Tax Section, Report on REMIC IO Interests*, 2005 TAX NOTES TODAY 22-13 (Feb. 3, 2005). There is no indication that anything will be forthcoming from the Service.

¹⁵The only example of how a REMIC might be used that is in the legislative history is an example, that, by cross reference to the fixed investment trust regulations, is the class structure that prompted the Sears regulations (*i.e.*, all payments first to one class, then to a second class, and so on).

¹⁶Prior to the enactment of the REMIC rules, mortgages were securitized in straight pass-through fixed investment trusts and by tranching debt issued by special purpose corporations, but the mortgage securitization industry wanted (and got) more. A brief effort to use the fixed investment trust rules to issue multiple classes of interests in mortgage pools was foreclosed by a 1985 amendment (the so-called “Sears” regulations, after a mortgage securitization by Sears Mortgage Corporation) to the definition of fixed investment trusts that, in general, required only a single class of beneficial interests. Reg. § 301.7701-4(c)(1).

lem by taxes imposed on transfers, or the owners, of residual interests.¹⁷ By way of comparison, suppose this rule, allowing allocations of taxable income without corresponding allocations of economic income, and not the "substantial economic effect" rule in the section 704(b) regulations,¹⁸ also applied to allocations for tax purposes of partnership income, gain, loss, and expense? Would that make sense?

What are the possible solutions to the federal income tax issues posed by "blockers," "stoppers," and the other complexities of the entity classification rules? A fundamental revision would eliminate RICs, REITs, common trust funds, and S corporations and develop a single form of pass-through entity. The difficulty is that, outside of ruminations by the Joint Committee¹⁹ and an occasional voice from academia,²⁰ there is no constituency in the government or in the private sector for fundamental reform—in fact, fundamental reform would be strongly opposed by the industries involved.²¹ Without a constituency, fundamental reform is simply not a practical suggestion. More modest steps, such as revising the rules in section 514 on the debt-financed income of tax-exempt organizations and developing uniform definitions of "good income" for tax-exempt organizations, RICs, REITs, publicly traded partnerships, and foreign investors,²² would be worthy undertakings, but these changes will not eliminate the use of blockers or stoppers. And even these more modest steps seem unlikely to garner support from industries that thrive on the existing complexity.

II. Tax-Exempt Organizations and Foreign Investors

The most frequent use of the terms "blockers" or "stoppers" are for investments in intermediate entities by tax-exempt organizations and foreign per-

¹⁷The huge disparity between the value of the residual interests and their share of the taxable income of the pool is illustrated by the transactions in which Enron sought to use the artificial basis in the REMIC residuals to shelter unrelated income. See, e.g., STAFF OF J. COMM. ON TAX'N, 108TH CONG., 1 REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS, (Comm. Print 2003) (the description of Project Steele). The possibility of duplicating these losses contributed to the enactment of section 362(e).

¹⁸T.D. 9398, 2008-1 C.B. 1143.

¹⁹See STAFF OF J. COMM. ON TAX'N, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY (Comm. Print 2008).

²⁰See Walter D. Schwidetzky, *Integrating Subchapters K and S—Just Do It*, 62 TAX LAW. 749 (2009) (urging in effect the repeal of Subchapter S).

²¹As discussed *infra*, all of these groups—as well as others, such as the publicly traded partnership industry—have active trade organizations or lobbying groups, none of which has any sympathy for this kind of simplification.

²²That is, income that is "good" in the sense of being excluded from unrelated business income by the "modifications" in section 512(c), included by a RIC or a REIT in income that counts towards qualification under sections 851 or 856 or by a publicly traded partnership in income that is described by the exception to the rules in section 7704(c), and income generated by activities that do not cause a foreign person to be engaged in a trade or business in the United States because the activities are covered by the safe harbors in section 864(b).

sons, and we will therefore start with these. These structures are, however, simply the beginning of the story, as subsequent sections of this Paper will demonstrate.

A. *Tax-Exempt Organizations*

Tax-exempt organizations, and in particular section 401(a) trusts and section 401(k) plans, are an important source of capital market investments. While there are a number of restrictions on the income-earning activities of tax-exempt organizations (*e.g.*, ERISA and in some cases the private foundation rules), the one that is most commonly encountered in capital markets is the tax on unrelated business taxable income imposed by sections 511–15. There are “modifications,” or exclusions from unrelated business taxable income, for income and related expenses from conventional capital market investments (*e.g.*, dividends, interest, income from securities loans, certain real property rents, capital gains, etc.),²³ but the modifications are overridden by the rule that (with narrow exceptions)²⁴ includes in unrelated business income any income from an asset that is debt-financed.²⁵

Examples of “blockers” or “stoppers” used by tax-exempt organizations would include the following:

1. *Investment in a REIT*

A tax-exempt organization invests in shares of a REIT to block debt-financed income of the REIT. Or it does so to block, as well, income of the REIT that goes beyond what would be excluded in the case of a direct investment by the “modifications” in section 512(b) because of the ability of a REIT, through taxable REIT subsidiaries or otherwise, to provide services beyond those allowed to tax-exempt organizations by the definition of “rent” in section 512(b)(3).²⁶ The REIT eliminates entity-level tax through the dividends-paid deduction, and the dividends received by a tax-exempt shareholder, as well as any gain from a sale of the REIT shares, are excluded from unrelated business income by the modifications in section 512(b) unless the acquisition of the REIT shares is debt financed.

There is a narrow statutory restriction in section 856(h)(3), relating to “pension-held” REITs, on investments in REITs by section 401(a) trusts. This certainly implies that outside of those restrictions it is acceptable to invest through REITs for the simple purpose of avoiding the tax on unrelated business taxable income. The statutory restriction is that, if a REIT would be “closely held” but for its ability to look through to the beneficiaries of shareholders that are section 401(a) trusts (and thus, because it is closely held,

²³I.R.C. § 512(b).

²⁴A tax-exempt organization that is a “qualified organization” may make leveraged investments in real estate under the specific circumstances provided in section 514(c)(9).

²⁵I.R.C. § 514.

²⁶Additionally, REITs may (sometimes at a cost) have other income that could not be received by a tax-exempt organization, such as income from foreclosure property.

could not qualify to be a REIT),²⁷ any section 401(a) trust that owns more than ten percent by value of the REIT must treat dividends paid by the REIT as unrelated business taxable income in proportion to the gross income of the REIT that consists of such income.

The restriction on blocking REIT income that would be unrelated business taxable income if received directly applies only where the REIT is "pension-held," which will be the case only if more than 50% in value of the REIT is owned by section 401(a) trusts that each own more than 10% in value of the REIT and one of which owns more than 25% in value of the REIT. The ownership thresholds for what is "pension-held" are bright-line tests, looking to actual not constructive ownership,²⁸ and so can be dealt with without much difficulty.

2. *Investment in Shares of a Foreign Corporation*

A tax-exempt organization invests in the shares of a foreign corporation to block (a) debt-financed income from the underlying investments, or (b) income from those investments, which might not be excluded by the modifications in section 512(b), but is not taxed to the foreign corporation under section 881 or section 882. And of course the foreign corporation is organized in a jurisdiction that does not subject its income to tax.²⁹

Dividends from a foreign corporation and gains from a disposition of its shares would be excluded from unrelated business taxable income by the modifications in section 512(b) unless the acquisition of the shares was debt-financed. What about income inclusions in respect of shares of a controlled foreign corporation or passive foreign investment company (PFIC)? The Service originally took the view that subpart F inclusions and PFIC inclusions resulting from a qualified electing fund (QEF) election would be excluded from unrelated business taxable income, at least (implying a look-through approach) where the income of the foreign corporation consisted of income that would be excluded by the modifications in section 512(b) if received directly.³⁰ Chastened by the legislative history of section 512(b)(17), which provides that income of a controlled foreign corporation that is insurance income is unrelated business taxable income to a tax-exempt shareholder, but does not extend this to any other income, the Service has since issued a number of private rulings which exclude subpart F and PFIC inclusions from unrelated business taxable income when section 512(b)(17) does not

²⁷Section 856(a)(6) requires that a REIT not be closely held, defined by reference to the stock ownership branch of the personal holding company test.

²⁸I.R.C. § 856(h)(3)(D).

²⁹Alternatively, the tax-exempt buys an in-the-money call, *i.e.*, a "barrier" option, on the appreciation in the value of the underlying investment and takes the view that it simply has an option (and not a purchase of the assets that is leveraged by nonrecourse debt to the option counterparty).

³⁰P.L.R. 1990-24-086 (Mar. 22, 1990).

apply.³¹ The rulings treat these inclusions as equivalent to dividends and thus as covered by the modifications in section 512(b).³² At different points, the use of foreign “blockers” has been the subject of proposed legislation, which implicitly or explicitly acknowledged and accepted the practice and sought only to make it unnecessary to use blockers to avoid the tax on unrelated business taxable income.³³

3. *Investment in Shares of a Domestic Corporation*

A tax-exempt organization invests in the shares of, and lends or leases to, a domestic corporation to block income that would not be excluded by section 512(b) if received directly and seeks to wipe out the corporate tax by deductible payments of interest, rents, etc. to the tax-exempt.

This use of a subsidiary is restricted by section 512(b)(13), which treats interest, rents, royalties, and annuities (so-called “specified payments”) from a controlled entity as unrelated business taxable income to the extent they reduce the net unrelated business income of the controlled entity; but it is presumably fine in cases not covered by section 512(b)(13)—for example, where the tax-exempt by itself (but taking into account constructive ownership under section 318) does not own more than 50% in vote or value of the corporation.³⁴

Section 512(b)(13) was an early effort to address blockers. It grew out of a transaction in which unrelated business taxable income was in effect converted into good income—specifically, working interests in oil and gas were conveyed by a tax-exempt organization to a corporation and net profits

³¹ Because the rule in section 512(b)(13) that treats the specified payments as unrelated business taxable income looks to the “taxable income” of the controlled entity, it would not apply to income of a foreign corporation that was not subject to U.S. tax (and dividends and subpart F and PFIC inclusions are not in any event specified payments). I.R.C. § 512(b)(13).

³² *E.g.*, P.L.R. 2002-23-069 (Mar. 13, 2006); P.L.R. 2003-15-034 (Jan. 14, 2003) (stating that this was unclear prior to the enactment of section 512(b)(17) but that the House Ways and Means Committee report on the enactment viewed subpart F inclusions as dividends that are excluded under section 512(b)); P.L.R. 2003-15-028 (Jan. 13, 2003); P.L.R. 2002-51-016 (Sept. 23, 2002).

