Statement of

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Before the
U.S. Senate Committee on Finance

Tax Reform: Examining the Taxation of Business Entities,
August 1, 2012

Chairman Baucus, Ranking Member Hatch, Members of the Committee. Thank you for inviting me to testify on this important topic. I would also like to thank you and your staffs for the time and effort devoted in recent months to considering substantial business tax reform and the myriad issues raised by such potential reform.

I bring to this testimony the perspective of four different types of experience. First is that of a lawyer who specialized in business taxation over a period of more than thirty years. During the first roughly ten years of that period, I focused on tax planning for closely held enterprises, both small and large and both commercial enterprises and services businesses; during the last twenty years or so I had a very diversified Wall Street practice representing investment banks, private equity firms, hedge funds, publicly traded partnerships and large corporations on both complex derivatives and other financial transactions and corporate and partnership matters. Second, I also look at things from the point of view of a part-time tax academic with a strong interest in the related disciplines of public finance and financial economics. Over the last three decades I have taught, and I continue to teach courses on corporate and partnership taxation, international taxation and business planning at Georgetown University Law Center, Columbia University Law School, the University of Miami Law School, and other institutions, which focus in large part on the issues we discuss here. Third, I served in the Office of Tax Policy of the Treasury Department in the administrations of Ronald Reagan and George H. W. Bush in a period during which a number of the issues we are considering here first began to emerge. Finally, I personally have been an investor in both small and large enterprises

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(albeit on a modest scale) and have found that my own inclinations as an investor affect my views on important tax issues.

Unfortunately, I must report that, despite this very varied experience and extensive study of the tax policy literature over a long period, I find most of the issues we will discuss in this hearing to be quite difficult ones. It is clear to me that we inevitably will be required to consider various subtle tradeoffs.

In my testimony I will focus on business entity taxation in five different settings. First, of course, is that of the publicly traded U.S. corporation, the type of business entity that tends to receive the most attention in the tax academic and public finance literature. The second is the closely-held business engaged in small or medium size businesses, both businesses like those of my grandfather and father in the Midwest manufacturing goods or equipment or distributing products, and businesses like today's emerging high technology enterprises in fields ranging from information technology to energy and biotechnology. The third context is that of the personal services business, such as management consulting, healthcare and my own former business of law. Fourth, I will discuss the publicly traded partnership. Finally, I will address various hybrid entity configurations in which multiple types of entities are employed to conduct a business enterprise, a type of structure that is extraordinarily common today.

My testimony will be divided into three parts: First, I will provide a summary historical overview of where we were at the beginning of the 1980s, and what happened importantly with respect to the taxation of business entities over the next three decades; second, I will provide a general tax policy perspective on the taxation of business entities, as a predicate to a more detailed discussion; in the final part of my testimony, I will discuss a number of contemporary issues pertaining to the taxation of business entities.

I. Historical Perspective: Where Were We; What Happened; Where Are We Now?

A. The Tax Setting in 1980.

Because, as we shall see, some of the historic policy concerns relating to our two-tier corporate tax system could re-emerge in the future, it may be useful to recall the tax setting when I first began to practice (and teach) tax law in the late 1970s and early 1980s before the "Reagan Revolution" and the Tax Reform Act of 1986 and its aftermath. First, as to large publicly held corporations, the so-called "classical" system of corporate taxation was in full force and effect: there was no real relief from double taxation; and even then financial products, like the seminal ARCNs product of the early 1980s, were being concocted on Wall Street that were intended to exploit the more favorable tax treatment of debt than equity in the C corporation context.

Second, in those days, business planning for the closely-held corporation engaged principally in businesses like manufacturing, product distribution, transportation or high technology was a very tax-intensive enterprise. The highest individual tax rate greatly exceeded the corporate tax rate, which meant that, in many contexts, taxation under Subchapter C was preferable to taxation on a flow-through basis. The planning involved could be quite aggressive, as taxpayers attempted to evade application of the penalty taxes like the accumulated earnings tax; and compensation planning and estate planning were both very much an integral part of the tax planning process for these entities. At the same time for some businesses who wished to distribute earnings currently a Subchapter S election had to be considered and might make sense.

Third, tax planning for services entities such as law firms and medical practices was also a tax-intensive affair. Because those were the days before so-called "parity," incorporation of a services entity was to a significant extent driven by the greater tax advantage associated with qualified retirement plans maintained by corporation. Moreover, because of the lower tax rate on the first $100,000 of corporate income, there was an incentive to "undercompensate" the service provider (the lawyer or doctor) by, for example, deflecting the law firm income to a professional corporation, which in turn paid salary compensation to the service provider (the lawyer) of $50 to $100,000 less than the income allocated by the firm. The late Martin Ginsburg and I, who taught the tax component of the business planning courses offered at Georgetown in those days, both practiced law through personal service corporations, which were in turn partners in law firms; tax planning for the "partnership including professional corporations" was my introduction to mixed-entity configurations, which are so commonplace today and which I will discuss later in this testimony.

