

# Toward a uniform business tax system: Examining proposals to tax large pass-through entities as corporations

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## MISSION STATEMENT

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth.

We believe that today's increasingly competitive global economy demands public policy ideas commensurate with the challenges of the 21st century. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by fostering economic growth and broad participation in that growth, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments.

Our strategy calls for combining public investment, a secure social safety net, and fiscal discipline. In that framework, the Project puts forward innovative proposals from leading economic thinkers—based on credible evidence and experience, not ideology or doctrine—to introduce new and effective policy options into the national debate.

The Project is named after Alexander Hamilton, the nation's first Treasury secretary, who laid the foundation for the modern American economy. Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces. The guiding principles of the Project remain consistent with these views.



# Toward a uniform business tax system: Examining proposals to tax large pass-through entities as corporations

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NOTE: This policy proposal is a proposal from the author(s). As emphasized in The Hamilton Project's original strategy paper, the Project was designed in part to provide a forum for leading thinkers across the nation to put forward innovative and potentially important economic policy ideas that share the Project's broad goals of promoting economic growth, broad-based participation in growth, and economic security. The author(s) are invited to express their own ideas in policy proposal, whether or not the Project's staff or advisory council agrees with the specific proposals. This policy proposal is offered in that spirit.

**BROOKINGS**

# Abstract

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The U.S. tax system raises insufficient revenue to meet national needs. The erosion of taxes on business income, including as a result of both the increasing use of pass-through entities and the growth in size and complexity of such entities, has been a significant driver of these revenue losses. Furthermore, applying pass-through taxation to an increasing number of complex arrangements has created substantial challenges for tax administration, compliance, and enforcement. This paper examines an approach that many policymakers have offered to address these issues: requiring large or complex pass-through entities to pay federal income tax at the entity level, as corporations do. This paper outlines the challenges that the current system presents and the reasons such an approach has been attractive. It then develops and evaluates a concrete proposal to treat certain pass-through entities as corporations, examining how such a proposal could be constructed and implemented and its revenue and distributional impact. Revenue and distribution estimates have been provided by the Urban-Brookings Tax Policy Center.

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# 1. Introduction

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The U.S. tax system raises insufficient revenue to meet national needs.<sup>1</sup> This shortfall contributes to large (and growing) national deficits, increasing national debt, and underinvestment in programs that would address critical national challenges. In this context, the erosion of taxes on business income over recent decades deserves attention. This paper examines an approach to addressing this issue that has been discussed conceptually for many years: taxing more pass-through entities as corporations. The paper outlines the challenges presented by the current system and the reasons such an approach has been attractive. It then examines a specific proposal in detail, analyzing how an administrable transition could be structured, which challenges will be difficult to avoid, and which alternatives and variations are worth considering.

Broadly speaking, businesses are currently taxed either as corporations under subchapter C (C corporations) or as some type of pass-through entity. C corporations face an entity-level federal income tax at a rate of 21 percent, with an additional layer of tax imposed on their owners when income is distributed. Pass-through entities, such as partnerships, S corporations, and sole proprietorships, generally do not pay federal income tax at the entity level; rather, their income, or loss, passes through to their owners, who then report such income or loss on their own tax returns and pay the associated taxes. (See box 1.)

Under current tax law, a business has substantial flexibility to choose whether to organize as a C corporation or as a pass-through. The choice made is often based significantly on tax consequences. The entity type that achieves the lowest overall federal tax liability will vary based on policy (including differences between the corporate and individual rates) and the characteristics of the business and its owners. In many cases, however, businesses can achieve substantial tax savings on both business and labor income by choosing pass-through treatment.

If policymakers were designing a tax system from scratch, fiscal, economic, and tax administration considerations would generally favor more uniformity in tax treatment of business entities with similar characteristics, especially in the case of large and complex entities. However, current law provides significant optionality under which rules originally written with simple business arrangements in mind<sup>2</sup> are increasingly applied to very large and complex organizations that have features that, historically, have been

associated with corporate treatment, such as limited liability for all owners.<sup>3</sup> As a result, pass-through tax rules designed to achieve logical results have become increasingly difficult to understand, apply, administer, and enforce. Negative consequences include foregone revenue; tax disparities, and therefore economic distortions, across various margins such as choice of legal entity and source and timing of financing and distributions; wasteful tax planning; and significant tax administration challenges that will only worsen with recent cuts to Internal Revenue Service (IRS) staffing and resources.

To address these issues, many analysts and lawmakers have suggested reforming how business entities are taxed. In particular, many have proposed requiring a subset of large or complex pass-through entities to pay federal income tax at the entity level, like C corporations do. Such a proposal could be implemented by requiring certain pass-through entities to be treated as C corporations or by levying a new pass-through entity tax on certain entities without changing their existing tax classifications.

However, the charge to tax large or complex pass-throughs such as corporations is not simple in practice, and existing proposals have generally been light on details. Accordingly, this analysis develops and evaluates a concrete proposal (the base proposal) that would require partnerships and S corporations with gross receipts above \$25 million to be treated as C corporations. In doing so, the analysis addresses design and implementation questions such as how best to define and measure whether an entity is large, whether and how groups of entities should be aggregated for this purpose, how the entity-level tax should be calculated and imposed, how transition rules would work, and how taxpayer responses are likely to affect the analysis.

Examining the base proposal brings into focus many of the key design choices and challenges involved in making such an idea workable, including their revenue, distribution, economic, and tax administration effects and trade-offs. The analysis also accounts for the fact that policymakers are not designing a tax system from scratch and must therefore navigate a complex transition from the status quo to any reformed system.

The Urban-Brookings Tax Policy Center (TPC) provides revenue and distribution estimates, which are the first set of detailed estimates for a proposal to tax

## BOX 1

# Overview of current US business entity tax classifications

## C corporations

- *How they are taxed.* C corporations currently pay tax on their income at a federal rate of 21 percent, and their shareholders pay additional shareholder-level income tax on such income when they receive distributions (i.e., dividends) or sell their stock.
- *Types of legal entities that can be taxed as C corporations.* State-law corporations (e.g., incorporated entities) are generally taxed as C corporations by default, but they can elect to be treated as S corporations instead if certain conditions are met (see below for more detail). Other types of state-law entities not treated as C corporations by default (such as LLCs, limited partnerships, and limited liability partnerships) may also elect to be taxed as C corporations under the check-the-box regulations.

## S corporations (a type of pass-through entity)

- *How they are taxed.* S corporations generally do not pay federal income tax on their own income. Rather, the S corporation's income, losses, deductions, and credits are allocated to its shareholders, in proportion to stock ownership and the shareholder report; the owners pay tax on such items on their own tax returns.
- *Types of legal entities that can be taxed as S corporations.* Domestic corporations that have 100 or fewer shareholders, have only one class of stock, and meet other eligibility criteria may elect to be treated as S corporations instead of as C corporations. Other types of state-law entities (such as LLCs, limited partnerships, and limited liability partnerships) may also elect to be taxed as S corporations if they otherwise satisfy the S corporation qualifications.