³³ The Tax Reduction and Reform Act of 2007, introduced by Representative Rangel in October of 2007, would allow direct investment by tax-exempts in hedge and other investment funds, and thus “would eliminate the current-law incentive . . . to invest in hedge funds and other investment funds through offshore ‘blocker’ corporations formed in tax haven jurisdiction.” Press Release on H.R. 3790 Tax Reduction and Reform Act of 2007 (Oct. 29, 2007), www.waysandmeans.house.gov/media/pdf/110/summaryfordistribution.pdf (quoting the release that accompanied the legislation). House Resolution 3497, introduced by Representative Levin, would (in the case of a limited partner) exclude from “acquisition indebtedness” the debt of a partnership incurred to purchase or carry securities or commodities in determining the unrelated business income of the limited partner. H.R. Res. 3497, 111th Cong. (2009).

³⁴ The specified payment rules also apply to controlled partnerships and other controlled entities. The original threshold was ownership of 80% or more in voting power and of any other class of the outstanding stock of the entity, but without any constructive ownership. The present 50% rule with constructive ownership was enacted in 1997. I.R.C. § 512(b)(13)(D).

overriding royalty interests were retained.³⁵ That a conversion was involved (as opposed to a non-arm’s-length transaction with a subsidiary) no doubt explains the strong statutory response—that is, that all of the specified payment is treated as unrelated business income to the extent it reduces income of the controlled entity that would be unrelated business income if received directly.

Section 512(b)(13)’s general rule, which treats the specified payments as subject to the tax on unrelated business income, might be compared with the more easy-going rules for taxable REIT subsidiaries. These permit activities that would generate bad income, if carried on directly by a REIT, to be carried on by a taxable REIT subsidiary, so long as any interest or other deductible payments made by the subsidiary to the REIT are at arm’s length.³⁶ That narrower rule may have provided the model for the exception to section 512(b)(13) in section 512(b)(13)(E), which applies to payments received or accrued before the end of 2012 (or later, if the provision is again extended) under a contract in effect on the date in 2006 when this was originally enacted or under a renewal of such a contract. Under the exception, which was obviously enacted for the benefit of a specific tax-exempt organization, the payments by the controlled entity are unrelated business income only to the extent not at arm’s length.³⁷

B. *Foreign Investors*

Foreign investors are subject to withholding tax on dividends and like items of fixed or determinable annual or periodic income, with a broad exemption for “portfolio” interest, and to regular rates of tax on income that is “effectively connected” with a U.S. trade or business.³⁸ Importantly, under the so-called FIRPTA rules, gain from the disposition of an interest in U.S. real property, which includes shares of a U.S. real property holding corporation, is always effectively connected, and thus taxable, unless covered by the exception for 5% or smaller interests in a regularly traded entity or the exception for shares of a domestically controlled REIT (or RIC).³⁹ “Effectively connected” income of a foreign corporation may also be subject to branch profits tax.⁴⁰

Examples of the use of blockers by foreign investors include the following:

³⁵United States v. Robert A. Welch Found., 334 F.2d 774 (5th Cir. 1964), *aff’d* 228 F. Supp. 881 (S.D. Tex. 1963).

³⁶I.R.C. § 857(b)(7) (imposing a 100% tax on redetermined rents and deductions and excess interest); I.R.C. § 163(j)(3)(c) (making the interest subject to the earnings-stripping rules).

³⁷I.R.C. § 512(b)(13)(E).

³⁸I.R.C. §§ 871, 881, 882.

³⁹I.R.C. § 897(c)(3), (h) (assuming in the case of a RIC that the termination clause in section 897(h)(4)(A)(ii) is extended).

⁴⁰I.R.C. § 884.

1. *Investment by Foreign Persons*

Foreign investors, seeking to take advantage of the domestically controlled REIT exception to the FIRPTA rules in section 897(h)(2), acquire each of their U.S. properties in a separate REIT which sells more than 50% in value of its shares to a U.S. person (and has charter restrictions to ensure that such ownership will be in place for at least five years).⁴¹ In effect, the investors elect out of the FIRPTA rules for any gain on the disposition of the directly owned percentage of the domestically controlled REIT. Oddly, if one believes there was a legislative purpose in the domestically controlled REIT rules, FIRPTA continues to apply to distributions made by a domestically controlled REIT or RIC out of gains from sales of interests in U.S. real property (subject to the narrow exception for distributions on shares traded on an established U.S. securities exchange made to a 5% or smaller shareholder).⁴²

Domestic control requires that less than 50% in value be “held,” either “directly or indirectly” by foreign persons during a five-year testing period.⁴³ The regulations say that the holder is the actual owner, which in turn is the person required to include the income in gross income,⁴⁴ and so it would appear that ownership by a RIC or a REIT (although not by a partnership), as well as by a domestic “C” corporation, would satisfy the requirement (although it is not clear the Service would agree in the case of a RIC or REIT).

The statute does not provide for constructive ownership in determining whether the less-than-50%-in-value test is met, which is odd because constructive ownership rules are used to determine whether the sale of regularly traded shares of a U.S. corporation that is a U.S. real property holding corporation is eligible for the exception to the FIRPTA that applies to sales by a foreign shareholder owning 5% or less of a class of such shares.⁴⁵ In the absence of constructive ownership, the ownership rule is not difficult to deal with.⁴⁶

Is this or the other uses of REITs described above and below particularly complicated to implement? There is a significant publicly traded REIT industry, but there are many more, by number, private REITs—that is, REITs that do not issue shares to the public and so generally operate free of securities law and other non-tax restrictions. One requirement for qualification as a REIT is that there be at least 100 holders of beneficial interests in the REIT, but that does not mean that the shareholders who step in to fulfill that requirement

⁴¹While ownership of a REIT must be evidenced by “transferable” shares or beneficial interests, such a restriction has not been viewed by the Service as inconsistent with this requirement. See P.L.R. 1996-30-016 (Apr. 26, 1996).

⁴²I.R.C. § 897(h)(1).

⁴³The same rule applies to distributions by a domestically controlled REIT attributable to gains from sales of U.S. real property but with a one-year testing period ending on the date of the distribution. I.R.C. § 897(h)(1).

⁴⁴Reg. § 1.897-1(c)(2)(i), *cross-referencing* Reg. § 1.857-8.

⁴⁵I.R.C. § 897(c)(6)(C).

⁴⁶See P.L.R. 2009-23-001 (Feb. 6, 2009).

must have a significant equity stake in the REIT (and, indeed, there are on-line sites for finding "accommodation" shareholders).⁴⁷

2. *Investment by a Partnership*

Taking this a step further, the foreign investors decide to use a partnership to hold their shares in each of the REITs and the REITs are leveraged by debt to the partnership.

The withholding tax exemption for "portfolio" interest turns off if the interest is paid to a shareholder that owns 10% or more in voting power of the voting stock of the corporation paying the interest.⁴⁸ Under Regulation section 1.871-14(g)(3), however, the determination of whether interest paid to a partnership is "portfolio" interest, and thus exempt from withholding tax, is made on a look-through basis, that is, at the partner level, and thus is portfolio interest in respect of any partner who is not a 10% or greater shareholder of the REIT.⁴⁹ This rule was adopted in 2007.⁵⁰ Why the rule that would exclude the interest from portfolio interest if the REIT was owned by a foreign corporation should not apply if the owner is a partnership (*i.e.*, a foreign entity that has checked the box) is a mystery. The whole purpose of the exclusion from portfolio interest was to exclude interest on debt to a person who had significant control over the debtor and thus over the terms of the debt. To the extent interest expense of the REIT replaces dividends from the REIT, U.S. tax is eliminated; together with the domestically controlled REIT rule, the after-tax consequences of the investment in U.S. real estate are much improved.

The rate of interest paid by the REIT would be subject to the arm's-length standard of section 482,⁵¹ but that leaves a good deal of latitude. The interest expense deductions of the REITs would also be subject to the earnings-stripping rules of section 163(j), but the benchmark, "adjusted taxable income," adds back all depreciation; and taxable income for this purpose is regular taxable income, not reduced by the dividends-paid deduction.⁵² The structure could also be used by a non-REIT subsidiary, but the use of a REIT offers the possibility of taking advantage of the domestically controlled exception to the FIRPTA tax on gain from sales of interests in U.S. real property.⁵³

⁴⁷ See REIT FUNDING LLC, www.reit-funding.com (last visited Sept. 19, 2010) (stating that "REIT Funding has a pool of 900+ accredited investors—many of whom are qualified purchasers for purposes of the Investment Company Act of 1940—allowing us to provide 100 shareholders in a fraction of the time it takes to accomplish this elsewhere. . . . Call us today. You'll be amazed at how easy we make it.").

⁴⁸ I.R.C. § 871(h)(3).

⁴⁹ Reg. § 1.871-14(b)(3).

⁵⁰ Reg. § 1.871-14(i).

⁵¹ See I.R.C. § 482.

⁵² I.R.C. § 163(j)(6).

⁵³ See I.R.C. § 1445(b)(3).

3. *Investment by Foreign Investors in Mortgage REITs*

A foreign person invests in shares of a mortgage REIT that buys distressed mortgages to avoid the risk that a direct investment, or an investment through a partnership, would (on account of workouts and renegotiations) cause the investor to be engaged in a trade or business in the United States and have taxable U.S. source income.

A REIT cannot be a financial institution referred to in section 582(c)(2), but that definition is limited, generally, to “banks”⁵⁴ and so is less confining than the rules in section 864, which would treat a foreign person as engaged in a trade or business in the United States if it was in the business of making loans here.⁵⁵ A taxable REIT subsidiary may be used to avoid (or at least significantly mitigate) the risk that such a REIT is a “dealer” with respect to mortgages. The REIT must consider, of course, the issues involved in mortgage modifications and the qualification of distressed debt as a mortgage on real property, which may be more constraining than in the case of a direct investment.⁵⁶

III. Regulated Investment Companies

Moving on from tax-exempt and foreign investors, can regulated investment companies, or RICs, function as blockers or use blockers?

RICs are corporations that, like REITs, eliminate entity-level tax through the dividends-paid deduction. Equity holders in a RIC are shareholders, not partners, and so are not attributed the activities, the assets, or the income of the RIC. RICs must meet gross income and asset tests, which are generally intended to limit their activities to investing and trading in 1940 Act securities.⁵⁷ Before the enactment of the Regulated Investment Company Modernization Act of 2010, dividends were not deductible if “preferential.”⁵⁸ RICs are, in general, the only way that a publicly traded 1940 Act registered entity can eliminate entity-level tax because the “good” income test in the publicly traded partnership rules is not available to a 1940 Act registered entity (with an exception if a principal activity of the partnership is investing and trading in commodities and commodity derivatives).⁵⁹

⁵⁴I.R.C. § 856(a)(4).

⁵⁵*See, e.g.*, G.C.M. 2009-010 (Sept. 22, 2009).