B. What Happened in the Next Three Decades

An enormous amount changed during the next thirty years. Indeed, quite a bit changed just from 1981 to 1986, and as a result I ultimately had to throw out every one of more than 500 draft pages I had written for a never to be published book on "Tax Planning for the Closely-Held Corporation."

1. Tax Rate Changes

To begin with, early in the Reagan Administration, the maximum tax rate applicable to the nonservices income of individuals was dramatically decreased, which, of course, had an enormous effect on tax planning, particularly for closely held businesses. Moreover, in fits and starts, with some variations in the tradeoff over time, the corporate rate and the maximum individual rate have converged over these three decades significantly to the point that even if the Obama administration and the Democrats get their way in the current debate over the extension of the Bush tax cuts, there will still be what I view as rough parity between the two rates.

2. Parity in Employees Benefits Taxation

In addition, very substantial parity has been achieved with respect to the taxation of tax-favored employee benefits between incorporated and unincorporated entities. Although the general problem of "overcompensation" of the service-provider present in the partnership including professional corporation remains, particularly in the context of S corporations, new rules were enacted that largely eliminated the type of income splitting that Marty Ginsburg and I were engaged in which exploited the lower rates on the first $100,000 of corporate income.

3. Repeal of General Utilities Doctrine

A third major development, as the more senior Members of the Committee will recall, was the repeal of the General Utilities doctrine in 1986. This repeal was directed at assuring that the gain inherent in corporate assets held by a C corporation would be fully subject to tax at the corporate level at least once; and this change did increase tax neutrality in certain respects in the context of taxable corporate acquisitions. However, General Utilities repeal also introduced its own nonneutrality as to tax regime choice. In part for this reason, the publicly traded partnership phenomenon began to gain force shortly after the 1986 Act, and a large number of S corporation elections were made.

4. Changes to the Classification Rules and the Rise of the LLC

Another major change occurred over the period from the late 1980s to the early 1990s, the development of new entity classification rules, which have had a huge effect on tax planning for business entities. Actual state law corporations still must be taxed under Subchapter C unless an S corporation election can be and is made. But limited liability of business owners can now, it appears, largely be achieved without regard to tax factors. An investor can form a limited liability company (LLC) to conduct a business enterprise, and the enterprise will generally be taxed on a pass-through (one tax) basis as a partnership (or a disregarded entity if there is only one owner); alternatively, the taxpayer can check the box and have the entity treated as a C corporation. For new entities, the role of the S corporation election has diminished significantly, although it remains of some interest to those who wish to engage in "under-compensation" of the service provider. Today, while entities taxed as C corporations are still very much part of the landscape for emerging enterprises, partnership taxation is generally a much more important subject than is corporate taxation in teaching courses like the business planning course at Georgetown I co-taught last Spring. And the newest law textbook on business planning for venture capital has a whole chapter devoted to LLCs.

5. The Rise of Multiple Entity Configurations

Moreover, partly because of the flexibility of the check-the-box rules, tax planning with respect to business now often entails the use of multiple types of entities, including entities taxed in the two-tax world like C corporations and flow-through entities like LLCs that are treated as partnerships for tax purposes, and including both U.S. and foreign entities. In our Georgetown business planning class last Spring, we simply had to discuss "Up C" structures and "Blockers." When my co-professor and I taught the same course together thirty years ago, those concepts were not even on the table.

6. Limited Corporate Integration

Finally, most recently, as a result of changes curing the administration of George W. Bush, we now have some relief for taxation of dividends. This relief, however, is of course slated to expire.

C. Where Does That Leave Us?

To some extent I describe this history to remind us that, for all our problems, there actually have been some positive developments in the taxation of business entities, at least from the perspective of my policy orientation. The overall rate on business income may be too high to satisfy our most ambitious goals, but the core rate structure applicable to many mainstream business enterprises is a lot less distortive than it was when I started my career; there really is quite a bit of neutrality in entity and regime choice today for ordinary business enterprises.

But significant challenges remain, which is in part why you are having this and other hearings. The highly competitive, interconnected world in which we find ourselves makes it more difficult to continue to have high corporate rates and be a bit sloppy about our corporate tax system, particularly with respect to its treatment of foreign income. Moreover, developments in financial engineering and sophisticated tax planning, developments in the world that I have inhabited for the last two decades, pose very significant issues, as we shall discuss further. The rise of private equity and other alternative investment vehicles such as hedge funds has, in particular, posed new and important issues, because it is to a large extent through private equity funds and hedge funds that U.S. tax-exempts and foreign taxpayers invest in our businesses. My own perspective is that we simply cannot fail to address those issues systematically and comprehensively at this point, whether or not we ultimately make major statutory changes.

II. General Policy Perspective

Before I begin discussing a number of specific topics, I would like to provide an overall policy perspective on business entity taxation, because my experience has been that most of our disagreements on specific issues emerge from differences in basic perspective.

