Taxation of Passthrough Entities in the US

Willard Taylor
New York University Law School

Instituto Brasileiro De Direito Tributario

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“Passthroughs” in the US

- In the US, there is “double taxation” if a “regular” corporation is used to carry on business
  - First, tax on the corporation at a 35% rate; and, second, tax on individual shareholders when earnings are paid out as dividends
- Over time, however, important exceptions to the corporate tax have emerged – for so-called “passthrough” entities
  - Which are business entities whose income is taxed only once
    - To the owners, and not to the entity

US passthrough entities

There are a number of these

- Regulated investment companies (or "RICs"
- Real estate investment trusts (or "Reits")
- Fixed investment trusts
- S corporations, and
- Partnerships, both private and publicly-traded
  - Which include limited liability companies as well as general and limited partnerships

Why are passthroughs important?

- First, their economic importance
  - Non-publicly traded businesses are overwhelming passthroughs
    - Principally limited liability companies and S corporations
  - Publicly-traded passthroughs that invest in securities, real estate and the natural resources sector are also significant
- Second, important tax policy questions
  - Why should some businesses be taxed as passthroughs when others are not?
  - What are the implications for passthroughs, such as S corporations and partnerships, if the US adopts an exemption system for taxing the foreign business income of "regular" corporations?

What is the history of passthroughs?

- For tax purposes, a "corporation" includes an entity that is incorporated under Federal or State law, but the tax definition also includes an "association"
  - But an "association" was not clearly defined, and
    - It was therefore uncertain for many years when an unincorporated business entity, such as a trust or a partnership, would be an "association" and thus subject to corporate income tax

Regulated investment companies

- In the case of regulated investment companies -- the US equivalent of "collective investment vehicles" – the issue was resolved by legislation enacted in 1936
  - The legislation allowed a RIC to deduct dividends paid to shareholders and to pass capital gains through to shareholders
  - The dividends paid deduction eliminated corporate tax
    - and, with the passthrough of capital gains, created parity between a direct investment in securities and an investment made through a RIC

Economic importance of regulated investment companies

- At the end of 2012, regulated investment companies
  - Managed $14.3 trillion of assets for 94 million U.S. investors
    - More than half of the world wide mutual fund assets of $26.8 trillion
    - And accounting for 23% of the financial assets of U.S. households
  - Also, huge presence in the capital markets
    - Owning 28% of US corporate equities, 16% of the bond market, 12% of US Treasury and Agency securities, 26% of tax exempt obligations and 42% of commercial paper

Qualification as a RIC requires that

- The entity be a domestic corporation which elects and is registered under the Investment Company Act of 1940
  - The '40 Act provides the non-tax regulatory framework
- 90% or more of its income be from the business of investing in securities, such as interest and dividends
- 50% or more of its assets consist of cash and securities and
  - With exceptions, excluding securities representing 5% or more of the RICs assets
- At least 90% of its ordinary income be distributed as dividends
  - In practice, RICs distribute all income and capital gain, thus eliminating any entity level tax

Real estate investment trusts

- The real estate industry sought parity with RICs, and in 1960 the real estate investment trust rules were enacted to permit "mutual funds for real estate"
  - That is, to provide rules that would allow small investors to make passive investments in real estate which was leased or mortgages that were secured by real estate without incurring an entity-level tax
- As in the case of regulated investment companies, corporate tax is generally eliminated by allowing a REIT to deduct dividends
  - Also, capital gains pass through to shareholders as capital gain

For a corporation to qualify as a REIT

- It must meet gross income, asset and distribution rules which, among other things, require that
  - It derive at least 75% of its gross income from real property
    - Generally, rent from real property and interest on loans secured by real property
  - At least 75% by value of its GAAP assets be interests real property or mortgages secured by real property, cash and Government securities
    - And limit most of the rest of its income and assets to non-real estate investment income and assets
    - 5% of gross income leeway
  - It distribute to shareholders at least 90% of its ordinary income
    - In practice REITs distribute all ordinary income and capital gain and thus eliminate an entity level tax

Economic importance of REITs

- REITs are not as economically important as RICs, but their growth has been significant
  - Not only in size but also in what REITs may do.
- At the end of 2012 there were 172 publicly-traded REITs, with an aggregate market capitalization of $603.5 billion
  - Significantly more if shares issuable on exercise of exchange rights are taken into account
- REITs now include companies actively engaged in providing cellular communication, data management and storage, outdoor advertising, cutting and milling timber, and lodging and healthcare facilities
  - Some have thousands of employees

Why the growth of REITs?