⁵⁶*See, e.g.*, Letter from NAREIT to The Honorable Michael Mundaca, Deputy Assistant Sec’y, U.S. Dep’t of the Treasury, and The Honorable Douglas Shulman, Commissioner, Internal Revenue Serv. (Aug. 12, 2009) (on file with author) (seeking a fixed loan to real estate value ratio (under Regulation section 1.856-5(c)) for mortgages that are modified, and also that the “amount” of a newly acquired distressed mortgage be its adjusted basis (not principal amount)).

⁵⁷I.R.C. § 851(b).

⁵⁸I.R.C. §§ 852, 562(c). The repeal applies to publicly offered regulated investment companies.

⁵⁹I.R.C. § 7704(c)(3).

RICs are important in terms of both the amount of their assets and the size of their presence in the capital markets. According to the Investment Company Institute (ICI),⁶⁰ U.S.-registered investment companies managed \$12.2 trillion in assets at the end of 2009 (because of the financial crisis, this was down from \$13 trillion two years earlier) for some 90 million U.S. investors, representing about a fifth of the financial assets of U.S. households.⁶¹ Investment companies are also important when measured by their stake in the financial markets—about 28% of U.S. corporate equities, 11% of U.S. and foreign corporate bonds, 12% of U.S. Treasury and agency securities, 35% of tax-exempt obligations, and 51% of the commercial paper market. Investment companies accounted for most of the foreign stocks and bonds purchased by U.S. residents.⁶² Examples of the use of a RIC as a blocker, and the use of blockers by a RIC (in addition to the master-feeder structure),⁶³ are discussed below.

A. *Investment in a RIC*

A tax-exempt organization (*e.g.*, a section 401(k) plan), or foreign person if FIRPTA is not a concern,⁶⁴ invests in the shares of a RIC that in turn invests in publicly traded partnerships that produce “good” income and “good” assets for the RIC qualification tests in section 851, and thus block the unrelated business taxable income that would result from a direct investment by the tax-exempt in such partnership.

Investments in publicly traded partnership by RICs are now specifically permitted by a 2004 amendment to section 851(b), enacted at the behest of the publicly traded partnership industry for the purpose of getting access to RICs and, in particular, to the section 401(k) market.⁶⁵ The scope of what is possible under the amendment is restricted by the asset diversification rules that apply to RICs—specifically, the rule in section 851(b)(3)(B) that limits investments in securities of qualified publicly traded partnerships (and certain other securities) to 25% in value of a RIC’s assets, although the use of tiered

⁶⁰A major source of information about RICs is the Investment Company Institute, and its website, INVESTMENT COMPANY INSTITUTE, <http://www.ici.org> (last visited Sept. 20, 2010). Among other things, it publishes each year a fact book; the numbers in the text are from the 2010 Investment Company Fact Book. INVESTMENT COMPANY INSTITUTE, 2010 INVESTMENT COMPANY FACT BOOK 7–10 (50th ed. 2010), available at http://icifactbook.org/pdf/2010_factbook.pdf.

⁶¹All numbers are for the end of 2009. INVESTMENT COMPANY INSTITUTE, *supra* note 60, at 7–10.

⁶²*Id.*

⁶³And the point that expenses of a publicly offered RIC reduce its investment company taxable income, and thus what will be taxed to shareholders, in effect allowing the shareholders a deduction for the expenses without regard to the limitations on itemized deductions. I.R.C. § 67(c)(2).

⁶⁴Publicly traded partnerships outside of the financial sector are heavily invested in assets that would be real property.

⁶⁵I.R.C. § 851(b)(2)(B).

RICs⁶⁶ could presumably increase the upper-tier RIC's exposure to publicly traded partnerships.⁶⁷ For the moment, however, there are practical problems in attracting investments from RICs because of their concerns about state and local taxes on the income from the partnerships and the fact that Schedule K-1s arrive only after the close of the year.

The same principle might apply to income of the RIC from derivatives and the like because the rule in section 851(b)(2)(A) that treats "other income" as "good" income for RIC purposes is broader in significant respects than what would be excluded from unrelated business taxable income by the modifications in section 512(b)—for example, in the case of a tax-exempt organization, income from derivatives is limited to income from notional principal contracts,⁶⁸ absent an IRS determination that other income qualifies; but in the case of a RIC would include, broadly, "other income . . . derived with respect to its business of investing in such stock, securities, or currencies."⁶⁹

B. *Investment by a RIC in a Foreign Corporation*

An example of the use of a blocker by a RIC would be a RIC that invests in the shares of a foreign corporation to block "bad" income—specifically, block the effect of Revenue Rulings 2006-1 and 2006-31, which exclude certain commodity-based income from the "other income" basket of "good" RIC income, by converting such income into dividends, subpart F inclusions or gains from the investment, all of which are "good" income for purposes of the RIC income test.⁷⁰

A RIC's ability to have subsidiaries is constrained somewhat by the asset tests of section 851(b)(3), which limit the value of the RIC's ownership of securities of any one issuer,⁷¹ but within these limits are approved in principle

⁶⁶For example, a RIC, in addition to owning interests in a publicly traded partnership, owns shares of a RIC which in turn owns interests in a publicly traded partnership and owns shares of a RIC which owns, etc.

⁶⁷Alternatively, investments could be made in an exchange-traded fund that tracks publicly traded partnerships, such as JPMorgan Alerian MLP Index ETNs. There are also closed-end funds that focus on investing in MLPs and do not qualify as a RIC (*e.g.*, the SteelPath Funds or the Fiduciary/Claymore MLP Opportunity Fund), but pay relatively little tax because of return of capital distributions from the underlying partnership investments. These target shareholders that do not want Schedule K-1 reporting or unrelated business taxable income. See also the discussion, *infra* Part VI, with respect to alternative investment vehicles and of the structures of Kinder Morgan Energy Partners and Enbridge Energy Partners.

⁶⁸Reg. § 1.512(b)-1(a)(1).

⁶⁹I.R.C. § 851(b).

⁷⁰I.R.C. § 851(b)(2)(A).

⁷¹Section 851(b)(3)(A) would exclude the shares of a subsidiary from the definition of "other securities"; section 851(b)(3)(B) limits the value of the securities of any one issuer (or two or more controlled issuers) to 25% of the value of the RIC's assets.

by a large number of private rulings,⁷² which is not surprising given the private rulings issued to tax-exempt organizations that use foreign blockers (as described *supra* Part II).

C. RICs that Invest in REITs

Prior to the American Jobs Creation Act of 2004, RICs that owned shares of REITs, although U.S. real property holding corporations, avoided some of the FIRPTA rules that applied to REITs, and thus operated in part as “blockers.” In that Act, however, the RIC industry in effect exchanged those advantages for the elimination of withholding tax on interest-related and short-term capital gains paid to foreign shareholders (and an extension to RICs of the domestically controlled REIT rule).⁷³ Both RICs and REITs are now “qualified investment entities,” and thus both are entitled to the benefits of the domestically controlled entity rule discussed above and the rule that excludes from FIRPTA (but not regular dividend withholding tax) distributions out of gains from dispositions of interests in U.S. real property that are made to 5% or smaller holders of shares regularly traded on an established U.S. securities market. Because U.S. tax treaties draw no distinction between RICs that are U.S. real property holding corporations and those that are not, however, a RIC that invests solely in equity REITs benefits from the somewhat better treaty relief from withholding on dividends than does a REIT.⁷⁴ Thus, the rate reduction to 15% applies to any dividends paid by a RIC but is limited in the case of a REIT to dividends paid to an individual owning a 10% or smaller interest in the REIT, dividends paid on a class of publicly traded shares to a holder of 5% or less of any class of the REIT’s stock, and dividends paid to a holder of 10% of the REIT if the REIT is diversified.⁷⁵

IV. What Can Be Done?

If we stopped here, could we conclude that there are at least partial solutions to the use of “blockers” or “stoppers,” assuming that a decision was made to address the issue in the first place? For example, would changes to the acquisition indebtedness rules in section 514 be a fix to some of the blocker

⁷² See, e.g., P.L.R. 2010-34-011 (Aug. 27, 2010); P.L.R. 2010-300-04 (July 30, 2010); P.L.R. 2010-26-017 (July 2, 2010); P.L.R. 2010-25-031 (Feb. 23, 2010); P.L.R. 2009-46-036 (July 8, 2009); P.L.R. 2009-39-017 (June 4, 2009); P.L.R. 2009-36-002 (May 26, 2009); P.L.R. 2009-32-007 (Apr. 29, 2009); P.L.R. 2009-12-003 (Nov. 19, 2008); P.L.R. 2008-40-039 (June 13, 2008); P.L.R. 2008-42-014 (July 17, 2008). Alternatively, RICs have invested in commodity-linked notes that are 1940 Act securities. See, e.g., P.L.R. 2009-52-019 (Sept. 13, 2009); P.L.R. 2009-46-036 (July 8, 2009); P.L.R. 2009-39-017 (June 4, 2009); P.L.R. 2009-36-002 (May 26, 2009); P.L.R. 2009-31-008 (Apr. 16, 2009); P.L.R. 2009-31-003 (Apr. 16, 2009).

⁷³ See Robert J. Staffaroni, *Foreign Investments in RICs and REITs*, 56 *Tax Law.* 511, 534–35 (2003).

⁷⁴ Another treaty and Code anomaly is the disparate treatment of dividends paid by RICs and mortgage REITs—a pure mortgage REIT may not be much different from a RIC that invests in nonmortgage debt securities.

⁷⁵ E.g., U.S. Model Income Tax Convention art. 10(4), Nov. 15, 2006.

issues? Certainly the use of blockers to avoid debt-financed income points up the need to consider revisiting the debt-financed acquisition rules that were enacted in the wake of *Clay Brown* and, by general consensus, are both overbroad⁷⁶ and too narrow.

The rules are overbroad because they apply in cases, such as conventional investments in publicly traded shares, where the tax-exempt organization is not providing value to other parties through its tax exemption (unlike the tax-exempt in *Clay Brown*, which was sharing its tax exemption with the former owners of the purchased business); the rules are too narrow because they ignore synthetic debt (e.g., total return equity swaps or, more recently, “endowment” contracts).⁷⁷

Simply eliminating the debt-financed rules for investments in an “investment fund,” as has been suggested,⁷⁸ would go way too far; and, by creating a sharp disparity between investment fund and non-investment fund investments (including direct investment) would much expand the selective use of entities to avoid section 514. The more limited exclusion proposed by House Resolution 3497 on July 31, 2009 (for limited partners in partnerships that incur debt to acquire or carry securities or commodities) would likewise create disparities based solely on the form of an investment—that is, as a limited partner in a limited partnership. Complete repeal of section 514 would be a more sensible approach, if the overbreadth was a sufficient reason to do so and there was no appetite to deal with synthetic debt. A more targeted approach, narrowing section 514 to focus on the nature of the financed assets and terms of the debt, might have the same problems as under present law (e.g., REITs might still be used to block income that was debt-financed within a narrower definition). Revising section 514 would in any case mean dealing with synthetic debt, such as equity swaps, endowment contracts, and options that are the economic equivalent of nonrecourse debt. Keep in mind that any pass-through entity (such as a partnership or a RIC) can achieve the equivalent of debt financing by issuing equity that functions as debt (and thus completely falls out of the rules in section 514)⁷⁹ and that this should also be considered in any revision of section 514.