A. Neutrality

In a perfect world, taxation of the business income would distort business activity as little as possible. Consistent with this perspective, I personally continue to believe, despite some fashionable academic commentary to the contrary, that the maximum rate applicable to both business and other income should be as low as possible consistent with raising necessary governmental revenues and a reasonable but relatively constrained level of progressivity as to tax rates.

This general world view has three central implications for the taxation of business entities. One is that in a perfect world the overall tax burden should not depend significantly on the business entity through which it is conducted, whether that be a state law corporation, limited liability company, partnership or other entity. Second, it would be optimum if there were not a substantial disparity between debt and equity financing of business activities conducted through an entity taxed as a corporation. Third, to the extent possible, the decision whether or not an entity distributes net profits of the business to the owner or owners of the equity of the entity should not depend materially on the tax burden on those distributions.

B. The Function of Entity Level Taxation; Relevance of Public Trading; Progressivity

I should emphasize at this point that my own policy perspective is that the function of taxation at the entity level is principally an administrative one, a question of collecting tax on business income. We cannot, of course, fail to tax U.S. business income generated by a corporate or other business entity currently. And at least in the context of a publicly traded corporation such as IBM or Microsoft, it would be difficult to collect tax efficiently at the shareholder level. It is an important question of design whether payment of the tax by the business entity (e.g. a corporation) is essentially as a withholding agent (in which case shareholder attributes may ultimately determine the applicable rates), or as the principal taxpayer (in which case the rate of taxation and other matters is determined at the entity level). But the ultimate goal is to impose only one level of tax on business income.

Thus, for example, the relevance of public trading reflected in the so-called PTP rules of section 7704, is not, in my view, a substantive one. As a matter of first principles, I do not believe the overall burden of taxation of business income should be increased as a surcharge for the liquidity benefits provided by public trading. In the perfect world, where we tax the income of publicly traded entities, including partnerships, should be based on practical concerns.

This one-level-of tax orientation does affect my views on some subtle issues. For example, so long as we do collect the tax on business income once, I am somewhat less fussed than some with respect to a limited measure of non-neutrality between different types of entities (flow-through or corporate) that conduct the same kind of business (for example, businesses engaged broadly speaking in the financial services arena).

This overall conception of the role of entity taxation may also have implications for one's approach to progressivity concerns. Taxing business income, for example, at a very high overall rate is, in my view, an extremely clumsy mechanism for addressing inequality; indeed, it may even ultimately harm progressivity. At the same time, it would be optimal if we could design an appropriate system for business income taxation that would not undo or distort the overall level of tax progressivity that we, as a polity, ultimately settle on. In this regard, a significant number of issues are potentially raised with regard to various forms of integration and business entity taxation and with respect to other related issues, such as capital gains policy.

C. Taxing All U.S. Business Income at Least Once

The other side of the coin of not overburdening the taxation of U.S. business income with multiple layers of taxation is assuring that all such income be, in fact, taxed at least fully once. I put my own emphasis on that task. Here my principal concern is with leakage of U.S. business income to the tax-exempt sector or foreign taxpayers; more broadly, I myself believe that we will have to reconsider the precise boundaries between the taxable and tax-exempt sectors. Virtually every important tax issue that I have spent time considering in recent years (carried interest, debt-equity, derivatives) ultimately is affected by the central role of such parties. The issues relating to the taxation of business entities are no exception. A comprehensive treatment of this topic is beyond the scope of this testimony; but as will become clear, even here, the issues cannot be completely avoided.

D. Why It Is So Difficult To Design An Efficient System Of Business Taxation

A major constraint that we face in designing a system of business entity taxation going forward that satisfies my admittedly very ambitious objectives is, of course, revenue. During these economically sluggish times in which we are not collecting sufficient tax revenues in the first place, it certainly will be difficult to implement ambitious full-scale corporate integration schemes without some significant offsetting revenue-enhancing feature. Later in this testimony, I will discuss a few other specific policy issues in which there may be design tradeoffs, affected in part by revenue considerations.

In addition, several other factors complicate greatly formulation of an appropriate policy approach to the taxation of business entities. One major one for me is uncertainty as to the economic incidence of business taxation.[1] Despite the development of a relatively voluminous literature since Harberger's original seminal work on the incidence of corporate taxation, there is really no firm consensus on this question, and it may very well vary from sector to sector. One public finance economist has remarked that it is difficult to discuss entity taxation intelligently when in fact there is no such thing. As Governor Romney (admittedly a bit clumsily) recently reminded us, taxation at the corporate level is ultimately a tax on people, whether investors, consumers or labor. There are also significant "tax incidence" issues at stake in the carried interest controversy, for example.