## Partnerships (a type of pass-through entity)

- *How they are taxed.* Partnerships generally do not pay federal income tax on their own income. Rather, the partnership's income, losses, deductions, and credits are allocated to its partners, who report and pay tax on such items on their own tax returns. Items are shared, economically and for tax purposes, according to the agreement of the partners (subject to complex allocation rules), but partnership tax rules generally provide substantial flexibility in allowing tax consequences to follow the partners' economic arrangement.
- *Types of legal entities that can be taxed as partnerships.* Generally, state-law entities other than state-law corporations (e.g., general partnerships, limited partnerships, LLCs, and limited liability partnerships) are treated as partnerships by default. Entities formed as corporations under state law are generally prevented from electing to be taxed as partnerships.

## Sole proprietorships and disregarded entities

- *How they are taxed.* A sole proprietorship or disregarded entity (DRE) reflects business or other activity carried on directly by an owner, without a separate regarded entity for federal income tax purposes. Accordingly, there is no entity-level tax, and all income, losses, deductions, credits, or other items are reflected directly on the owner's income tax return.
- *Types of legal entities that can be taxed as sole proprietorships.* Many sole proprietorships operate under state law without the formation of any legal entity at all—the sole business owner simply operates the business directly. Other state-law unincorporated entities that would normally default to partnership treatment for federal income tax purposes (e.g., general partnerships, limited partnerships, LLCs, and limited liability partnerships) are disregarded (i.e., effectively taxed as sole proprietorships) for federal income tax purposes when they have only a single economic owner. These entities (e.g., a single-member LLC) are effectively ignored, and do not exist as separate (pass-through or corporate) entities, from a federal income tax perspective.

large pass-throughs as C corporations that account for the significant changes in tax law made by both the Tax Cuts and Jobs Act (TCJA) in 2017 and the One Big Beautiful Bill Act in 2025. TPC estimates that the base proposal would raise nearly \$140 billion over 10 years and would raise more than \$25 billion annually by 2035. And, if paired with an increase in the corporate rate (to 30 percent), the base proposal would raise nearly \$470 billion over 10 years and more than

\$63 billion annually by 2035, in each case over and above what the corporate rate increase would raise on its own. The policies are complementary in that the base proposal would help bolster a corporate tax rate increase by guarding against the use of pass-through entities to avoid it.

The estimates also suggest that the base proposal reduces tax disparities because it raises revenue only to the extent that firms are indeed paying lower taxes

as pass-through entities than they would as C corporations. The base proposal is highly progressive: Once fully phased in, 94 percent of the tax increase would fall on the top 10 percent of the income distribution, with the vast majority of that (66 percent) concentrated in the top 1 percent. Moreover, the base proposal would affect only the largest 0.7 percent of pass-through entities while reaching nearly half (49 percent) of all pass-through net income. And because the base proposal would determine tax treatment based on an explicit size threshold, it would generally exclude small businesses.

While it presents significant transition and implementation challenges, taxing large pass-throughs as C corporations could also provide benefits for tax administration by moving entities out of administratively challenging pass-through tax regimes. But transitioning many complex businesses onto a new regime will require a tremendous amount of work, and great care should be paid to minimize unnecessary administrative burden. Accordingly, making such a proposal workable will require policymakers to give significant attention to many detailed and complicated elements of policy design, many of which are discussed below and in Appendix 2 (the Technical Appendix). Of particular note, strong aggregation rules will be needed, both to measure entity size accurately and to prevent the use of multiple commonly owned entities to avoid the rules in form but not substance. But sound fixes to existing aggregation rules are possible, and many of these fixes would have benefits outside of this proposal.

The paper also examines some alternatives to the base proposal, including setting different gross

receipts thresholds, using thresholds other than gross receipts for determining which pass-throughs are subject to corporate tax, and adopting an alternative pass-through entity tax approach. The analysis concludes that, if policymakers are interested in imposing entity-level taxes on pass-through entities based on size, applying C corporation tax treatment to firms above a particular gross receipts threshold is likely the most feasible approach.

More broadly, the paper concludes that taxing certain large or complex pass-through entities as C corporations is worth keeping on the menu of options for business tax reform, particularly given that the political constraints on the next opportunity for reform are currently unknowable. The proposal examined here functions best and yields the most revenue when paired with increases in the corporate tax rate and other complementary fixes to the business tax base.

The paper thus focuses on building a blueprint for careful policy design and moving the discussion forward on an approach that has been attractive to policymakers for decades but needs considerable additional policy design work. The paper does not unreservedly endorse taxing large or complex pass-through entities as corporations, in part because fully evaluating such a proposal against other options for raising revenue depends on policy and political considerations that are beyond the scope of this analysis. However, the clear need for additional revenue and potential obstacles to other pass-through tax reforms means the proposal warrants further consideration and development.

## 2. The challenge

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The significant increase in the use of pass-through entities over traditional corporations, and the increasing scale of many pass-through entities, has eroded federal tax revenue on both business and labor income. For business owners, choosing pass-through tax treatment often—though not always—means a lower total federal tax liability than choosing to be taxed as a C corporation.<sup>4</sup> And, while pass-through tax rules aim to achieve logical and reasonable results on the whole, their continued application to an increasing set of large and complex arrangements results in administrative and compliance problems, including a lack of tax enforcement, that contributes materially to the loss of tax revenue.

### (a) The rise of pass-through entities

Over the past several decades, business and economic activities have moved increasingly into pass-through entities and away from C corporations. Figure 1a shows that, as between the three primary business entity tax classifications that are treated as separate entities from a federal income tax perspective (i.e., C corporation, partnership, S corporation—leaving out sole proprietorships and disregarded entities, or DREs), the number of pass-through entities has far exceeded the number of C corporations since the late 1980s. By 1996 the number of S corporations alone exceeded the number of C corporations. And by 2002 the number of partnerships alone had overtaken the number of C corporations. The number of pass-through entities has continued to grow faster than the number of C corporations in subsequent decades.

These shifts have been matched by a shift in the distribution of business income. As shown in figure 1b, the pass-through form now captures about 60 percent of total net income—a much higher share than in 1980, when pass-throughs captured only about a fifth of total net income. The increased use of partnerships and S corporations has driven most of that growth.

The growth of the pass-through sector seems to have been accelerated in part by a series of federal and state policy changes starting in the 1970s. Federal changes to corporate and individual tax rates over this period increased the attractiveness of pass-through entities relative to C corporations.<sup>5</sup> And states increasingly created new types of unincorporated business

entities (such as limited liability companies, or LLCs) that offer various legal benefits and that largely default to pass-through treatment for federal income tax purposes.<sup>6</sup> It appears that state policy and federal income tax policy were largely uncoordinated, and federal income tax rules generally sought to adapt and keep up with new legal entities.