Another possible step would be to provide a look-through to the underlying assets and income of controlled corporations and to conform the definition

⁷⁶See generally N.Y. STATE BAR ASS'N, REPORT ON SECTION 514: DEBT-FINANCED INCOME SUBJECT TO UBIT (2010); *Offshore Tax Issues: Hearing Before the S. Comm. on Finance*, 110th Cong. (2007) (statement of Suzanne Ross McDowell, Partner, Steptoe & Johnson LLP); Suzanne R. McDowell, *Taxation of Unrelated Debt-Financial Income*, 34 EXEMPT ORG. TAX REV. 197 (2001).

⁷⁷On endowment contracts see P.L.R. 2009-52-059 (Sept. 30, 2009), P.L.R. 2009-51-037 (Sept. 23, 2009), P.L.R. 2009-47-065 (Aug. 29, 2009), P.L.R. 2009-22-061 (Mar. 5, 2009), and P.L.R. 2009-19-056 (Feb. 13, 2009); on notional principal contracts see Regulation section 1.512(b)-1(a)(1).

⁷⁸Kimberly S. Blanchard, *Repeal the Debt-Financed Rule as Applied to Exempt Investors in Funds*, 2009 TAX NOTES TODAY 172-11 (Sept. 9, 2009).

⁷⁹For example, a closed-end RIC that issues debt-like preferred stock.

of "good income" for purposes of the RIC qualification rules, the definition of income that is covered by the trade-or-business safe harbors in section 864(b), and other rules.

Take swaps and derivatives as an example.⁸⁰ "Good" income for a RIC (as previously noted) broadly includes "other income (including but not limited to gains from options, futures, or forward contracts)" so long as it is "derived with respect to its business of investing" in stocks, securities, or currencies, and so would include income from swaps and other derivatives derived from that business, but not from investing in commodities.⁸¹ Although REITs may have a significant amount of non-real estate investment income and may also hedge real estate investments, there is no rule of similar breadth—the only rules on derivatives entered into by REITs relate to hedges of debt incurred to acquire real estate, transactions that manage the risk of foreign currency fluctuations, and foreign currency gains.⁸² In the case of a tax-exempt organization, the modifications in section 512(b) exclude income from notional principal contracts—but income from other derivatives is excluded only if it is "substantially similar" to that income, is from "ordinary and routine investments," and has been "determined by" the Service to so qualify.⁸³ The same rule is used under the "good" income test that applies to a publicly traded partnership, but (except in a case where the income is derived in connection with investments in stocks, securities, or currencies)⁸⁴ only if what "measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership."⁸⁵ And in the case of a foreign investor in stocks and debt securities, whether entering into derivatives is covered by the trade or business safe harbors in section 864(b) depends on whether that can be viewed as an "activity closely related" to the buying, selling or trading in shares, debts instruments or options on shares or debt instruments.⁸⁶ Proposed regulations would expand the rules to include "effecting transactions in derivatives for the taxpayer's own account, including hedging transactions," but these will be effective only when adopted, were proposed in 1998, and seem to be permanently on hold.⁸⁷

⁸⁰ Other examples might be the divergent definitions of good rents in the case of a REIT and a tax-exempt organization or of commodities in the section 864(b) safe harbors and in the publicly traded partnership rules of section 7704.

⁸¹ See Rev. Rul. 2006-1, 2006-1 C.B. 262; Rev. Rul. 2006-31, 2006-1 C.B. 1133.

⁸² I.R.C. § 856(c)(5)(G), (n). These exclude the income from gross income for the purposes of either or both of the two gross income tests, *i.e.*, it is neither in the numerator nor the denominator. Additionally, REITs could, like any entity, use the hedging rules to integrate hedges with debt owned by the REIT.

⁸³ Reg. § 1.512(b)-1(a).

⁸⁴ See I.R.C. § 7704(d)(4).

⁸⁵ Reg. § 1.7704-3(a)(1).

⁸⁶ Reg. § 1.864-2(c)(2)(i)(c).

⁸⁷ Prop. Reg. § 1.864(b)-1, 63 Fed. Reg. 32, 164 (1998). Additional rules apply if the investments are in commodities.

The point is that all of the definitions differ, without any clear purpose for the differences, and thus encourage the selective use of entities. Developing consistent definitions of “good” income in the pass-through entity provisions would be a positive step towards the elimination of complexity.⁸⁸ This might, however, lead to the conclusion that income from publicly traded partnerships should be “bad” income for RICs and should continue to be “bad” income for foreign investors, as well as to other rules that would narrow for particular entities what is “good” income.

But simply working on section 514 and the “good” income rules would not address all of the issues raised by the blockers described above (*e.g.*, the use of the domestically controlled REIT rules or the aberrational interpretation of portfolio interest in the case of a partnership lender), and would not address the further issues raised by the additional illustrations of “blockers” and “stoppers” that are set out below.

V. Publicly Traded Partnerships

Publicly traded partnerships, as defined in section 7704(a) and the related regulations, are treated as corporations unless, for the current and all preceding taxable years in which there was public trading in interests in the partnership, 90% or more of the partnership’s gross income was described in section 7704(c) and the partnership was not registered under the 1940 Act.⁸⁹ The definition of “good” income in section 7704(c) is quite broad, and there are over 100 publicly traded partnerships in the oil and gas, pipeline, hard minerals, timber, and other industries that generate “good” income and thus are not corporations. More recently, financial industry players (such as KKR, Ziff-Ochs, Fortress, and Blackstone) have also become publicly traded partnerships.⁹⁰ Publicly traded partnerships have a significant capital markets presence and today consist largely of partnerships that were formed after the 1987 enactment of the publicly traded partnership rules. The growth of publicly traded partnerships has been significant—more than tenfold in the case of “energy” publicly traded partnerships, from 7 with a market capitalization of \$1 billion, to 78 with a market capitalization of \$147 billion over 13 years.⁹¹ Growth is expected to continue despite the fact that subchapter

⁸⁸ See 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 TAX LAW. 95 (1999).

⁸⁹ I.R.C. § 7704(a)–(c).

⁹⁰ See NAT'L ASS'N OF PUBLICLY TRADED P'SHIPS, <http://www.naptp.org> (last visited Nov. 20, 2010). Additionally, some exchange-traded funds investing in commodities and commodity derivatives (*e.g.*, PowerShares DB Multi-Sector Commodity Trust, which consists of separate trusts, classified as partnerships, that invest in energy, oil, precious metals, gold, silver base metals, and agriculture derivatives) are publicly traded partnerships and meet the “good” income test.

⁹¹ See Wachovia Capital Mkts., LLC, *MLP Primer—Third Edition: Everything You Wanted to Know About MLPs, But Were Afraid to Ask*, NAT'L ASS'N OF PUBLICLY TRADED P'SHIPS (July 14, 2008), http://www.naptp.org/documentlinks/Investor_Relations/071508wachoviaprimer.pdf.

K was not designed for, and does not easily accommodate, public trading in partnership interests.⁹²

Blockers are used with partnerships both to block public trading in interests in the partnership and, if the partnership is publicly traded, to block income that, if received directly by the partnership, would not be “good” income for purposes of the exception in section 7704(c).⁹³

A. “Blocking” Public Trading

It is now accepted that, because of the definition of public trading in the section 7704(a) regulations, a single economic enterprise that is publicly traded in part need not be subject to corporate tax on all of its income—notwithstanding that it does not as such qualify as a REIT or a RIC, and that its income falls out of the definition of good income in section 7704(c).⁹⁴

Specifically, there is no look-through to trading in the equity interests in a partner in determining whether the underlying partnership is publicly traded. As a consequence, a publicly traded corporation, which may be a RIC or a REIT or not, may own interests in a partnership and block public trading in the interests in the partnership.⁹⁵

1. UpREITs and DownREITs

This started, of course with UpREIT and DownREIT structures—that is, REITs that own only, or significantly, general partnership interests in partnerships that are otherwise owned by partners that are not REITs. Public trading in the shares of the REIT does not make the partnership publicly traded, which makes sense if one assumes that the assets and income of the partnership could have been owned or earned directly by the REIT without affecting its qualification as a REIT or owned and earned directly by a publicly traded partnership without triggering section 7704(a). In other words, the UpREIT structure was not driven by the avoidance of entity-level tax as opposed to the tax concerns of the investors—specifically, the investment company exception to section 351(a) that is in section 351(e) and, if it applied (on the theory that there was a “constructive” transfer to the REIT),

⁹²Among the many tax issues are (1) the inability to associate capital accounts with particular partnership interests, (2) the difficulty of allocating partnership income, gain, or loss when interests are traded frequently, (3) the possibility that trading will trigger the partnership termination rule in section 708(b)(1)(B), and (4) the complexity of implementing a section 754(c) election. Additionally, partnership interests are not section 1236(c) securities and thus are not covered by the rules on securities lending.

⁹³I.R.C. § 7704(c).

⁹⁴I.R.C. § 7704(a), (c).

⁹⁵The regulations specifically say that an interest in a partnership or a corporation, including a RIC or a REIT, that holds an interest in a partnership (the lower-tier partnership) is not considered to be an interest in the lower-tier partnership. Reg. § 1.7704-1(a)(2)(iii). UpREIT structure is blessed as avoiding the “investment company” rule in section 721(b), and seemingly otherwise, by Example (4) of Regulation section 1.701-2(d).

would cause the non-REIT investors in the partnership to recognize gain on their transfers of property to the REIT.⁹⁶

2. Master-Feeder Structures

In a master-feeder (or hub and spoke) structure, RICs are feeders (or “spokes”) in a structure in which the master (or “hub”) fund, organized as a trust, is classified as a partnership. These structures are common, driven by economies of scale in portfolio management, simplicity in comparison to a single multi-class fund, and sometimes by the goal of allowing direct foreign investment in the partnership through investment in a foreign feeder (as opposed to investment through a RIC).⁹⁷

One could, on the same reasoning applied above to UpREITs and DownREITs, conclude that there is nothing offensive in saying that a partnership is not publicly traded because one or more of its partners is a publicly traded RIC. The partnership assets and income will be taken into account in determining whether the RIC meets the qualification requirements and so avoidance of entity-level tax is not the purpose. It does take the UpREIT analysis one step further, however, because the “good” income exception to the publicly traded partnership rules would not be available to the master or hub if it was registered under the 1940 Act.⁹⁸

But there are other issues involved in master-feeder structures that deserve some thought. Whether dividends paid by a RIC are “preferential” within the meaning of section 562(c), and thus nondeductible until the law was changed at the end of 2010, was an important issue for RICs.⁹⁹ The master-feeder structure operated as a way of blunting the preferential dividend rule. Specifically, the determination of whether a dividend is preferential was made at the RIC level, and the master-feeder structure (as opposed to a single RIC with many more classes of shares than if it was not part of such a structure) thus mitigated the preferential dividend issue that may come up because of differential expense allocations among classes of shares.¹⁰⁰ Additionally, if

⁹⁶The UpREIT/DownREIT structures provide the non-REIT investors with an option at some point to achieve liquidity by exchanging their interests in the partnership for shares of the REIT or cash. The non-REIT investors defer tax until there is an exchange.