A second major problem is that an optimum design for the treatment of corporate entities ultimately depends on the proper taxation of capital. Payment or accrual of interest on "debt" instruments of a corporation is, of course, deductible, whereas a corporation receives no deductions for the cost of equity capital. This distinction creates significant distortions and inefficiency. A number of the corporate integration schemes, including those addressed by Professor Warren in his written testimony, are efforts to cope directly with the pervasive problem of the debt-equity distinction. I might also note here that I believe there are broader tax arbitrage issues that are associated with the taxation of corporate finance (and executive compensation) in the public corporation context that may merit further scrutiny. Because there have been recent hearings on debt-equity and financial products, however, I will not discuss those issues here.

Third, the interrelationships between the capital gains preference and the appropriate taxation of both corporations taxed under Subchapter C and partnerships and LLCs taxed under Subchapter K raise important issues. One basic question, for example, is the tax rate that should be applicable to the sale of corporate stock of a C corporation, an issue that implicates both corporate integration issues[1] and capital gains concerns like lock-in. In addition, as discussed in a report issued by the Treasury Department late in the administration of George W. Bush, strong arguments can be made for some capital gain preference at the corporate level.[2]

Fourth, the differing contexts of closely-held corporations and publicly-held corporations raise very difficult questions both of policy and administrability. I have recently been struck, for example, by how much the economics literature concentrates on the taxation of dividends in the publicly-held corporation context. As we will discuss later, dividend taxation in the closely held corporate context may pose a different set of concerns. Similarly, the policy concerns with respect to the taxation of executive compensation, for example, may be completely different in the closely-held and publicly held contexts.

Finally, I think we all understand that the extreme instability of our political system with respect to tax and budgetary issues has ultimately become a significant detriment for both economic policy generally and tax policy in particular. I have been struck recently how students of tax policy now view attainment of a measure of stability as, independently, a significant issue of policy design. Whatever the merits of dividend taxation relief, for example, it certainly cannot make sense for it to be turned on and off again completely every few years, depending upon who is, temporarily, on top in the political wars.

III. Current Issues of Business Entity Taxation

A. Lowering the Maximum Corporate Tax Rate

The threshold question that we face today is whether the maximum corporate rate should be lowered significantly. The resolution of this issue will in turn affect the appropriate treatment of a number of other issues related to the taxation of business entities that we will discuss here.

Although a full discussion of the question is beyond the scope of this testimony, I will state here that I am squarely in the camp of those that believe a significant effort should be made to lower the rate applicable to corporate business income, while at the same time broadening the tax base applicable to such income. First, the intensely competitive international situation drives us to such an effort: while reforming the taxation of international income is probably the dominant consideration, lowering rates generally is also important. Second,

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[1] See Burman, **The Labyrinth of Capital Gains Tax Policy**, pp. 76-77 (1999).

[2] "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," Office of Tax Policy, U.S. Department of Treasury, pp. 72-75 (Dec. 20, 2007).

from the point of view of economic efficiency, we, in many ways, now have the worst of all worlds, relatively high marginal rates coupled with various distortive preferences that lead to a significantly lower average rates of collection. Third, a lower applicable rate might facilitate (somewhat) resolution of other difficult issues of tax reform, including for example the taxation of international income. Thus, while I am deeply skeptical that we can achieve, consistent with fiscal responsibility, the more ambitious goals that have been publicly announced (a rate of 25 percent for example), I think the effort to do the best we can on corporate rate reduction and base broadening is a worthwhile one.

From the time this issue started to be discussed, however, I have thought that the elephant in the room is the question what happens to maximum individual rates at the same time corporate rates are lowered. I am very skeptical, for example, that we can, in the context of our existing political machinery, achieve broad-based tax reform simultaneously permitting quite low maximum rates applicable to both entities taxed as C corporations and individuals, even though that would be my perfect world. Thus, in my view, we are likely to face a series of subtle tradeoffs, some of which I will discuss here.

B. The Tax Treatment of Closely-Held Business Entities

Assuming, for the moment, that it does become impossible, after business tax reform, to maintain our rough current rough parity between the top marginal rates applicable at the corporate and individual levels, a basic policy issue we will face is the tax treatment of closely-held businesses. Some of the relevant issues were comprehensively discussed recently by Professor Daniel Halperin of Harvard Law School,[3] and I will highlight a few here. To anticipate the discussion that follows, I will say at the outset that I am ultimately not comfortable with permitting a very large disparity between the maximum individual and corporate tax rates to re-emerge.