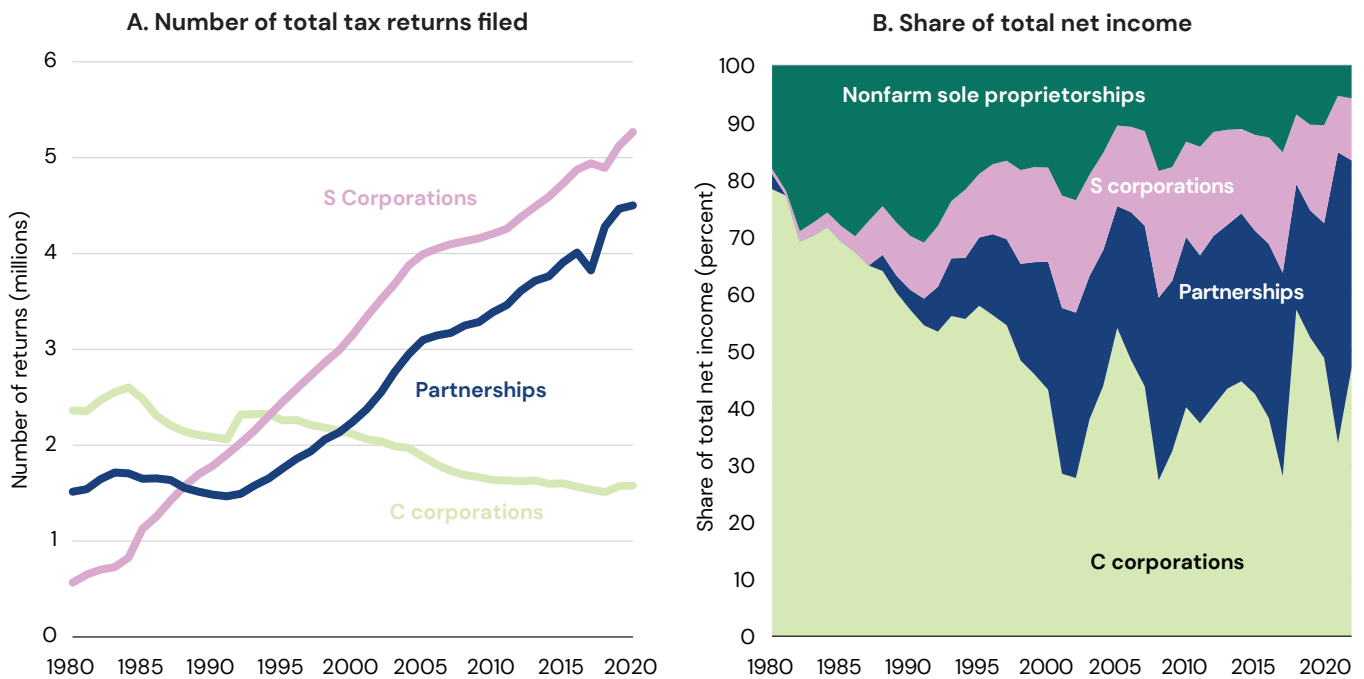
The check-the-box regulations, issued in 1996, also contributed to the overall shift toward pass-through entities by giving business owners greater certainty and flexibility when choosing their entity's federal income tax classification.<sup>7</sup> The check-the-box regulations allow eligible entities to choose whether they are taxed as corporations or as pass-throughs for federal purposes.<sup>8</sup> The rules in place prior to check-the-box had generally sought a more substance-based approach, treating entities as C corporations when they had certain corporate characteristics under a multi-factor test (even if those entities were not organized as corporations under state law).<sup>9</sup> This was, in part, an effort to ensure that federal income tax classification followed state legal entity classification. However, with some effort and complication, taxpayers were generally able to effectively elect corporate or pass-through treatment under these rules by complying with (or intentionally flunking) this multi-factor test. But by formalizing these taxpayer elections, the check-the-box rules thus made achieving the desired tax treatment much simpler and more certain.

### (b) Revenue losses from the growth in pass-through entities

Corporate income is generally taxed twice,<sup>10</sup> while pass-through income is taxed only once at the owner level. For individuals, this means federal income tax is imposed on their pass-through business income once, at marginal individual tax rates up to 37 percent. Certain pass-through owners are also eligible for section 199A's qualified business income deduction, which lowers the top rate on their share of such income from 37 percent to 29.6 percent. As a result, the top rate for an individual's pass-through business income before section 199A (37 percent) is already lower than the overall effective tax rate that would apply to such income in a C corporation structure (39.8 percent), and the top rate that applies to the

FIGURE 1

## Total tax returns and share of total net income, by entity type, 1980–2022



Source: Internal Revenue Service, n.d.; Joint Committee on Taxation (JCT) 2025.

Note: Panel A figure data is from Joint Committee on Taxation (JCT), Overview of the Federal Tax System as in Effect for 2025, JCX-28-25, September 5, 2025. Panel B figure data is from IRS, SOI Tax Stats Integrated business data, Table 1 (1980–2015) and IRS, Corporate Tax Returns (2016–2022).



individual’s pass-through business income eligible for section 199A (29.6 percent) only widens this gap.

Aside from these general rate differentials, specific types of pass-through entities provide other unique tax advantages. (See the box 1 for a general overview of the differences between types of pass-through entities and how they are taxed.) For example, S corporation owners exploit a well-known loophole to avoid both the net investment income tax (NIIT) and employment taxes on what is effectively labor income.<sup>11</sup> Partnerships provide a broader range of tax benefits since they generally provide significant flexibility to structure transactions in a way that minimizes tax liability. For example, partnerships allow owners to move assets in and out of the business without triggering tax much more easily than other entities (both C corporations and other pass-throughs). They also allow partners significant flexibility in deciding how income, deductions, liabilities, and other tax items are shared, including through special allocations. These flexibilities often result in lower tax liabilities and can encourage aggressive structuring that is driven purely by minimization of the partners’ overall tax liabilities.<sup>12</sup>

The type of entity that will deliver the lowest overall federal tax liability for a business and its owners depends on both policy (including the difference between the corporate and individual rates, and whether

those rates change over time) and the specific characteristics of the entity and its owners. For example, after the TCJA lowered the corporate tax rate from 35 percent to 21 percent, the choice between corporate and pass-through treatment became a much closer call for many businesses, although, as shown in figure 1b, the share of business income flowing to pass-through entities was broadly similar in 2022 to what it was in the several years preceding the 2017 enactment of the TCJA.<sup>13</sup>

Use of the pass-through form also now extends to many large and complex organizations that have features traditionally associated with corporate treatment, such as centralized management, limited liability for all (rather than only some) equity owners, and public trading. Many large operating businesses now go public through a special structure (the Umbrella Partnership–C Corporation, or Up–C) designed to maintain pass-through treatment for the underlying operating business, at least for a significant period.<sup>14</sup>

Pass-through tax rules have struggled to keep up with these changes. Some rules are outdated and difficult to apply to real world structures, and others have become incredibly complex through piecemeal updates intended to address specific structures or strategies.<sup>15</sup> In particular, partnership tax rules have evolved into a network of varied and sometimes inconsistent

options that are difficult to administer and full of complexity and ambiguity, in certain cases facilitating aggressive tax planning.<sup>16</sup>

The result is that many businesses have been able to achieve significant tax savings by opting to use the pass-through form, which has taken a significant toll on federal tax revenues. Using 2011 data, Cooper et al. found, “The average federal income tax rate on U.S. pass-through business income is 19 percent, much lower than the average rate on traditional corporations. If pass-through activity had remained at 1980’s low level, strong but straightforward assumptions imply that the 2011 average U.S. tax rate on total U.S. business income would have been 28 percent rather than 24 percent, and tax revenue would have been approximately \$100 billion higher.”<sup>17</sup> The TCJA’s deep cut of the corporate tax rate from 35 percent to 21 percent—much larger than its cut to the top individual rate—reversed some of the tax advantages of the pass-through form. However, the TCJA’s enactment of the section 199A deduction for certain pass-through income, as well as its tax preferences for certain categories of investment, has meant that pass-through income generally continues to be taxed at a significantly lower rate than C corporation income.<sup>18</sup>