- At least four reasons.
  - First, relaxation of the rules that were intended to make REITs vehicles for passive investments.
    - Since 1999 REITs may have “taxable REIT subsidiaries”
  - Taxable REIT subsidiaries can provide any service to tenants and, indeed, can do anything
    - Restricted only by
      - The fact that the subsidiary is taxable on its income and
      - That not more than 25% of a REITs assets can be shares or non-mortgage securities of such subsidiaries

Why the growth of REITs?

- Second, a generous view as to what is “real property”
  - That it not only includes land and buildings and improvements, but also any “inherently permanent” structure
    - Such as a cellular tower, a pipeline, or a data storage facility
  - And the willingness of the IRS to conclude that the value of intangible assets can be allocated to the real property and not treated as a separate non-real estate assets
    - Even for an active business with significant operations and long-standing customer relationships,

Why the growth of REITs?

- Third, the ability of a REIT to provide private real estate investors with a tax-deferred exit
  - By contributing properties to a partnership underneath the REIT -- a so-called “UpREIT” structure
- Finally, a “regular” corporation which holds significant real estate, may become a REIT, directly or in a reorganization, with acceptable tax costs.
  - “Conversions” include most US timber companies, as well as companies owning cellular communications facilities, data storage facilities and outdoor advertising facilities

Private REITs

- Apart from publicly-traded REITs (and public non-traded REITs), private REITs are used in specific transactions.
  - The requirement of 100 or more owners is not a meaningful constraint
    - The ownership of those shareholders can be nominal (and indeed the shareholders may be provided by on-line services).
  - The ”closely-held” rule provides that a REIT may not be owned to the extent of 50% or more by five or fewer individuals or tax-exempt entities, such as pension plans
    - Not a meaningful restriction – particularly because there is a look through to beneficiaries of a benefit plan

Alternatives to a REIT?

- REITs are the vehicle of choice for a publicly-traded entity
  - Largely because, unlike partnerships, they accommodate tax-exempt and foreign investors, and
  - Because conversion of a regular corporation to a partnership, as opposed to a REIT, would involve significant up-front tax costs.

S corporations and partnerships

- S corporations and limited liability companies, are the predominant way in which non-publicly traded businesses are organized in the US
  - In 2007, 94% in number of business entities and accounting for 38% of business receipts.
    - Growth of about 1% a year for 24 years
    - There are now more than 4 million S corporations and 3 million partnerships, of which about 2 million are limited liability companies

What is an S corporation?

- An S corporation is a corporation, but its income is taxed as though distributed to the shareholders – like a partnership
  - Must elect to be an S corporation
  - Must be owned by 100 or fewer shareholders, all of whom are US citizens or residents (or specified trusts or tax exempts) and
- The S corporation rules were enacted in 1958 at a time when a business could limit the personal liability of its owners only by incorporating and paying corporate tax
- The purpose was to eliminate tax as a consideration in the choice of an entity
  - To not force small businesses to choose between entity level taxation and personal liability of the owners for the entity's obligations

S corporations and limited liability companies

- Subsequently, in the '90s, all States enacted limited liability company statutes
  - These entities are not incorporated but provide limited liability to the owners (or members) and the governance flexibility of a corporation, and
  - In 1997, the IRS adopted the "check the box regulations" which taxed limited liability companies as partnerships or proprietorships
- Thus, the reasons for S corporations disappeared
  - But this has not slowed their growth

Are there other publicly-traded passthroughs?