⁹⁷SUSAN A. JOHNSTON & JAMES R. BROWN, *TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS* ¶ 8.03 (WG&L 2000).

⁹⁸I.R.C. § 7704(c)(3).

⁹⁹Section 562(c) provides that a distribution is not a dividend for purposes of the deduction “unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent the former is entitled . . . to such preference,” with a narrow exception for variations in “administrative expenses” of a RIC distributions in the case of shareholders which made initial investments of \$10 million or more. After much agony, the Service set out guidelines for determining whether allocations of expenses within and among classes of shares create preferential dividends. *See* Rev. Proc. 1996-47, 1996-2 C.B. 338; Rev. Proc. 1999-40, 1999-2 C.B. 565.

¹⁰⁰JOHNSTON & BROWN, *supra* note 97, ¶ 8.03[2] n.59.

foreign investors invest in a feeder that is a foreign corporation, and is not regarded as doing business in the United States because of section 864(b), the complexity of investing in a RIC (*i.e.*, the withholding tax rules that apply to capital gain, and interest-related and short-term capital gain dividends) has been eliminated (although the benefit of the expense allocation allowed by Revenue Ruling 2005-31 has been lost).¹⁰¹

3. *UpREIT Structures Outside of Real Estate and Investing in Securities*

The UpREIT and master-feeder structures are, of course, used outside of real estate and investing in stocks and securities—for example, a publicly traded corporation owns only limited partnership interests in a limited partnership that is otherwise owned by others. This too is blessed by the definition of public trading in the section 7704 regulations.¹⁰² But the stakes here are quite different than in the case where the partner is a REIT or RIC. This use of the UpREIT structure allows a single economic enterprise to operate both as a partnership that is not subject to entity-level tax because it is not publicly traded, and as a partnership that is subject to entity-level tax, as a corporation, on its share of the underlying partnership’s income—a sort of hybrid entity. Is this appropriate tax policy?

B. *Blocking “Bad” Income: Ownership of a Corporate Subsidiary*

A second example of blockers and publicly traded partnerships is the case, now common, where a publicly traded partnership invests in the shares of a corporation to avoid having income that is not “good” income for purposes of section 7704(c) (*i.e.*, that is earned by the corporation). If the corporation is domestic, it seeks to eliminate U.S. tax on the income of the corporation by interest expense (which, together with dividends from the corporation, is “good” income). Deductible payments to the partnership are not constrained by the rules that apply to payments by a taxable REIT subsidiary.¹⁰³ If the corporation is foreign, the partnership, assuming it is not registered under the 1940 Act, relies on the cross-reference in the “good” income rules of section 7704(c) to the “other income” described in section 851(b)(2)(A) to cover inclusions from controlled foreign corporations and passive foreign investment companies, as well as dividends and gains from the sale of shares of such corporations—a structure that has been approved in private rulings.¹⁰⁴

¹⁰¹Revenue Ruling 2005-31, 2005-1 C.B. 230, allocates expenses away from short-term capital gain and capital gain dividends, thus permitting a disproportionate allocation of expenses against interest-related income and other dividends.

¹⁰²Reg. § 1.7704-1(a)(2)(iii) (relating to tiered entities).

¹⁰³Section 857(b)(7) imposes a 100% tax on redetermined rents, redetermined deductions, and excess interest expenses of a taxable REIT subsidiary. Interest paid by such a subsidiary to the REIT is also subject to the earnings-stripping rules.

¹⁰⁴P.L.R. 2007-28-025 (Mar. 23, 2007); P.L.R. 2007-22-007 (Feb. 26, 2007) (both involving publicly traded partnership formed to invest in collateralized debt obligations (CDOs), but also owning foreign corporations that were CDO issuers).

Legislative proposals (now seemingly asleep) may prevent this in the case of income from advisory and other specified services with respect to assets held directly or indirectly by the partnership.¹⁰⁵

C. Taxable REIT Subsidiaries

The “hybrid tax rate” enterprise that results from blockers and publicly traded partnerships has a parallel in the now widespread use by REITs of taxable REIT subsidiaries.¹⁰⁶ The publicly traded REIT industry is not comparable in size to the RIC industry but the market capitalization is significant—close to \$500 billion at its pre-financial crisis peak.¹⁰⁷ Private (*i.e.*, non-publicly traded REITs) are also significant, as are so-called public nontraded REITs which, although they issue shares in registered offerings, are not publicly traded. There has been significant growth in equity REITs over the last 20 years, possibly reflecting the increased extent to which REITs may, through taxable REIT subsidiaries, provide services to tenants and manage and operate properties, as well as other changes in the tax law.

Qualification as a REIT requires, among other things, that the REIT meet specific asset and income tests, generally restricting its non-real estate activities and limiting the direct conduct of its real estate activities to investing in real property and real property mortgages and “passive” leasing. The restrictions were significantly relaxed by a 1999 amendment, which allows, within limitations, a REIT to have taxable REIT subsidiaries.¹⁰⁸ A taxable REIT subsidiary is any corporation in which the REIT owns stock, directly or indi-

¹⁰⁵The American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. (2010), passed by the House in May 2010 but rejected by the Senate, would exclude from “good” income any income from a partnership that is treated as ordinary income under the “carried interest” provision of the bill, but with a ten-year delay in the effective date. The bill also provides exceptions for (1) certain UpREITs and Down REITs (specifically, a partnership that is publicly traded because its interests are convertible in shares of a REIT that owns 50% or more of the partnership and which meet the income and asset tests that apply to a REIT), and (2) a partnership that owns interests in other publicly traded partnerships if substantially all of its income is ordinary or is section 1231 gain.

¹⁰⁶A drafting alternative to taxable REIT subsidiaries might have been to allow REITs to earn non-real estate income within restrictions and then to impose tax on the non-real estate income.

¹⁰⁷For information on the industry see NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS (NAREIT), <http://www.nareit.org> (last visited Nov. 20, 2010), and from there access specific publicly traded REITs. The financial crisis hit the industry hard. According to NAREIT statistics, the number of public REITs declined from 183 (at the end of 2006) to 136 (at the end of 2008)—about the level in 1991; the market capitalization declined over this period from \$438 billion to \$191.6 billion—about the level in 2003. Some recovery did occur in 2009—142 public REITs, with a market capitalization of \$271.2 billion. *Historical REIT Industry Market Capitalization: 1972–2009*, NAT’L ASS’N OF REAL ESTATE INV. TRUSTS, <http://www.reit.com/IndustryDataPerformance/MarketCapitalizationofUSREITIndustry.aspx> (last visited Nov. 20, 2010).

¹⁰⁸REIT Modernization Act of 1999, Pub. L. No. 106-170, 113 Stat. 1860 (pt. II, subpt. A).

rectly, if the corporation and the REIT so elect, and any corporation in which a taxable REIT subsidiary owns 35% or more in voting power or value.¹⁰⁹

There is no restriction on the activities of a taxable REIT subsidiary. It may manage and operate real property, which was the purpose of the taxable REIT subsidiary provision; it can also do anything else that makes business sense. The restrictions relate to the extent to which a REIT’s assets may consist of securities of such a subsidiary, on rentals by the REIT to the subsidiary, and on the pricing of transactions between the REIT and the subsidiary. Taxable REIT subsidiaries are widely used.¹¹⁰

1. *Investment in a Taxable REIT Subsidiary*

A REIT owns the shares of a taxable REIT subsidiary to avoid the restrictions on what it can do directly, *i.e.*, to block the exclusion in section 856(d) from “good” income of “impermissible tenant services” income. There are statutory restrictions in section 856(c)(8) on the ability to “strip” the taxable REIT subsidiary’s tax base with rent, interest, and other deductible payments, and also in the case of interest in the earnings-stripping rules (*i.e.*, section 163(j)(3)(C)); the income and asset tests of section 856(c) also restrict the extent to which a REIT may hold shares of a taxable REIT subsidiary and receive dividends and nonmortgage interest from such a subsidiary.¹¹¹ Within those constraints, however, a taxable REIT subsidiary can do whatever is desired. The taxable REIT subsidiary rules are an explicit recognition or encouragement of the use of blockers by a pass-through entity, at least where the income of the blocker is subject to tax.

D. *The Partnership “Anti-Abuse” Regulations*

The example in the regulations that blesses the UpREIT structure is in the partnership “anti-abuse” regulations adopted in 1994.¹¹² These regulations,

¹⁰⁹I.R.C. § 856(l). There is an exclusion for certain corporations operating or managing lodging or health care facilities.

¹¹⁰See Thornton Matheson, *The Development of Taxable REIT Subsidiaries, 2001–2004*, 27 STAT. INCOME BULL. 96–98 (2008), <http://www.irs.gov/pub/irs-soi/01-04coreitbul.pdf> (reporting that there was “rapid growth” in the number, assets, and income of taxable REIT subsidiaries during the period covered, and that in 2004 there were 704 taxable REIT subsidiaries with \$68.2 billion of assets and \$10 billion in profits).

¹¹¹The restrictions are on taxable REIT subsidiaries: (a) not more than 25% of the assets of a REIT can be represented by stock or other securities of any taxable REIT subsidiary, but within that limitation a REIT can have more than 5% in value of its assets in stock or other securities of a taxable REIT subsidiary and can own more than 10% in voting power and value of the stock or other securities of a taxable REIT subsidiary; (b) the stock or other securities of taxable REIT subsidiaries are taken into account in determining whether more than 25% of the assets of the REIT are securities (other than government securities, cash, cash items, interests in REMICs, and shares of other REITs) and thus reduce the room allowed for other nonreal estate investments; and (c) dividends from taxable REIT subsidiaries are “good” income only for purposes of the 95% of gross income test, not the 75% of gross income test. I.R.C. § 856(c)(4).