The degree of flexibility found in partnerships—one of the hallmarks of partnerships<sup>19</sup>—also contributes to revenue loss. Tax rules that provide pass-through entities flexibility to achieve favorable tax treatment can facilitate and encourage legitimate business and economic activity, but they also cost the federal government significant tax revenue. As many have pointed out, much of this flexibility is found in the allocation rules, which are complex and sometimes vague, and that govern how partnerships allocate income and other tax items among owners.<sup>20</sup> One recent study estimated that the federal government lost \$251 billion in revenue between 2011 and 2020 due to the flexibility found in current partnership allocation rules (relative to counterfactual scenarios where stricter rules were in place).<sup>21</sup>

## (c) Tax administration challenges

Applying pass-through taxation to an increasing number of very complex arrangements has created substantial challenges for tax administration, compliance, and enforcement. The partnership tax rules generally seek to (1) give business owners wide latitude to write their economic deal, (2) impose one level of tax at the time income is earned, and (3) cause tax consequences to follow the owners’ agreed economic arrangement. These are reasonable and logical goals in the abstract, and subchapter K (the provisions of the Internal Revenue Code that govern the tax treatment

of partnerships) can often achieve these results. However, the subchapter K rules can also invite abuse, particularly in very complex arrangements<sup>22</sup> and especially because IRS enforcement and information-gathering capabilities have diminished.

Despite the increased prevalence of partnerships, it has become difficult to obtain some of the most basic information about them, including the number and identity of partnership owners. Research using IRS data has found that about 26 percent of partnership income could not be readily traced to known types of entities or individuals.<sup>23</sup>

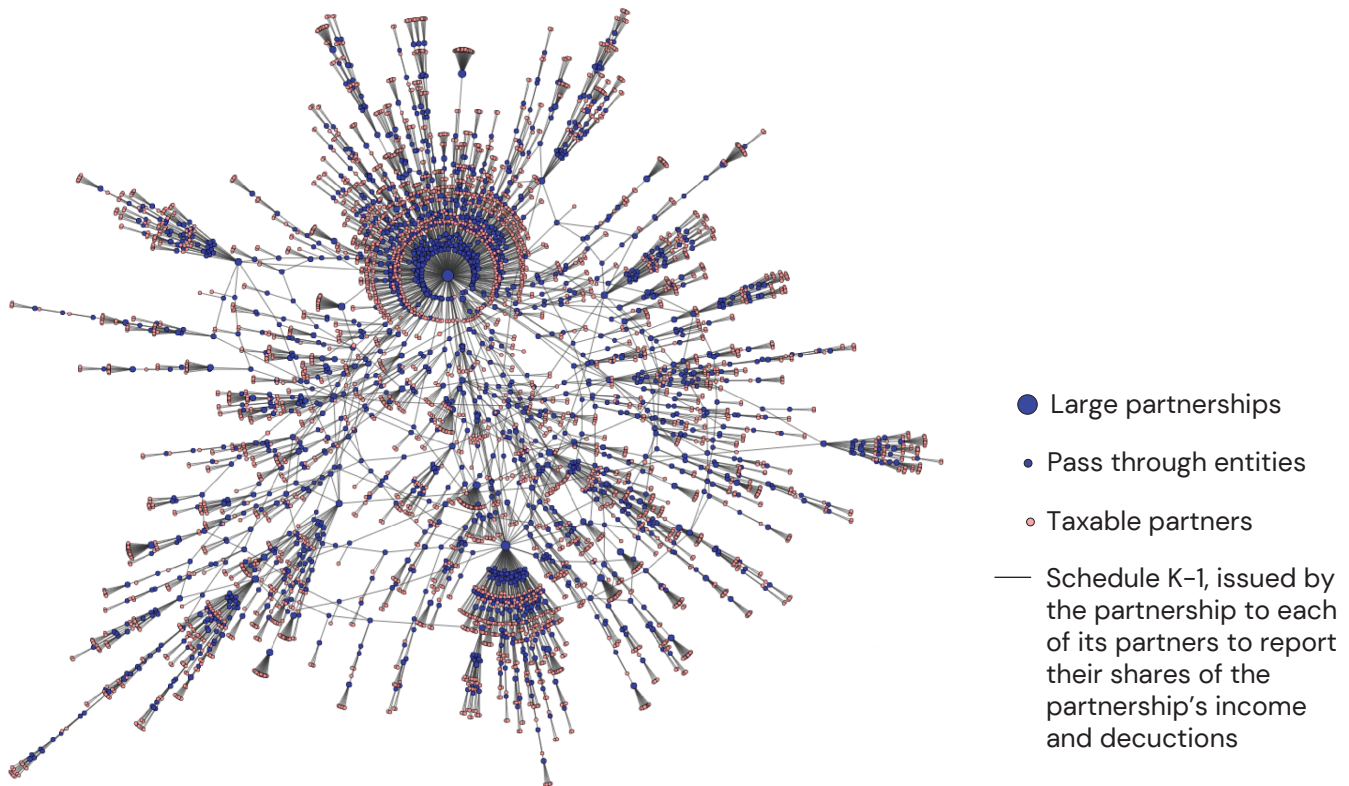
Part of the reason for these difficulties in collecting information about partnerships is that the laws governing partnership tax administration are weak in many ways. Although the network of interconnected entities has expanded, particularly in the investment fund world,<sup>24</sup> there is still little third-party reporting that allows the IRS to verify partnership income (and other tax attributes) independently. The reporting required with respect to partnership assets and ownership structures is limited and, in many cases, uninformative. Partnership tax reporting is also outdated and inconsistent, requiring significant information to be reported on nonuniform schedules, which increases the difficulty of deciphering partnership arrangements and tax positions from tax returns alone and thus increases the IRS’s workload.<sup>25</sup>

Furthermore, interconnected partnerships can lead to very large and exceedingly complex structures. Complex networks can involve partnerships owned by chains of other entities (including other partnerships) and can even include circular ownership, where entity #1 owns an interest in entity #2, which in turn owns an interest in entity #1, inadvertently or intentionally creating an ownership loop. This occurs more commonly as separately managed and unrelated partnerships invest in, and transact with, each other in a complex market; many partnership networks do not consist of a single overall organization, business, or firm. Still, between 2002 and 2019 there was a staggering increase in the number of partnerships qualifying as large (i.e., \$100 million or more in assets and 100 or more total partners) and complex (i.e., 20 or more tiers of ownership)—from 36 to more than 6,000 (figure 2).

The complexity and lack of clarity in many partnership structures makes it difficult for the IRS to audit them,<sup>26</sup> even though those same features tend to make partnerships major contributors to the “tax gap” (i.e., taxes owed legally but not paid). The IRS currently estimates that pass-through entities (including partnerships, S corporations, and some trusts and estates) contribute about \$40 billion annually to the tax gap, though there is significant uncertainty in this estimate due to information gaps.<sup>27</sup> Nevertheless, only 0.1 percent of partnerships and S corporations were audited by the IRS in 2020—lower than the 0.7 percent audit

FIGURE 2

## Complex network of partnerships in visual form



Source: Government Accountability Office 2023.