- In the 1960s, the IRS adopted new regulations on what was an "association"
  - Because the rules were mechanical, it was possible to structure partnerships that were publicly-traded but nonetheless not "association" for tax purposes
- This posed a threat to the corporate tax base
  - And the tax law was amended in 1987 to treat any publicly-traded partnership as a corporation unless more than 90% of its gross income was derived from specified sources

90% gross income test

- The specified sources included income from commodities, investments, real estate and - most importantly – natural resources
- The principal use of publicly traded partnerships has been in the natural resources sector of the US economy.
  - There are now about 90 such partnerships (and more if those traded over the counter or otherwise not on a public exchange are included) with an aggregate market capitalization of more than $395 billion,
    - mostly in “midstream” activities, such as gathering and processing, compression, transportation, and storage, terminals and marketing.
    - Refineries are seen as next possible area of growth, and there are a large number of energy companies that hold assets which might be moved into publicly-traded partnerships.

Publicly-traded partnerships

- In addition, there are publicly traded partnerships in other areas
  - Such as asset management and investment
    - including Blackstone, KKR, Lazard and Carlyle
- The market capitalization of all publicly traded partnerships is $440 billion

How are foreign investors taxed?

- In the case of a RIC that does not invest in shares of REITs,
  - No US tax on gain from a sales of shares or on a distribution of capital gain
  - No US tax on dividends paid out of short term capital gains or out of net interest income
  - 30% withholding tax on other dividends
    - Reduced by treaty to zero in the case of a pension plan and 15% in the case of other shareholders

How are foreign investors in a REIT taxed?

- Equity REITs are so-called US real property holding corporations
  - Which is any US corporation if 50% or more by value of its business assets are interests in US real property
- As a consequence, there is US tax at regular rates on gains of a foreign shareholder from sales of shares and on distributions to the shareholder of gain from sales of real property
  - But there are exceptions for
    - Gain from the sale of shares of a publicly traded class of shares by a 5% or smaller shareholder,
    - Distributions of gain on a class of traded shares in the case of a 5% or smaller shareholder
    - Gain from the sale of shares of a REIT which is "domestically controlled"
      - That is owned for the preceding 5 years to the extent of more than 50% in value by US persons

How are foreign shareholders of a REIT taxed?

- REITs are very important to foreign investment in US real estate – often, the vehicle of choice
  - Unlike an investment made directly or through a partnership, no tax on the sale of shares of a REIT which is "domestically controlled"
    - That is, a REIT that is owned for the preceding 5 years to the extent of more than 50% in value by US persons

How are foreign shareholders of a REIT taxed?

- Dividends paid out of ordinary income are subject to 30% withholding tax, reduced by treaties to
  - Zero in the case of a pension plan which does not hold more than 10% of the REIT
  - In other cases to 15%, but only if
    - The shareholder does not hold more than 10% of the REIT and is an individual,
    - The dividend is paid on a publicly-traded class of shares to a holder that does not own more than 5% of any class of shares, or
    - The dividend is paid to a not more than 10% holder of a “diversified” REIT
- A few treaties, including the US treaties with Australia and the Netherlands, extend the 15% rate further

Foreign investment in other Passthroughs

- In the case of a partnership, a foreign investor would ordinarily be doing business in the US
  - Thus, taxed as regular rates on the investor's share of the income of the partnership, whether or not distributed
  - And also on gain from a sale of a partnership interest, unless the partnership was publicly traded and the investor owned 5% or less
- In the case of S corporations, foreign investment is restricted because the shareholders must generally be individuals who are residents or citizens
  - To side step this, an S corporation could form a partnership in which the foreign investor would be a partner

What are the tax policy questions?

- Why should some businesses benefit from pass through treatment and others not?
  - For example, why should a company that provides cellular communications facilities be exempt from entity-level tax when, say, an automobile company is not?
    - Not only an issue in the case of REITs, but also for publicly-traded partnerships which dominate oil and gas pipelines, refining and so-called mid-stream assets
  - More a product of history than a rational tax policy decisions

What are the tax policy questions?

- How to reconcile reform of the US rules for taxing foreign business income of "regular" corporations with passthrough entities
  - For example, if the US adopts an exemption system, but maintains a preferential rate of tax for dividends from regular corporations, the effective rate on foreign income of a regular corporation will be less than for foreign income earned by an S corporation