1. Planning For Closely-Held Enterprises Today

To begin our discussion, let us first review the situation today. At this point, a simple way to look at the situation is that the principal gating issue in entity and tax regime choice with respect to closely held businesses relates to who are going to be the principal owners of the equity of the enterprise. Closely-held enterprises like my grandfather’s or father’s in the Midwest that were owned principally by U.S. taxable individuals are likely, today, to be conducted through an LLC taxed on a flow-through basis. An alternative paradigm often applies to the emerging enterprise in the information technology space or the biotechnology

[3] Halperin, “Reducing the Potential Inequity of Reducing Corporate Rates,” Tax Notes, p. 641 (February 1, 2010) (Halperin).

arena, for example, that fully expects to attract investment by institutional venture capital or private equity partnerships comprised in large part of U.S. or foreign tax-exempt investors. Even today, a corporation taxable under subchapter C or an LLC that checks the box to be treated as a corporation for tax purposes may be formed in that setting because of the concerns of institutional investors with respect to trade or business income or unrelated debt financed income (as well as other tax concerns). The additional tax burden relative to pass-through treatment is not, however, that significant today because of the relative parity of the maximum individual and corporate rates, the relatively low tax rate on dividend distributions and the low capital gains rules applicable to sales of corporate stock. Moreover, although there is some advantage to the tax partnership (LLC) form in dealing with founder equity interests received for services, that issue can usually be dealt with relatively easily in the subchapter C context as well, with some messiness, but ultimately without great tax "friction."

2. Tax Planning for the Closely Held Business if the Rate Differential Becomes Significant

If the rate differential became very substantial again – let us say for illustration 40 percent maximum individual rate and 28 percent maximum corporate rate, tax planning for the closely held business would change substantially, reverting in many ways back to a setting like that I faced early in my career in tax planning for closely held businesses and that I briefly summarized earlier in this testimony. Use of the business vehicle as, in part, an "incorporated pocketbook" would again become part of the tax planning scene, as wealthy closely-held business owners might want to hold more of their portfolio assets at the corporate level and benefit from lower rates at that level. I would undoubtedly start teaching the accumulated earnings tax and personal holding provisions again after a 25 year hiatus. Genuine concerns of tax progressivity would be raised. Admittedly, we could, as suggested by Professor Halperin, buttress the government's arsenal a bit to deter the use of the corporation from being used as a tax shelter for investment and services income; in this regard the step-up-in basis at death would become a particularly significant issue to address. At the end of the day, however, I believe a tax rate differential that significant would be a tax lawyer's dream rather than particularly good for the economy.

It may be worth considering at this point two different conceptions of the function of business income taxation. Consider first the situation I confront today in my own investments in small enterprises. Assume that I, together with a number of other taxable U.S. investors, have invested in LLCI, LLCII and LLCIII and that the income from each of those separate business enterprises is taxed at a roughly 40 percent marginal rate on a flow through basis because we have not checked the box. In this situation, although I might quarrel a bit with the marginal rate (I certainly would prefer it to be lower), there is a significant amount of tax-economic neutrality. If, for example, excess earnings are generated by the business conducted by LLCI, the entity (a partnership for tax purposes) can distribute those earnings to me without an additional layer of taxation; and if I am inclined to do so, for entirely economic reasons, I can invest part or all of those distributed earnings in LLCII or LLCIII or a new enterprise without a significant tax friction. On the margin, taxation of business entities is not significantly interfering with economic activity.

Under a competing conception of the role of business entity taxation, a "split-rate" structure could be adopted applicable to closely-held and other business enterprises. Thus, for example, the overall tax social contract could be that the rate of taxation applicable to business income of a closely held interest could be 28 percent rather than 40 percent, but only so long as the original capital and later generated net earnings remain committed to the business enterprise. To the extent that withdrawals from the business enterprise are made, a significant level of tax would be imposed (perhaps even 40 percent or higher). At these rate levels, the split rate structure would start to approach the structure in place more than three decades ago.

The tradeoffs associated with such a structure were very much in evidence in the 1970's and very early 1980's, when I first began to practice tax law. Indeed, in my teaching at that time, the operation of that split-rate structure was the principal focus. The tax "social contract" was enforced, clumsily and inefficiently, by the high marginal tax rate applicable to corporate dividends and penalty taxes such as the accumulated earnings tax.

I personally much prefer the basic situation in place today with relative parity of maximum rates and, for now at least, significant dividend tax relief if the business enterprise is conducted in an entity taxed as a corporation. The key is that I can move my investments (and the fruits of such investments) relatively efficiently among different enterprises with different co-owners. In some ways, I view this issue as analogous to the issues we face in the international tax arena; I am in general uncomfortable with high tax rates being applied at the margin to the redeployment of capital (by, for example, repatriation of earnings).

Taking all this into account, where I come out on the relevant tradeoffs, is that we should make every effort to maintain a rate differential of no more than 6 to 7 percent between the maximum corporate rates and maximum individual rates. Implicit in that judgment is the view that some of the revenue gained by general base broadening should be committed to keeping the maximum individual rate relatively low; and in my view, that means base broadening itself must be undertaken with an eye firmly focused on general progressivity concerns.

C. The Second Level of Taxation: Dividend Relief and Capital Gains Taxation on Stock Sales

Both of the issues we have discussed thus far ultimately affect analysis of the question of dividend relief, whether relief of the type reflected in the Bush tax cuts (in effect, a partial exemption at the shareholder level), or more systematic integration of the type discussed by Professor Warren both in his scholarly work and in his written testimony. Thus, it is difficult to discuss this policy question meaningfully without knowing what the maximum rate will be at each of the individual level and the corporate level and without separately taking into account the publicly traded and the closely-held contexts. The tax rate applicable to capital gains is, of course, also relevant although I tend to view that question here as part of the overall corporate tax policy inquiry.