Note: Figure is from the Government Accountability Office's publication "Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships, 2023."



rate for C corporations. Similarly, as of 2019 the IRS audit rate for large partnerships (defined as partnerships with more than \$100 million in assets and more than 100 partners) had dropped to below 0.5 percent, far lower than the 5 percent audit rate for corporations of the same size (\$100 million or more in assets).<sup>28</sup>

In sum, absent challenges in administration, there are compelling arguments for pass-through taxation. It allows tax liability to be based directly on individual owner capacity, it minimizes differential treatment based on formal distinctions (such as the use of equity or debt capitalization), and it theoretically reduces cross-border tax planning by causing tax to be based (at least in the U.S.) on owner characteristics that are difficult to change. However, the theory has become inconsistent with the practice; attempting to align taxation with owner-level characteristics becomes incredibly difficult to administer with respect to operations of significant size and complexity,<sup>29</sup> and the ability to mix and match pass-through and corporate treatment within specific organizations means that some of the benefits of a pure pass-through system go unrealized.<sup>30</sup>

## (d) The wide range of approaches to pass-through tax reform

The rise in the number of pass-through entities, and the resulting revenue and tax administration challenges, have made tax policy experts increasingly concerned about the degree to which businesses can choose their own tax treatment, exploit the flexibility and complexity of existing rules, expend significant resources on complex tax planning, and engage in aggressive or unlawful tax minimization strategies. There is a wide spectrum of policy proposals that seek to address these issues by reforming how pass-through and other business entities are taxed, including the following:

### *Specific fixes to the pass-through (or broader business) tax base*

Some proposals focus on fixing specific pass-through tax rules that pose the greatest need for clean-up and modernization or the greatest risk of abuse. The Tax Law Center and The Hamilton Project previously

published a report on many such options.<sup>31</sup> Reforms that close specific loopholes and gaps in the application of self-employment tax to labor income earned through pass-through entities, and proposals that would repeal or reform section 199A, also fit in this category, among many others.<sup>32</sup>

### *Reducing electivity*

Some proposals would reduce the extent to which business entities can self-select among different tax classifications but would stop short of imposing a universal, or near-universal, system of business entity taxation.<sup>33</sup>

### *Fundamental business tax reform*

Various proposals suggest larger reforms that would move toward a uniform taxation of all business entities.

Certain of these proposals, sometimes referred to as integration proposals, would subject most or all businesses to either mandatory entity-level taxation or mandatory pass-through taxation.<sup>34</sup>

### *Proposals to tax only the largest or most-complex pass-through entities at the entity level*

These proposals fit somewhere between the more-specific and the more-fundamental proposals summarized above. They would essentially turn off pass-through treatment for the largest or most-complex pass-through entities, either by requiring them to be taxed as C corporations or by creating some other mechanism to impose tax at the entity level. Section 3 examines the attractions and challenges of this approach.

# 3. Attractions and challenges of taxing large or complex pass-through entities as corporations

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There is a long history of tax reform proposals and budget plans from across ideological lines that propose to tax a subset of pass-throughs at the entity level (see Appendix 1). Taxing large, complex, or corporate-like pass-through entities at the entity level is attractive because, in principle, it could have significant benefits.

## (a) Revenue

In proposals that provide revenue estimates, the approach is typically estimated to raise anywhere from \$100 billion to hundreds of billions over a decade (or up to tens of billions of dollars per year, amounting to up to about 0.1 percent of annual GDP). These estimates depend on corporate and individual tax rates and other features of then-existing tax law and policy. They are also sensitive to policy design choices.

## (b) Distribution

Partnership and S corporation income is even more heavily concentrated at the top of the income distribution than income from corporate dividends. As of 2022, some 70 percent of partnership net income (less partnership net loss) and some 64 percent of S corporation net income (less S corporation net loss) flowed to filers with more than \$1 million in adjusted gross income (AGI).<sup>35</sup> Only about 42 percent of corporate dividends accrued to the same group (figure 3).<sup>36</sup> Partnership and S corporation income is also a greater share of total income for high-income filers than it is for lower-income filers. In 2022, partnership net income (less partnership net loss) made up approximately 8 percent of total income for filers with more than \$1 million of AGI, but less than 1 percent of total income for filers with less than \$1 million of AGI.<sup>37</sup> Similarly, S corporation net income (less S corporation net loss) was approximately 16 percent of total income for filers with more than \$1 million of AGI, but only 2 percent for filers with less than \$1 million of AGI.<sup>38</sup> Thus, proposals that increase taxes on the income of large partnerships and S corporations have the potential

to increase taxes for high-income filers with minimal effect on the tax liability of low- and middle-income filers.

Proposals to tax certain pass-throughs at the entity level can also be tailored, via the use of an explicit size threshold, to minimize tax increases on true small businesses.<sup>39</sup> This can help assuage concerns that small businesses face liquidity problems when their taxes are increased, even when the owners of those businesses are in the top 10 percent—or even the top 1 percent—of the income distribution.<sup>40</sup> This, of course, raises the question of how best to define and measure the terms “large” and “small.” Some proposals may require some operating businesses that are small on a standalone basis to be considered as part of a larger group of related entities (to ensure that the tax cannot be avoided), with tax and administrative implications for those businesses. These nuances are explored below and in the Technical Appendix.<sup>41</sup>