¹¹²T.D. 8599, 1995-2 C.B. 12.

together with the subsequent adoption of the check-the-box regulations, are in fact an important source for the view that there is nothing wrong in the selective use of the entity classification rules and that “economic substance” is not involved in the choice of legal entity. Apart from the UpREIT and S corporation examples (discussed, respectively, above and below), the anti-abuse regulations give a further example: a 50–50 venture between a U.S. and a foreign corporation that is organized as a U.S. partnership so that the U.S. corporation can take a direct foreign tax credit for its share of the partnership’s foreign taxes (rather than the indirect credit that would be available if the venture were organized as a foreign corporation).¹¹³ A U.S. partnership may also be used by investors who want to opt out of the PFIC provisions (and, albeit, into the CFC provisions) under the “overlap” rule in section 1297(d).¹¹⁴ The regulations can also be read as broadly sanctioning the use of a partnership for whatever tax purpose the partners may have in mind, so long as the partnership is real¹¹⁵ and does not “abuse” subchapter K or a specific rule outside of subchapter K.

VI. Alternative Investment Vehicles

“Alternative investment vehicles” are entities that avoid the allocation to foreign or tax-exempt partners of effectively connected or other “bad” income that might be earned by a partnership by segregating the income, sometimes in a separate partnership, and not allocating it to foreign or tax-exempt partners. This is common in the fund world.

There are also taxpayer-specific alternative investment structures. For example, Kinder Morgan Energy Partners, a publicly traded partnership seeking to attract investment from RICs and tax-exempt and foreign investors, is owned in part (about 30%) by Kinder Morgan Management, a publicly traded limited liability company that has elected to be a corporation for tax purposes.¹¹⁶ Shares of that corporation are purchased by those investors. Kinder Morgan Management, which has been delegated the management rights of the general partner, owns a special class of interests in Kinder Morgan Energy Partners (the “i-units”) that receive additional units to match in value the cash distributions made on the publicly traded class of interests in Kinder Morgan Energy Partners (the “common units”) and are not entitled to any allocation of income, gain, loss, or deduction until the liquidation of Kinder Morgan Energy Partners (at which time there will be an allocation that will equalize the capital accounts of the i-units with the capital accounts of the common units). Kinder Morgan Management takes the view that it will have no mate-

¹¹³ Reg. § 1.701-2(d), Ex. (3).

¹¹⁴ P.L.R. 2011-08-020 (Nov. 8, 2010).

¹¹⁵ *Id.* Ex. (1).

¹¹⁶ See KINDER MORGAN, <http://www.kindermorgan.com> (last visited Sept. 21, 2010).

rial amount of taxable income until that point.¹¹⁷ Tax-free stock dividends are paid to holders of interests in the publicly traded corporation to match the distribution to the corporation of additional units. Essentially the same structure is used by another significant publicly traded partnership, Enbridge Energy Partners, LP, and its general partner, Enbridge Energy Management, LLC.¹¹⁸

A different example, in the publicly traded partnership industry, but not of an alternative investment vehicle, is Navios Maritime Partners LP, a Marshall Islands, NYSE-listed partnership headquartered in Greece that is engaged in the ownership and chartering of drybulk vessels.¹¹⁹ Its income is generally exempt from U.S. or foreign tax, as income from the operation of ships, and it elects for U.S. tax purposes to be a corporation. As a consequence, U.S. shareholders, whether tax-exempt or otherwise, take into account only dividends paid, and the dividends are "qualified" dividends (unless extraordinary), assuming that its income from time charters is from services, not rents, and that it is not a passive foreign investment company.¹²⁰

VII. S Corporations

Is there any role for blockers in the S corporation world? S corporations are a significant part of the business economy. The Service's Statistics of Income (SOI) indicate that "S corporations continue to be the most prevalent type of corporation."¹²¹ They are hugely popular—in 2003,¹²² S corporations

¹¹⁷ There are also exchange-traded notes tied to an index of MLPs. Eric Ryan, *Bear Stearns Lists BearLinx Aleria MLP Select Index ETN on NYSE*, N.Y. STOCK EXCH. (July 20, 2007), <http://www.nyse.com/press/1184928629497.html>. Additionally, as noted above, there are closed-end funds (e.g., the SteelPath Funds and the Fiduciary/Claymore MLP Opportunity Fund) that invest in publicly traded partnerships and are taxable, but rely on the relatively low rate of tax that results from distributions not out of taxable income.

¹¹⁸ See ENBRIDGE ENERGY MGMT., <http://www.enbridgemanagement.com> (last updated 2010). Distributions by taxable closed-end funds that invest in publicly traded partnerships are taxable to the extent out of earnings and profits.

¹¹⁹ See NAVIOS MARITIME PARTNERS, <http://www.navios-mlp.com> (last visited Sept. 21, 2010).

¹²⁰ *2009 Unit Distributions U.S. Tax Treatment*, NAVIOS MARITIME PARTNERS, <http://navios-mlp.irwebpage.com/files/UnitDistributionsTaxTreatment.pdf> (last visited Sept. 21, 2010).

¹²¹

For Tax Year 2003, about 61.9 percent of all corporations filed a Form 1120S. The total number of returns filed by S corporations for Tax Year 2003 increased 5.9 percent to nearly 3.3 million, from nearly 3.2 million reported in Tax Year 2002. S corporations became the most common corporate entity type in 1997.

SOI Tax Stats—S Corporation Statistics, INTERNAL REVENUE SERVICE, <http://www.irs.gov/tax-stats/bustaxstats/article/0,,id=96405,00.html> (last visited Sept. 21, 2010).

¹²² The most recent year for which such statistics are available. Kelly Luttrell, Patrice Treubert & Michael Parisi, *Integrated Business Data, 2003*, INTERNAL REVENUE SERVICE, 48 (2003), <http://www.irs.gov/pub/irs-soi/03intbus.pdf>. While S corporations represent a smaller percentage of the corporations with business receipts over \$5 million, they represent about 30% of those with business receipts over \$50 million, an increase of about 7% over the prior year (as opposed to about 1% for "C" corporations).

accounted for about 62% of all corporate income tax returns, reflecting a 36.3% increase in the prior six years.¹²³ Partnerships were a less popular choice than S corporations for businesses formed in each of the years 1997 through 2002, but pulled slightly ahead (42.6% vs. 39.4%) in 2003 with limited liability companies taking the lead in the case of partnerships and representing in 2003 about 46% of all newly formed partnerships.¹²⁴

S corporations are, of course, corporations that elect to be so treated, with the general consequence that the electing corporation is exempt from tax and its income, gain, and loss pass through shareholders as though they were partners in a partnership.¹²⁵ Qualification requires, among other things, that there be no more than 100 shareholders (treating all members of a family as one for this purpose) and that the shareholders are individuals who are not nonresident aliens or are specified trusts, estates, and tax-exempt organizations.¹²⁶ As the S corporation rules have evolved, the restrictions on operations (such as earning foreign income or owning subsidiaries) have largely been eliminated, leaving only the shareholder-level qualification requirements.

How serious are the numerical and other shareholder limitations on eligibility to be an S corporation?

A. *Partnership to Accommodate Ineligible Shareholders*

An S corporation cannot have a nonresident alien as a shareholder, so instead it carries on its business through a partnership in which nonresident aliens are partners (and presumably have rights that make them economically equivalent to shareholders of the S corporations). This is blessed by Example (2) of Regulation section 1.701-2(d), the partnership anti-abuse regulations. And if this works for a nonresident alien, why not when a “C” corporation or other ineligible person wants to have an equity interest in the business carried on by the S corporation? And if S corporations can be partners in partnerships, special allocations of partnership income, gain, or loss could have the effect of side-stepping the apparent purpose of the requirement in section 1361(b)(1)(D) that an S corporation have only one class of stock.

¹²³Dominated by wholesale and retail trade, professional and other services, construction, and manufacturing (but these statistics do not reflect the ability of banks to be S corporations). *Id.* at 49–51.

¹²⁴In addition to the SOI, see *Filing Characteristics and Examination Results for Partnerships and S Corporations*, TREASURY INSPECTOR GEN. FOR TAX ADMIN. (Aug. 28, 2006), <http://www.treas.gov/tigta/auditreports/2006reports/200630114fr.pdf>.

¹²⁵I.R.C. §§ 1361–79; see also Martin A. Sullivan, *Passthroughs Shrink the Corporate Tax by \$140 Billion*, 130 TAX NOTES (TA) 987 (Feb. 28, 2011).

¹²⁶While most tax-exempt shareholders of an S corporation must treat their shares of its income as unrelated business taxable income, there is an exception for shareholders that are ESOPs. See I.R.C. § 512(c).

B. *Partnership to Increase Numerical Limit on Shareholders*

The numerical limitation on the shareholders that an S corporation may have has increased over time from 15 to 100, treating all members of a family as one, but it is still possible that the numerical limitation might be exceeded. In such a case, could there be several S corporations, each a partner in a single business? This is blessed by Revenue Ruling 1994-43—reversing the position previously taken by the Service in Revenue Ruling 1977-220.¹²⁷ Stating that the purpose of the numerical restriction is “administrative simplicity,” Revenue Ruling 1994-43 says that “administrative simplicity is not affected by the corporation’s participation in a partnership with other S corporation partners; nor should a shareholder of one S corporation be considered a shareholder of another S corporation because the S corporations are partners in a partnership.”¹²⁸ The revoked ruling, which went the other way, was based on the motive for the structure—that is, that “the principal purpose for organizing the separate corporations was to make the” S corporation election.¹²⁹

VIII. **Structured Finance**

The use of tiered entities in structured finance is also common, essentially to staple interests in cases where for tax reasons interest in a single entity would not work.

A. *Real Estate Mortgage Investment Conduits or REMICs*

One example would be a tiered real estate mortgage investment conduit (REMIC). REMICs are used to securitize real property mortgages, as previously noted.¹³⁰ Qualification requires that an asset test be met (generally, a fixed pool of real property mortgages), that regular interests—of which there can be as many classes as desired—satisfy certain requirements with respect to interest payments, and that there be only one class of residual interests.¹³¹ The income from the mortgages and the REMIC assets is reduced by interest and original issue discount on the regular interests, which are always treated as debt, and the balance of the taxable income from the assets is attributed to the holder (or holders) of the residual interest (or interests).

In a tiered REMIC structure, for example, an upper-tier REMIC issues regular interests based on regular interests in the lower-tier REMIC that, because of the definition of what are acceptable payments of interest on a regular interest in a REMIC, could not have been issued directly by the lower-

¹²⁷Rev. Rul. 1994-43, 1994-2 C.B. 198.

¹²⁸*Id.*

¹²⁹*Id.*

¹³⁰The rules are set out in sections 860(a)–(d) and in section 7701(i), relating to taxable mortgage pools.