As a thought experiment, let us first assume again that corporate tax rates are lowered substantially relative to the maximum individual rates. Some have suggested recently, including Len Burman in testimony before you, that it might be reasonable to consider discontinuing the provision of dividend tax relief at the individual level because the lower corporate rates will in part compensate for the overtaxation of corporate income and the revenue saved could be utilized more effectively elsewhere. At the same time, Professor Halperin has argued that a substantial tax rate on corporate dividends would be necessary to buttress progressivity and constrain exploitation of the advantageous corporate-level rates by wealthy individuals in the closely-held context if the maximum rate on corporate income were reduced significantly. The same points of view might be consistent with a relatively robust tax rate on gains from the sale of corporate stock, certainly solidly above the current 15 percent rate.

However, as noted above, I personally am ultimately not really comfortable with re-introducing a very substantial rate disparity in the first place. Thus, while I might feel a bit more flexible in the public corporation context eliminating this dividend relief, I am significantly less comfortable in the closely-held context.

Now let us consider an alternative future: assume that the tax reform efforts underway in Congress now fail and we end up with a rate structure for individuals and corporations roughly like that before the Bush tax cuts (except perhaps as to the treatment of middle-income taxpayers). In that setting, I guess I continue to have a bit more favorable view of retaining the dividend relief now in place than some tax academics might have (including perhaps Professor Warren). I would acknowledge that dividend taxation is truly a complicated subject under our current system.[4] There is a burgeoning literature in economics on the

[4] For a good overview, see Shaviro, Ch. 5.

uncertain behavioral effects of the dividend relief provided during the Bush administration.[5] There clearly remains a non-neutrality between dividends and share-buybacks because shareholder basis can, in part, be recovered with respect to the latter; and the dividend relief we have provided only ameliorates the distortive effect of the debt-equity distinction in, at best, a very modest way.

But for reasons I will not fully develop here, if the substantial reform effort fails, and no alternative integration mechanism is adopted, I would continue the experiment of partial dividend taxation relief into the future. In fact, I would extend the relief now pending further consideration of broader reform. In these regards, I am motivated in significant part by the treatment of closely-held enterprises that may very well continue to be conducted in entities taxed under Subchapter C. I also am somewhat influenced by what I perceive to be the possible behavioral responses of taxable investors like myself in the public markets if dividend relief is completely eliminated with respect to publicly traded stock in the context of a very low interest rate world with substantial uncertainty.

D. Treatment of Services Businesses

While raising not nearly as many intractable issues, the tax treatment of services entities has also become an issue in recent years.[6] This renewed interest was in part fueled by the news stories relating to the S corporations of Messrs. Edwards and Gingrich; it also has been prompted by the increased number of quite large services businesses, including law firms like those in which I practiced the last twenty or so years of my own career. My own perspective here is quite simple; services income should be taxed fully at the same rate as services income generally once and only once.

To begin with, let us consider what I have termed earlier in this testimony "undercompensation", and what one student of tax policy has recently called "labor stuffing." While under section 269A, for example, the Internal Revenue Service has been granted authority to address the planning arrangements that proliferated in the 1980s, I do believe a broader grant of statutory authority for combating this type of planning is perhaps merited that would buttress the government's efforts in the corporation context and, in the future, perhaps elsewhere. The result will be some disputes of fact and ultimately more tax litigation. But there is no reason the Internal Revenue Service should not have the clear authority to assert that all the income of an entity substantially generated by

[5] A useful review of the earlier literature on the subject is contained in Darmapala, "The Impact of Taxes on Dividends and Corporate Financial Policy: Lessons From the 2000s," in Viard, **Tax Policy: Lessons From the 2000s**, 199 (2009).

[6] See Halperin at pp. 650-652 for a discussion of some of the most important of these issues.

services is taxed as services income as opposed to, for example, ordinary income of an S corporation.

More recently, a completely different issue has been raised, at least in some circles: should a portion of the income generated by a large services business such as a large law firm, in effect, potentially be subject to an incremental tax at the entity level? I really do not believe we should go there. I probably do think there is something akin to goodwill or growing concern value associated with my old firm Davis Polk, for example. If it were decided pass-through taxation regimes should no longer be available to larger businesses, one could argue that a large law firm should not be able to "zero-out" its net income with deductible compensation paid to the "partners." Thus, there would be some amount to be taxed at the entity level and potentially subject to tax again when distributed. But here again my own policy orientation determines my bottom line conclusion; one level of taxation is enough, and in this context the key policy emphasis should be to assure the earnings are treated fully as services income subject to the Medicare portion of self-employment taxes and the like when appropriate and, in fact, collected.