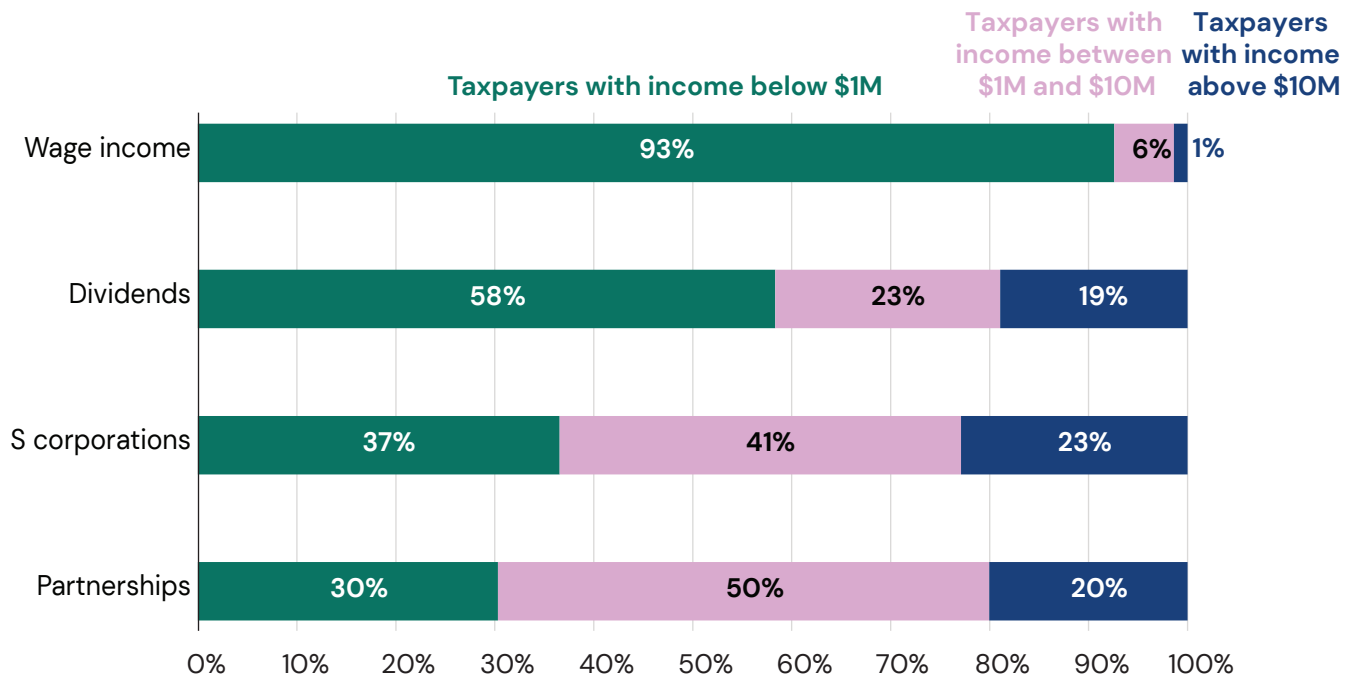
## (c) Parity

Pass-through taxation has existed since the beginning of the income tax,<sup>42</sup> and it originally served as a relatively simple way to tax small groups of partners undertaking joint economic activity on an aggregate (rather than separate entity) basis.<sup>43</sup> But many large and complex pass-through entities today have most, if not all, of the hallmarks traditionally associated with separate entity (i.e., corporate) taxation, including centralized management, limited liability for all owners, and, in some cases, public trading of their equity interests.<sup>44</sup> This has raised the question of why pass-through income should be taxed differently (and in many cases more lightly) than the income of traditional corporations.

These considerations motivate many business tax proposals that seek to draw a clearer distinction between C corporations and pass-throughs based on their legal and substantive characteristics. Applying an entity-level tax to some large or complex pass-throughs is a rough-justice way to achieve this without taking on—and potentially getting bogged down in—a

FIGURE 3

## Distribution of various types of income by adjusted gross income, 2022



Source: Internal Revenue Service 2022.

Note: Figure data are from IRS, SOI Tax Stats—Individual statistical tables by size of AGI for tax year 2022 (filing year 2023), at Table 1.4. 99.5 percent of taxpayers have income below \$1 million, 0.48 percent of taxpayers have income between \$1 million and \$10 million, and 0.02 percent of taxpayers have income above \$10 million. S corporation and partnership income is net income less net loss. Dividends includes ordinary and qualified dividend amounts. Wage income is calculated from Form W-2 wages.



return to the entity classification rules that existed prior to the check-the-box rules or a much larger project to rewrite business taxation so that it more perfectly aligns tax treatment with substantive characteristics in every case.<sup>45</sup>

Taxing large or complex pass-throughs as corporations also has the advantage of automatically maintaining parity among such entities even as corporate and individual tax rates change. In recent tax debates, policymakers have sometimes argued for or against broader tax changes on the basis that they would reduce or increase disparities in the tax rates applicable to corporations relative to pass-through entities (or vice versa). If all large or complex pass-through entities were subject to the same tax treatment, many of these parity concerns would no longer constrain decisions about corporate and individual tax rates.

Notably, current law already applies corporate tax treatment to a narrow set of partnerships under section 7704, which treats most publicly traded partnerships as corporations. Current law excepts certain publicly traded partnerships from this treatment, although proposals, including a bipartisan legislative proposal from Max Baucus and Chuck Grassley (who were, at the time, the Senate Finance Committee chair

and ranking member) have proposed to curtail or refine these exceptions.<sup>46</sup> Even without those exceptions, however, the scope of section 7704 would be limited.<sup>47</sup> Nonetheless, the provision is some precedent for treating a subset of pass-throughs as too much like corporations for partnership treatment.

### (d) Reducing inefficient tax-induced economic distortions

Research has suggested that the incentive to use pass-through entities over C corporations due to their tax benefits may reduce access to public capital, thereby reducing investment and employment.<sup>48</sup> To the extent that these tax benefits are arbitrarily more accessible to some industries or businesses than others, they could also induce wasteful economic distortions in investment and ownership patterns across types of economic activity. As Martin A. Sullivan has put it,

If some competitors in an industry are exempt from corporate tax and others are not, the tax treatment results in inefficient excess investment for the fortunate and inadequate levels

of investment for everyone else. There is also inefficiency across industries. If the apple industry is filled with tax-favored investors and the potato industry is not, there are too many apples and too few potatoes.<sup>49</sup>

Thus, removing or shrinking the set of entities for whom the tax benefits of pass-through treatment are available could, all else equal, improve the allocation of economic resources. This has explicitly motivated several past proposals. For example, citing Goolsbee (2004), Mackie-Mason & Gordon (1997), and Gordon & MacKie-Mason (1994), the Obama administration's 2012 Framework for Business Tax Reform notes,

(iii) Distorting the form of businesses. The ability of large pass-through entities to take advantage of preferential tax treatment has placed businesses organizing as C-corporations at a disadvantage. By allowing large pass-through entities preferential treatment, the tax code distorts choices of organizational form, which can lead to losses in economic efficiency; business managers should make choices about organizational form based on criteria other than tax treatment.<sup>50</sup>

Furthermore, requiring uniform C corporation treatment for large entities may be more attractive the more efficient the corporate tax is at raising revenue. There is a large literature about potential reforms that could make corporate taxation more efficient. Some recent research has additionally argued that cash flow taxes on businesses are a particularly efficient way to raise revenue and are best levied at the entity level.<sup>51</sup> In general, a business cash-flow tax (one that allows businesses to expense, or deduct, the cost of investments up front) raises revenue from only above-normal returns on investment, potentially minimizing investment disincentives.<sup>52</sup> However, a cash-flow tax achieves a zero tax rate on the normal return to investment only if investments are expensed at the same tax rate as the subsequent income from the investments is taxed. Pass-through income—because it is taxed directly at the pass-through owner level—may be subject to tax at different rates in different years, which could result in either negative or positive taxes on the normal returns to investment. Imposing corporate tax at a flat rate on all large businesses could go a significant way toward solving this problem.

## (e) Tax administration advantages

As discussed above and elsewhere,<sup>53</sup> large and complex pass-through entities generate significant compliance and administrative challenges. It can be

difficult for the IRS to understand their financial and economic arrangements, as well as the tax positions they take, based on existing information reporting.<sup>54</sup> Proposals that reform the tax treatment of large or complex pass-through entities can therefore reduce these compliance and administrative costs. As the Bush administration's 2005 President's Advisory Panel on Federal Tax Reform (Advisory Panel) explained,

Requiring all large entities, including partnerships, to abide by the same business tax rules would provide fewer opportunities for tax shelters and less exploitation of loopholes. For example, a consistent treatment of income from large businesses would shrink opportunities to use a partnership structure to avoid taxes. Many recent tax shelters were designed to exploit the complicated partnership rules.<sup>55</sup>

Furthermore, requiring the largest and most complex partnerships to be taxed as C corporations, and thus carving them out of subchapter K, could address many of subchapter K's existing problems. The largest and most complex partnerships, as well as "internal" partnerships (i.e., those owned by members of a single related party group), raise some of the most difficult and high-dollar subchapter K issues. Taxing them as C corporations could help by confining existing partnership tax rules largely to smaller and simpler entities that better resemble the types of arrangements for which subchapter K was originally written.