¹³¹Section 860G(a)(1) defines regular interests.

tier REMIC.¹³² In other words, the tiering is tax-driven—that is, driven by the limitations imposed by the definition of a regular interest. This is approved by the regulations which provide that a

REMIC (or two or more REMICs) and one or more investment trusts can be created pursuant to a single set of organizational documents and the separate existence of the REMIC(s) and the investment trust(s) will be respected for federal income tax purposes even if for state law purposes or for federal securities law purposes those documents create only one organization.¹³³

The regulations go on to say that the documents must require the tiers “to account for items of income and ownership of assets” in a way that “respects the separate existence of the multiple entities.”¹³⁴

1. *Fixed Investment Trusts*

Other examples of tiered structures in structured finance include the use of fixed investment trusts. Fixed investment trusts are trusts described in Regulation section 301.7701-4(d). They are grantor trusts for tax purposes,¹³⁵ and thus the income and assets of the trust are treated as the income and assets of the trust beneficiaries. Qualification as a fixed investment trust requires that there be no power to vary the investment of the certificate holders (*i.e.*, that the assets be a fixed pool of passive assets, such as mortgages and other debt instruments, royalties, or equities, and that, with exceptions, there is only one class of beneficial interests).

Fixed investment trusts are of course used outside of mortgage and other securitizations and, where available, are perceived to have reporting and other advantages over publicly traded partnerships and RICs. Outside of securitizations, there are (1) significant publicly traded fixed investment trusts that hold mineral royalty interests, typically overriding royalties on oil and gas measured by net profits,¹³⁶ (2) exchange-traded funds that are fixed invest-

¹³² See, *e.g.*, JAMES A. PEASLEE & DAVID Z. NIRENBERG, *THE FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS* 509–14 (3d ed. 2001) (defining a regular interest in section 860G(a)).

¹³³ Reg. § 1.860F-2(a)(2)(ii).

¹³⁴ Reg. § 1.860F-2(a)(2); see also Reg. § 1.860G-1(2)(v) (contemplating tiers of REMICs); P.L.R. 1991-48-040 (Aug. 29, 1991).

¹³⁵ Reg. § 1.671-2(e)(3).

¹³⁶ But also on other minerals (*e.g.*, Mesabi Trust, Great Northern Iron Ore Trust, and Penn Virginia Resources) and copyrights (Mills Music Trust). The oil and gas trusts ordinarily hold net profits overriding royalties—these include BP Prudhoe Bay Royalty Trust, Cross Timbers Royalty Trust, Dominion Resources Black Warrior Trust, Easter American Natural Gas Trust, LL&E Royalty Trust, North European Oil Royalty Trust, Marine Petroleum Trust, Mesa Royalty Trust, Panhandle Royalty Trust, Permian Basin Royalty Trust, Sabine Royalty Trust, San Juan Basin Royalty Trust, Sante Fe Energy Trust, and Torch Energy Royalty Trust.

ment trusts holding fixed portfolios of shares,¹³⁷ and (3) gold bullion and other precious metals.¹³⁸

B. *Investment by a Fixed Investment Trust in a Partnership*

A fixed investment trust invests in an entity classified as a partnership but holding shares, debt instruments, and like passive assets to block Schedule K-1 reporting (*i.e.*, replace Schedule K-1 with Forms 1099). It is unclear whether this works in light of private rulings,¹³⁹ which seem to attribute the activities of the partnership or limited liability company to the trust in determining whether it is or is not a fixed investment trust, regardless of whether the interest held by the trust is that of a general partner or a limited partner member of a limited liability company.¹⁴⁰ This issue, however, likely remains unresolved.

¹³⁷For example, the dozen or so exchange-traded funds established by Merrill Lynch (the “HOLDERS Trusts”) to invest in specific sectors, such as Biotech, Broadband, Oil Services, and Regional Banks. Additionally, unit investment trusts, holding fixed portfolios of stocks or securities, are sometimes fixed investment trusts for tax purposes, although registered under the 1940 Act.

¹³⁸SPDR Gold Trust; streetTRACKS Gold Trust; and the various ETFs Physical trusts, such as ETFs Physical Platinum Shares. SPDR Gold Trust held bullion with an approximate value of \$54.8 billion at the end of September 2010. SPDR GOLD SHARES, www.spdrgoldshares.com.

¹³⁹A trust invests in

a limited liability company [which] is treated as a partnership for federal tax purposes. LLC will acquire, hold and manage a portfolio of investments. The governing document of LLC permits the managers of LLC to sell assets in the portfolio and acquire new assets. LLC will issue two classes of interests: common interests and manager interests. Holders of common interests and holders of manager interests have different rights to the income, deductions, credits, losses, and distributions of LLC. Manager interests will be held by a select group of investors who are also responsible for managing LLC. The common interests of LLC will be held by Trust.

Trust is organized under the laws of State as a trust. The governing documents for Trust provide that Trust is only permitted to hold common interests in LLC. Trust will issue certificates and each certificate will entitle the holder to all the income, gain, profit, deductions, credits, losses, and distributions associated with one common interest in LLC.

....

To determine whether Trust is an investment trust that is classified as a trust under section 301.7701-4(c), it is appropriate to consider the nature and purpose of Trust. Trust is holding the interests in LLC for the purpose of providing investors with the benefits of the managed investments of LLC. *These investment activities would result in Trust failing to be classified as a trust if Trust were permitted to engage in those activities directly. Because the nature and purpose of Trust under this arrangement is to vary the investments of the certificate holders, Trust is a business entity under section 301.7701-2(a) for federal tax purposes and not an investment trust that is classified as a trust under section 301.7701-4(c).*

G.C.M. 2007-005 (Feb. 5, 2007) (emphasis added).

¹⁴⁰*E.g.*, P.L.R. 1986-32-025 (May 12, 1986) (implying that the no-power-to-vary test is applied by attributing the partnership activities to the partners).

C. Investment by a Fixed Investment Trust in Regular Interests of a REMIC

Fixed investment trusts are used to securitize mortgages, sometimes in connection with tiered REMICs.

A fixed investment holds a class of regular interests in a REMIC, which provide for a floating rate of interest that is subject to a cap and enters into a swap with an unrelated counterparty that will offset the cap. The swap is not an asset of the REMIC and therefore does not affect its qualification as a REMIC. In the specific example in the regulations, a REMIC issues one class of regular interests entitled to principal and interest at a floating rate (but subject to an interest rate cap) and another class entitled to everything that is left after the first class is paid down. The first class is transferred to a fixed investment trust together with a third-party contract that entitles the trust to payments that in effect will offset any possible reduction in the floating rate of interest from the operation of the cap.¹⁴¹

D. Use of a Fixed Investment Trust in Conjunction with a REMIC

A fixed investment trust that owns an interest in a commercial mortgage in which a REMIC also has an interest because the interest held by the fixed investment trust could not be issued separately as a regular interest in the REMIC—for example, a fixed investment trust holds the right to default interest, other than interest representing a step-up after a specific date, prepayment premiums and other fees charged to the borrower of a commercial mortgage, and the REMIC holds rights to other payments. An example in the regulations illustrates this with a sponsor who transfers a pool of mortgages to a trustee for specific classes of certificates where the sponsor also creates an investment trust.¹⁴²

E. Investment by a Fixed Investment Trust in a RIC

In connection with a structure intended to provide capital to an insurance company, if needed, a RIC is established that invests in high-grade debt obligations. Its shares are held by a fixed investment trust that sells a put to the insurance company entitling the insurance company to issue shares of its preferred stock to the trust in exchange for the value of the commercial paper portfolio of the RIC. The return to the investors is the sum of the return on the commercial paper and period payments under the put. The trust is there to enter into the put and avoid a concern, based on Service private rulings,

¹⁴¹ Reg. § 1.860G-2(i).

¹⁴² See Reg. § 1.860G-2(i)(2)(i–ii).

that the value of the put is its strike price and that the RIC would not meet the asset diversification tests if it sold the put directly.¹⁴³

IX. What Is in the Future?

The focus of this Paper is on the contribution to the complexity of the tax law that results from the multiple entities that exist for tax purposes, not on whether their use in tiered and like structures is good or bad.

Is simplification in the future? The Joint Committee ruminations about entity classification, and the comments from the academic community, have been largely limited to the question of whether S corporations make sense in a post-check-the-box world and do not address RICs, REITs, REMICs, taxable mortgage pools,¹⁴⁴ or publicly traded partnerships. The alternatives for dealing with the contradictory co-existence of S corporations and limited liability companies grapple with the problem of built-in gains and earnings and profits from "C" corporation years, as well as the need to address the employment tax discrepancies between shareholder employees and members or partners in a limited liability company or partnership,¹⁴⁵ but the hope that S corporations would accept any such change, even if it could be worked out, seems to neglect the on-going and huge popularity of S corporations. As noted above, in 2003,¹⁴⁶ S corporations accounted for about 62% of all corporate income tax returns, reflecting a 36.3% increase in the prior six years.¹⁴⁷ There is no evidence that the availability of limited liability companies and the 1996 adoption of the check-the-box regulations have stopped growth.¹⁴⁸

¹⁴³ See P.L.R. 1988-23-067 (Mar. 11, 1988) ("If Taxpayer writes a put or call option, its potential loss is not limited and, therefore, the Taxpayer should be regarded as owning the security that is the subject of the option to the extent of the value of such a security. Accordingly, the measure of its investment is the value of the underlying security."); P.L.R. 1988-14-052 (Jan. 13, 1988). The private rulings seem to confuse liabilities with assets.

¹⁴⁴ See STAFF OF J. COMM. ON TAX'N, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 22 n.22 (Comm. Print 2008).

¹⁴⁵ On this discrepancy, see U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-10-195, TAX GAP—ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES (2009), which states that the "GAO calculated that in . . . 2003 and 2004 . . . , the net shareholder compensation underreporting [by S corporations] equaled roughly \$23.6 billion, which could result in billions in annual employment tax underpayments."

¹⁴⁶ The most recent year for which such statistics are available. Luttrell et al., *supra* note 122. While S corporations represent a smaller percentage of the corporations with business receipts over \$5 million, they represent about 30% of those with business receipts over \$50 million, an increase of about 7% over the prior year (as opposed to about 1% for "C" corporations). *Id.* at 49. In addition to the SOI see *Filing Characteristics and Examination Results for Partnerships and S Corporations*, TREASURY INSPECTOR GEN. FOR TAX ADMIN., (August 28, 2006), <http://www.ustreas.gov/tigta/auditreports/2006reports/200630114fr.pdf>.

¹⁴⁷ Luttrell et al., *supra* note 122, at 54.