E. Publicly Traded Partnerships

The treatment of publicly traded partnerships (PTPs) presents, for me, a less straightforward series of issues, in significant part because of where Congress has already come on these issues. Here also, my strong one-tax orientation, my emphasis on administrative issues as to the location of tax collection and my concerns about achieving the proper boundaries with respect to the tax-exempt sector affect my overall views, which are ultimately not strongly-held ones in this particular context.

Today, under section 7704 publicly traded partnerships, as defined in the Code and Regulations, are subject to treatment essentially as C corporations unless certain exceptions are met, the most important of which are applicable when the partnership has certain type of "qualifying income." A significant number of PTPs are in existence that qualify for those exceptions. The taxation of PTPs generally was addressed in an excellent recent article by Eric Sloan and Matthew Lay.[7]

[7] Sloan and Lay, "Beyond the Master Limited Partnership: A Comprehensive Review of Publicly Traded Partnerships," 88 Taxes, No. 3, 229 (March 2010).

1. When Should Partnership Interests Be Treated As Publicly Traded

The first issue I would like to discuss briefly here is whether the current regime for determining whether a partnership is a publicly traded partnership in the first instance is workable and gets the question about right. Personnel at Treasury in the late 1980's and early 1990's (including myself) were responsible for developing the current regulations. The basic inquiry is to determine whether "taking into account all the facts and circumstances the partners are readily able to buy, sell or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market."[8] A number of safe-harbors and other detailed rules are provided intended to implement the basic concept. Those rules are exhaustively discussed in the article of Eric Sloan and Matthew Lay, and I will not go into them here. The rules do pose some tricky issues, and there have been significant developments in the financial marketplace since the rules were originally developed. However, having practiced in the area myself and re-considered the rules for panels and the like over the last few years, I am not particularly uncomfortable with the basic line drawing that has been done. In other words, I do not believe a significant policy concern is raised by how we have drawn the line as whether an entity should be treated as a publicly traded partnership in the first instance. It is important to note, in this regard, that I am coming to that conclusion in part because I believe these rules operate in a way that is consistent with administrative considerations for reporting and collecting tax; the line they draw coincides with a boundary that generally permits the complex rules of partnership taxation to be applied accurately.

2. The Reporting and Collection Mechanism for PTPs

Where I believe there is a question legitimately meriting further consideration is with respect to PTPs that are exempt from the rules, for example because the entity has the requisite amount of so called qualifying income. The core issue is whether the entity can be expected to comply fully with the complex subchapter K rules in a context where the interests are publicly traded. The technical and practical issues are well-discussed by Messrs. Sloan and Lay who work extensively in the area. Based on my own experience as a lawyer for a few PTP clients and on a few major transactions involving PTPs, I believe taxpayers and their advisors have, on balance, been quite responsible in trying to make the system work, and I personally doubt any great harm to the fisc is being done currently. However, like Professor George Yin, I am not entirely comfortable

[8] Regulation Section 1.7704-1(c)(1).

with the situation.[9] In my perfect world, I would concede that the principal types of "qualifying income" are subject only to one level of tax (and benefit from preferences like the capital gain preference), but collect the tax at the entity level. In other words, I would not re-visit the basic judgment as to C corporation status, but I might at least consider a different administrative approach to tax reporting and collection.

While I have not carefully thought about the point, one possible difficulty with this entity-level approach to collection, as a practical matter, may be the treatment of tax-exempts. Under today's rules, as discussed by Messrs. Sloan and Lay, tax-exempts can generally invest in these entities subject generally only to application of the normal unrelated business and unrelated debt financed rules applicable to tax-exempts investing in partnerships; and leaving aside for the moment the so-called Advisor PTP Structure, I am not particularly bothered by that situation. As a result, however, if there were entity-level collection, it would be necessary to formulate some sort of refund mechanism for tax-exempts allocated income that otherwise, as to them, should bear no tax burden. I am not sure of the real scope of this practical problem because many PTPs may be unsuitable for investment by tax-exempts anyway.

3. The Advisor PTP: The Blackstone PTP and Its Progeny

That leaves the question whether what Sloan and Lay call the Advisor PTP structure should be viewed as covered by the PTP exceptions or whether, as originally proposed by Chairman Baucus and Senator Grassley (in proposed legislation that was not ultimately adopted), these partnerships should have not been excepted from the PTP rules. My guess is this policy question has in effect been decided by inaction, but I will discuss it briefly. Unlike Professor Yin[10] I do not view the Baucus-Grassley proposal as a "back-door" way to address the carried interest question. While I strongly oppose the proposed carried interest rules (at least in their current incarnation) for reasons that I will not go into here, I at the same time continue to believe the basic approach (assuming it was made administrable) of the Baucus-Grassley proposal was a reasonable exercise in line drawing as to what kind of income should be subject to the PTP rules; whether or not the capital gains income from the carry allocated through these entities can benefit from the preference, it is akin to financial services income, which generally has not been viewed by Congress as appropriately excepted from the

[9] Yin, "Publicly Traded Partnerships, Closely Held Corporations and Entity Classification for Tax Purposes," 88 Taxes, No. 3, 329 (March 2010) (Yin).