Additionally, compared to proposals that would require a more comprehensive rewrite of business taxation, taxing large or complex pass-through entities at the entity level affects fewer businesses and may thus strike policymakers as more feasible. At the same time, the approach could complement or facilitate other meaningful reforms. For example, it could facilitate the simplification of partnership tax rules, since many of their complexities are less relevant to the types of smaller and simpler partnerships that would be left in subchapter K.<sup>56</sup> Indeed, several commentators have suggested a new, unified regime for these smaller pass-through entities that would meld certain features of subchapters S and K.<sup>57</sup> Similarly, others have proposed restricting pass-through treatment to smaller and simpler firms as part of a series of reforms that include both tax administration and enforcement changes to the pass-through tax base.<sup>58</sup>

These conceptual advantages must be weighed against the potential trade-offs and practical challenges of the proposal. As discussed further below, these include (1) complexity in basic design and implementation, including how to address avoidance; (2) significant transition challenges; (3) uncertainty from year to year; and (4) potential adverse impacts on domestic investment.<sup>59</sup>

# 4. The proposal

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If the tax system was being designed from scratch today, revenue, equity, and tax administration considerations would support a more uniform, and less elective, treatment of business entities that have similar characteristics. Imposing entity-level tax on large or complex pass-throughs is one way to move closer to this result, which has been attractive to many policymakers. There are themes across proposals, including a desire to measure similarity based on size in order to carve out some subset of small businesses.<sup>60</sup> However, most prior proposals are out of date or have not been specific enough to allow policymakers to evaluate them against other options. In particular, proposals of this nature require a closer look to evaluate whether transition and ongoing implementation challenges can be adequately addressed.<sup>61</sup>

To fill that gap, this paper examines a concrete proposal to tax all large pass-through entities as C corporations. The proposal is similar in structure to many of the existing proposals summarized in Appendix 1, but it includes more-detailed discussion of, and recommendations regarding, many of the thorny implementation and transition issues policymakers would need to address. The intent is to enable policymakers to evaluate whether these implementation and transition challenges can be solved. Additionally, the paper provides and analyzes new revenue and distributional estimates from TPC. The Technical Appendix dives even deeper into many of the policy design and implementation details.

In general, the base proposal would require all large partnerships and S corporations—those with gross receipts exceeding \$25 million—to be treated as C corporations for federal income tax purposes.<sup>62</sup> The overarching approach focuses on building on existing tax rules that already impose C corporation treatment on certain pass-through entities (e.g., publicly traded partnerships) as much as possible, and the size threshold tracks several of the proposals in Appendix 1.

## (a) Key elements of the base proposal

### Focusing on partnerships and S corporations

The base proposal would apply to partnerships and S corporations. It would not apply to certain specific

types of entities or arrangements that are commonly thought of as pass-throughs, such as regulated investment companies (RICs), real estate investment trusts (REITs), and sole proprietorships. Additional considerations regarding this approach are discussed in Section 5, below.

### Defining “large” and measuring size

Identifying and capturing only large pass-through entities requires defining which entities are large, and doing so in a way that tax rules can measure. For this purpose, the base proposal would use a \$25 million gross receipts threshold. TPC’s estimates index this \$25 million threshold for inflation using the C-CPI (chained CPI).

### Gross receipts would be averaged over a three-year period

A gross receipts test must not only set the dollar amount but also must establish the period over which such dollar amount is measured. Existing gross receipts tests measure average annual gross receipts over a period of three taxable years.<sup>63</sup> This ensures that an anomalous single year outcome does not push a business into (or out of) the regime.

### The base proposal should be coupled with reforms to existing aggregation rules

Any size-based approach to the threshold, including the base proposal’s gross receipts test, should incorporate aggregation rules. Aggregation rules address the circumstances in which separate entities with common ownership should be counted as a single entity for testing purposes. For example, if partnership A and partnership B each has gross receipts of \$13 million, but both are owned and controlled by the exact same two partners, it is more appropriate to treat them as a combined organization with gross receipts of \$26 million (and thus each would be treated as a separate corporation under the base proposal).<sup>64</sup>

Strong aggregation rules are needed to ensure that (1) entity size is measured accurately (including on an group-wide basis where appropriate); and (2) entities are not able to manipulate their size, and thus avoid C corporation treatment, simply by separating into multiple smaller entities. Various aggregation

rules exist under current law, but technical reforms are needed to ensure they are effective in this context. Such reforms include ensuring that commonly owned and controlled entities are aggregated regardless of the nature of their activities (i.e., whether they are engaged in business or investment activities) and ensuring that all entities (corporate or pass-through) can be aggregated due to sufficient overlapping economic ownership or control. These technical reforms are discussed further in the Technical Appendix. Several of these reforms should be pursued even outside the context of this proposal.

Aggregation rules mean some businesses with minimal receipts (if examined alone) will face administrative burdens associated with testing and proving their size.

### A several-year transition timeline is likely appropriate

Implementing the base proposal will require a delayed effective date to give taxpayers and the IRS time to evaluate and implement the rules. Complying with the proposal is likely to be complex for many taxpayers, since it will include evaluating whether entities are subject to the regime (including under aggregation rules), the impact of any required conversions, and whether it is preferable to restructure economic and entity arrangements before the rules go into effect. Similarly, the U.S. Department of the Treasury (Treasury) and the IRS will need time to craft guidance necessary for compliance and administration. Thus, while the estimates here assume an immediate effective date to better understand the long-run revenue path, it is likely appropriate to provide a relatively long transition period, potentially several years.

### Required conversions should be handled in the same manner as under existing rules

Existing rules require certain entities to be treated as corporations, such as certain publicly traded partnerships, and allow other entities to be treated as corporations, such as pass-through entities that elect to be treated as corporations under the check-the-box rules. These rules set out the mechanics by which such conversions occur. Under those mechanics, the relevant entity is treated as first contributing all of its assets to a new corporation in exchange for stock and then distributing that stock to its partners or owners in liquidation. Conversions required under the base proposal should also follow these mechanics.

### Limited transition relief is likely appropriate for conversions that trigger immediate tax

For most entities, the deemed conversion steps above will be nonrecognition transactions (i.e., will not trigger tax). But some conversions could trigger immediate tax liabilities. Transition rules could provide relief by deferring the tax liability in some manner. One approach is to provide that all conversions required under the proposal are nonrecognition transactions regardless of other rules; those rules might then require additional basis or other adjustments. Another is to allow the resulting tax to be paid in installments, which is less complex and aligns with how tax rules and proposals have addressed similar scenarios.<sup>65</sup>

### Guidance from Treasury will likely be needed to address the complex issue of how to impose corporate treatment on existing partnership equity arrangements

Under current law, partnership interests are characterized and taxed very differently from corporate stock. Accordingly, how partnership interests are treated once the entity is a corporation (i.e., translating partnership interests into corporate stock for tax purposes) will be a complex analysis in many cases.