¹⁴⁸ Partnerships were a less popular choice than S corporations for businesses formed in each of the years 1997 through 2002, but pulled slightly ahead (42.6% vs. 39.4%) in 2003 with limited liability companies taking the lead in the case of partnerships and representing in 2003 about 46% of all newly formed partnerships. *Id.*

Moreover, S corporations sometimes provide advantages not available to limited liability companies.¹⁴⁹

Each of the major pass-through industries—RICs, REITs, publicly traded partnerships, S corporations—has trade associations¹⁵⁰ or active lobbying groups,¹⁵¹ and each of these have public agendas for what they would like to see from Congress and the Service. None has suggested the simplification of the entity classification rules would be useful, and their agendas, if enacted, will only increase complexity and the use of blocker and stoppers.

To start with RICs, the Investment Company Institute has endorsed House Bill 3429, the “Generate Retirement Ownership through Long-Term Holding Act of 2009,” which would defer taxation to individual RIC shareholders of reinvested capital gains until redemption or death.¹⁵² Deferral would, of

¹⁴⁹Banks with insured deposits may now be S corporations if they do not use the reserve method of accounting for bad debts, but could not qualify as partnerships under the current check-the-box regulations because their deposits are insured; ESOPs, which can be shareholders in an S corporation without unrelated business taxable income, cannot be partners in a partnership without unrelated business taxable income. See STAFF OF J. COMM. ON TAX’N, TAX REFORM, *supra* note 144, at 43 n.80 (describing the benefit of the latter rule to the Tribune Company).

¹⁵⁰See INVESTMENT CO. INST., <http://www.ici.org> (last visited Nov. 20, 2010); NAT’L ASS’N OF REAL ESTATE INVESTMENT TRUSTS, <http://www.nareit.org> (last visited Nov. 20, 2010); NAT’L ASS’N OF PUBLICLY TRADED PARTNERSHIPS, <http://www.naptp.org> (last visited Nov. 20, 2010).

¹⁵¹For example, S corporations have the Independent Community Bankers of America, a trade association and lobbying group for community banks. Because many community banks are now S corporations, they speak up for changes in the S corporation provisions. See *infra* note 158.

¹⁵²And is endorsed by the ICI and, remarkably, given the rather pathetic tax policy argument, by some academics. See *Key Tax Issues*, <http://www.ici.org/taxation> (last visited Oct. 24, 2010); John C. Coates, IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591–689 (2009).

The ICI position with respect to the GROWTH Act is available on its website, and is basically as follows:

Legislation known as the Generate Retirement Ownership Through Long-Term Holding Act of 2009 (“the GROWTH Act”) would address this problem by deferring tax on automatically reinvested capital gain distributions until fund shares are sold. Under the GROWTH Act, the reinvested gains would compound, untaxed, in the fund, and an investor would pay tax on the fund’s gains only when the investor decided to redeem the shares and incur the gain. By reducing current tax bills and allowing earnings to grow tax-deferred, the GROWTH Act would boost long-term savings.

ICI Position: ICI supports and urges the passage of the GROWTH Act, which will encourage savings by allowing mutual fund shareholders to keep more of their own money working for them longer by deferring capital gains taxes until they actually sell their investment. The legislation provides a sensible way for millions of Americans to create a more secure financial future for themselves and their families.

INVESTMENT COMPANY INST., <http://www.ici.org/taxation> (last visited Oct. 24, 2010).

course, create a huge disparity between RIC investment, on one hand, and direct investment or investment in a non-RIC fund, on the other.

The ICI also supported House Bill 4337, the “Regulated Investment Company Modernization Act of 2010,” which was enacted at the end of 2010.¹⁵³ On the positive side, that Act repealed the preferential dividend rule in the case of publicly offered RICs. As originally passed by the House, it would have also overruled Revenue Ruling 2006-31 and treated income from investing in commodities as good income for purposes of the gross income test, thus eliminating the need for RICs to use foreign subsidiaries and structured commodity linked notes to gain exposure to commodities.¹⁵⁴ But without further refinement the provision with respect to commodities would have created an overlap between publicly traded partnerships that invest in or trade commodities and RICs—if the entity was registered under the 1940 Act, it could get pass-through treatment only as a RIC; if not registered, it could get pass-through treatment only as a publicly traded partnership. It is not clear what this distinction has to do with tax policy (as opposed to the percentage of its assets invested in one or the other). The provision would also have meant that RICs would become vehicles for investing in commodities that are not covered by the safe harbor for foreign investors in section 864(b), and so suggests that any such change should be accompanied by a reconsideration of what is allowed to a RIC and what is allowed under section 864(b) to a foreign investor.¹⁵⁵

The other industry agendas are less precise. The REIT agenda has included increasing the percentage of the REIT’s assets that may consist of securities of taxable REIT subsidiaries (it was raised from 20% to 25% in 2004) and changes that would facilitate investment by REITs outside the U.S.

More to the point, the REIT industry supports House Bill 4539, the “Real Estate Revitalization Act of 2010,” which would amend the FIRPTA rules to eliminate U.S. real property holding corporations (or, put differently, exclude interests in U.S. real property holding corporations from the definition of an interest in real property) and also treat dividends paid by a RIC or a REIT out of gains from sales of U.S. real property interests as ordinary dividends (not gains subject to FIRPTA).

¹⁵³Regulated Investment Company Modernization Act of 2010, H.R. 4337, 111th Cong. (2010).

¹⁵⁴It would do this by amending the “other income” language in section 851(b) to replace foreign currencies with commodities and repealing the authority of the Treasury to exclude by regulations foreign currency gains. *Id.*

¹⁵⁵Other industry legislative initiatives include House Bill 4912 (2007), which would require income accrual on prepaid derivatives, and thus equalize the treatment of investments in RICs and so-called exchange-traded notes. *See also* Keith Lawson, *Investment Company Institute Comments on Tax Treatment of Exchange-Traded Notes*, 2008 TAX NOTES TODAY 100-22 (May 22, 2008) (endorsing House Bill 4912 as a “first step,” but urging a constructive ownership model for the taxation of prepaid forwards).

The reason for including shares of U.S. corporations that are predominantly invested in U.S. real estate in definition of an interests in U.S. real property is to eliminate, to the extent feasible, any difference in the tax treatment of direct and indirect investment in U.S. real property, and the enactment of the Real Estate Revitalization Act will create that very disparity in tax treatment. Direct investment in U.S. real property, or investment through a partnership, would result in tax when the assets, or partnership interests, were disposed of, as well as tax at regular rates (in most cases) on operating income and branch profits tax in the case of an investment by a foreign corporation. If the investment was made through a REIT or RIC, there would be no U.S. tax on gains from sales of shares of the REIT or a RIC under the Act, nor entity-level tax when the underlying assets were subsequently sold; while there would be a withholding tax on dividends, leverage could reduce the cost of that tax. The Act would simply exacerbate tax-induced distortions.

Additionally, the REIT industry supports House Bill 5901, the “Real Estate Jobs and Investment Act of 2010,” which would increase from more-than-5% to more-than-10% the ownership threshold for the FIRPTA exemption for tax on a sale of, or a distribution on, regularly traded shares of a REIT that is a U.S. real property holding corporation.¹⁵⁶ While more modest than the Real Estate Revitalization Act of 2010, the bill would for no sound reason give investment in REITs an advantage not available to investment in other traded U.S. corporations that are U.S. real property holding corporations, including RICs that are U.S. real property holding corporations because they invest in REITs.

The S corporation agenda has generally included increasing the number and kind of permissible shareholders, modifying the one class of stock rule to permit straight preferred, eliminating the remnants of the passive income rule, and shortening the gain recognition period for assets acquired with built-in gain.¹⁵⁷ The huge presence of S corporations gives the agenda credibility, and in any event is a formidable political obstacle to any change that would disadvantage S corporations.

¹⁵⁶And provide a further exemption for gains from sales, and distributions on, shares held by a publicly traded entity that is a qualified shareholder, to the extent an investor in the entity does not directly, or through the entity, own more than 10% of the REIT and there is a tax treaty reduction in the withholding tax on ordinary dividends paid to the entity (e.g., in the case of certain Australian and UK entities).

¹⁵⁷The testimony of the Independent Community Bankers of America was in favor of (1) increasing the number of allowable S corporation shareholders from 100 to 150, (2) allowing IRAs to be shareholders of S corporations, and (3) allowing the issuance of straight preferred stock by S corporations. *S-Corps: Recommended Reforms that Promote Parity, Growth and Development for Small Businesses: Hearing Before the Subcomm. on Finance and Tax of the H. Comm. on Small Business*, 110th Cong. (2008) (testimony of Cynthia Blankenship, Vice Chairman/COO, Bank of the West), available at <http://www.icba.org/files/ICBASites/PDFs/test061808.pdf>. See also the “S Corporation ESOP Promotion and Expansion Act of 2010,” S. 3803 and H.R. 5207, 111th Cong. (2009–2010), which are being pushed by The ESOP Association, www.esopassociation.org.

In the case of publicly traded partnerships, the industry will presumably continue to press (as they have in the past) for expansions to the good income definition in section 7704(c) and, possibly, for more changes that will increase the ability of RICs to invest in publicly traded partnerships. In short, simplification is not part of any industry’s agenda.

REMICs are also used in tiered structures, as illustrated above, to side-step the definition of what is a “regular interest.” The issue is not so much their use in those structures, however, but whether any purpose at all is served by bending tax policy to facilitate mortgage securitization. That is essentially what REMICs do. The rule that deems all regular interest in the REMIC to be debt, and thus creates residual interests with a negative value because of the phantom income allocated to those interests, makes no sense from a tax policy point of view and contributes immeasurably to the complexity of the REMIC rules.¹⁵⁸ To revert to an analogy made at the beginning, would it make sense to eliminate the requirement that partnership allocations have substantial economic effect to facilitate sales of partnership interests and the securitization of partnership assets?

A simple answer to this REMIC issue would be to repeal the rules altogether; another, more limited solution would require that the cash entitlement of a residual interest was always equal to, or at least sufficient to pay current tax on, the income allocated to that interest.

¹⁵⁸On the complexity point, consider Code sections 860E, F, and G, and Regulations sections 1.860E-1(c) and 860G-2(a)(4), that (1) prevent the use of net operating losses to reduce the taxable income generated by a residual interest, (2) treat the income as unrelated business taxable income in the case of a tax-exempt organization subject to the tax on unrelated business taxable income, (3) impose a tax on the transfer of a residual interest to a disqualified organization, *i.e.*, a tax-exempt person not subject to the tax on unrelated business taxable income, (4) impose tax on a REIT, partnerships, and other pass-through entity that holds residual interests and has equity owners that are disqualified organizations, (5) impose withholding tax on residual interests held by nonresident aliens and foreign corporations, and (6) impose tax on transfers of certain residual interests to foreign persons or in tax-avoidance transactions.