[10] Yin at 229.

PTP rules. Here again I may be somewhat affected in my views by the treatment of investors that are tax-exempts.

F. UP C and Similar Multiple Entity Structures

A central feature of the contemporary tax planning landscape for business entities is the use of structures in which entities with more than one type of tax treatment are used simultaneously in configurations ranging from the relatively simple to the quite complicated. In my view, many of those structures do not raise significant policy concerns, particularly when viewed from the perspective of my policy predilections. But that decision should be made by Congress advertently, not with ignorance of the actual facts on the ground.

One now quite commonplace such structure is the use of a one-tax flow-through entity such as an LLC treated as a partnership together with a publicly traded entity. This type of structure originated in the real estate area (so-called UPREITs, etc.), but is now more and more common in other settings. Those in the know often refer to one variation of such structure as an "Up C" structure.

Consider, for example, the closely held business historically conducted in partnership form (or more likely an LLC taxed as partnership) whose current owners (the founders) now want both access to the public capital markets for their business and, ultimately, to provide an exit into the markets for disposition of all or part of their own equity interests in the future. A C corporation is formed to sell stock equity to the public that in turn invests in the partnership with the founders (or a newly formed tax partnership to which the old partnership or LLC interests are contributed by the founders). At the same time the equity interests of the founders are made economically exchangeable, subject to limits, into the corporate stock of the public C corporation. The income of the tax partnership conducting the actual business remains subject to one-tax flow-through treatment to the extent allocable to the founders; to the extent allocable to the C corporation, the income is potentially subject to two levels of tax. The founders are also able to avoid the immediate tax transaction costs that might have been entailed if they had simply checked the box before the offering for their entity to be taxed as a C corporation and the old entity went public, or they contributed their equity interests to a new C corporation in connection with the offering by that C corporation.

Does this type of structure present a core tax policy problem? If you believed that the kind of potential exit to a liquid public market involved here should not be available without the business income of the structure potentially being subject in its entirety to a two-level tax regime, you might think so. From my own perspective, however, this particular type of relatively straight-forward multiple entity configuration is ultimately not, in the main, problematic. There is nothing about this configuration itself that prevents assessment of one full level of tax on business income, which for me is the ultimate goal as I have emphasized.

G. Blockers and Stoppers

A more urgent area of policy concern in my view is the general proliferation of blockers and stoppers in business tax planning. Indeed, a blocker entity is generally involved in the Advisor PTP structure. In a recent article,[11] Willard Taylor, a distinguished member of the New York bar, recently defined these entities as follows:

> Generally, 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.

I believe a systematic policy assessment of these structures is long overdue. But I want to be careful as to what I am saying here: it is perfectly possible to me that, in many contexts, most of us could agree that the role of the blocker is an entirely benign one. Moreover, in some cases, as Mr. Taylor points out, if the blocker were not permitted, the taxpayer might be able to use a financial derivative instead to achieve its purposes. (Another reason these issues are such difficult ones.)

Three aspects of the current situation with respect to blockers concern me the most. First, some policy questions – such as the proper limits of the unrelated debt financed income rules – are in effect being answered through the use of foreign blockers. A long line of Treasury Department officials in the administrations of both parties (including myself) have tolerated the use of such offshore blockers because they believed that the underlying unrelated debt-financed income rules being avoided were overbroad. Given all the controversy generated over recent years, however, I think it is clear the basic substantive issue should be tackled head on.

Second, in some contexts, the use of a blocker puts significant pressure on the debt-equity distinction in our tax law. In hearings such as this one, we commonly focus on the economic efficiency costs of the debt-equity disparity with respect to corporate finance. But everyday, in a wide variety of contexts, this slippery and arbitrary distinction shows up with respect to the use of blockers

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[11] Taylor, " 'Blockers', 'Stoppers' and the Entity Classification Rules," 64 Tax Lawyer 1 (Fall 2010).

in a way that potentially affects the basic business tax base substantially. In some contexts, the income subject to our business tax base is being determined virtually entirely by the operation of a blocker.

Third, I expect that some very subtle issues as to the appropriate boundary between the taxable world and the U.S. tax-exempt world are raised by the use of off-shore blockers in particular. Consider, for example, the use of a foreign corporate blocker through which both U.S. tax exempts and foreign taxpayers invest into the United States. The effect often will be view to treat the two different classes of investors (U.S. tax exempts and foreign taxpayers) the same for determining the U.S. business tax base and, generally, to treat the two types of taxpayers as foreign for this purpose. I am not certain (either way) that those are the correct policy results. Here too the boundary between the tax-exempt and taxable worlds ultimately must be addressed to rationalize entity taxation.