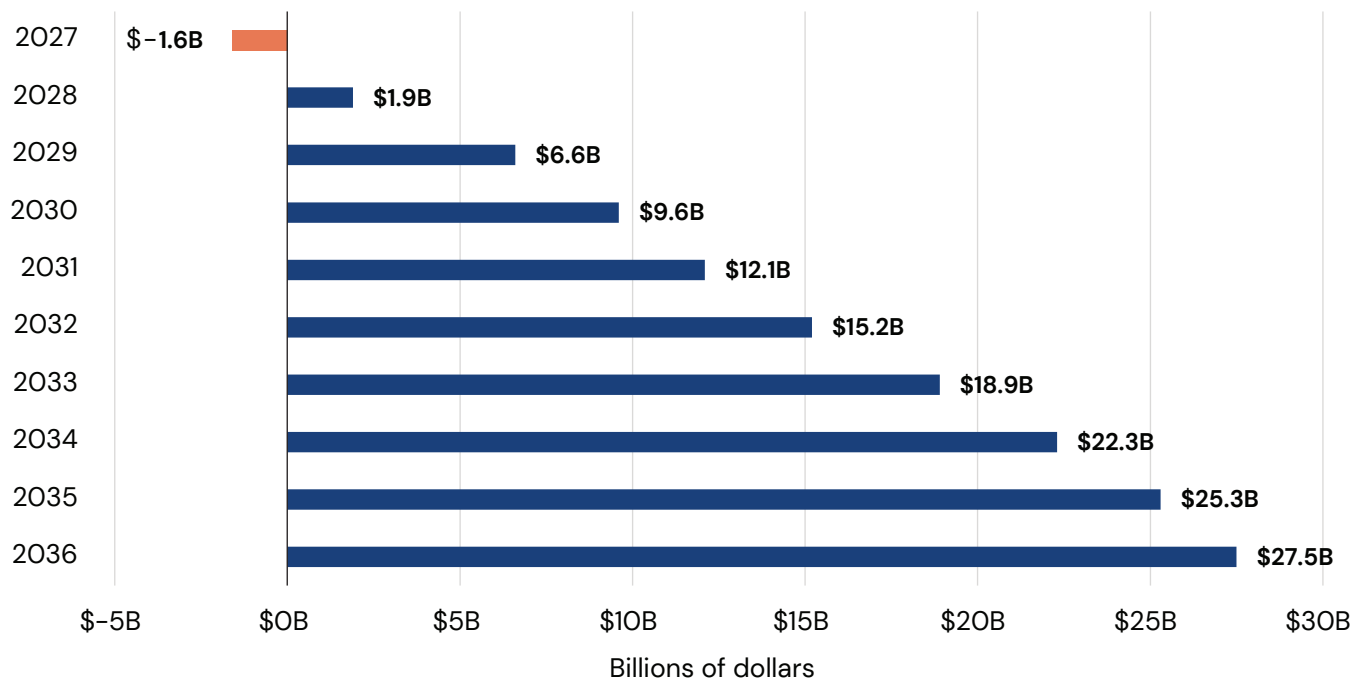
The federal tax system must already deal with this issue to some degree (e.g., because LLCs with partnership economics can, and in certain cases do, elect to be treated as corporations). But today's rules are largely elective and thus do not address the breadth of such issues that could arise under the base proposal. Given the variety in partnership economic arrangements, detailed prescriptive rules that translate partnership economics into corporate stock would be highly complex. More realistically, rules will need to provide general guidance that clarifies expected areas of confusion, such as general rules or guidelines for when differences in economic rights will create separate classes of stock. This detail is perhaps best addressed via regulation. The length of the transition period before effectiveness is also relevant here: A longer transition period could allow taxpayers to evaluate the issue and modify their arrangements accordingly ahead of the effective date, and thus lessen the need for guidance.

### Entities that later fall above or below the size threshold

The rules will need to address entities that become, or cease to be, large once the system is in effect. These entities may fall into, or out of, the rules on an ongoing

FIGURE 4

## Revenue raised by base proposal, 2027–36



Source: Tax Policy Center 2026.

Note: Figure shows revenue estimates for the base proposal, i.e., requiring partnerships and S corporations with gross receipts exceeding \$25 million to be treated as C corporations for federal income tax purposes. Revenue and distribution estimates have been provided by the Urban-Brookings Tax Policy Center.



basis. For entities that later cross the size threshold for being large and thus fall into the rules, the considerations should be largely the same as for initial conversion, discussed below. For entities that are large but later drop below the size threshold, the base proposal would prohibit an elective conversion back to pass-through treatment under the check-the-box rules.<sup>66</sup>

## (b) Revenue and distributional impact of the base proposal

### (i) Revenue

With a current law baseline, the base proposal to treat all partnerships and S corporations with gross receipts above \$25 million as C corporations would raise roughly \$140 billion over the 10-year window from 2027 and 2036. This estimate assumes an effective date of January 1, 2027.

As figure 4 shows, the proposal loses revenue in the first year after enactment but then begins raising revenue in 2028. Revenues then ramp up over the course of the decade, ultimately reaching more than \$25 billion per year starting in 2035.

The revenue is backloaded because the estimates assume that pass-through entities captured by the

regime will seek to avoid increased tax liability in early years, such as by retaining earnings (rather than distributing them) to minimize the second layer of the corporate tax. Essentially, due to the current 21 percent corporate rate, retained corporate earnings are subject to less tax than pass-through business income allocated to individual owners. But this is the case only to the extent such earnings remain inside the corporation or shareholders retain their stock. Thus, as such, retained corporate earnings are assumed to be distributed or otherwise taxed at the shareholder level over time, while revenues from the proposal build over the 10-year window.

### (ii) Distribution

The base proposal would impact nearly half (49 percent) of total pass-through entity net income but fewer than 1 percent of total partnerships and S corporations. Approximately 83,000 partnerships and S corporations would be converted into C corporations under the proposal, which represents just under 0.7 percent of all such entities (0.9 percent of S corporations and 0.4 percent of partnerships). About two-thirds of the entities that would be affected are S corporations and the remaining one-third are partnerships. Section 5 below discusses alternatives that would focus more

TABLE 1

## Distributional analysis of base proposal in 2035

Expanded cash income level	Share of total federal tax change
Bottom 90 percent	6.1 percent
Top 10 percent	93.8 percent
90–95 percent	4.2 percent
95–99 percent	23.3 percent
Top 1 percent	66.3 percent

Source: Tax Policy Center 2026.

Note: Numbers for bottom 90 percent and top 10 percent may not sum to 100 percent due to rounding. Revenue and distribution estimates have been provided by the Urban–Brookings Tax Policy Center.

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TABLE 2

## Impact of alternative thresholds for C corporation tax treatment

	Revenue (billions of dollars)		Shares covered by proposal	
	2027–36	2036	Pass-through entities (2036)	Pass-through net income (2036)
<b>Gross receipt–based thresholds</b>				
\$10 million	\$169.9B	\$34.2B	1.34 percent	63 percent
\$25 million (base proposal)	\$137.8B	\$27.5B	0.66 percent	49 percent
\$50 million	\$124.8B	\$24.7B	0.30 percent	43 percent
\$250 million	\$58.3B	\$11.5B	0.04 percent	20 percent
<b>Asset–based thresholds</b>				
\$50 million	\$115.8B	\$22.1B	0.80 percent	N/A
\$100 million	\$98.0B	\$11.8B	0.40 percent	N/A

Source: Tax Policy Center 2026.

Note: Revenue and distribution estimates have been provided by the Urban–Brookings Tax Policy Center.

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specifically on partnerships. Additionally, since TPC’s estimates index the \$25 million threshold for inflation, growth in the number or share of entities captured by the proposal over time is due to real growth.

Nearly all (94 percent) of the total tax increase arising under the base proposal, once fully phased in, would be borne by those in the top 10 percent of the income distribution (table 1). Furthermore, the majority of the tax increase—66 percent—would be borne by the top 1 percent. This is unsurprising given the concentration of pass-through income among high-income taxpayers.

These distributional estimates use standard TPC incidence assumptions for pass-through business income and allocate the change in tax to affected owners.<sup>67</sup>

### (c) Revenue and distributional impact of variations to the base proposal

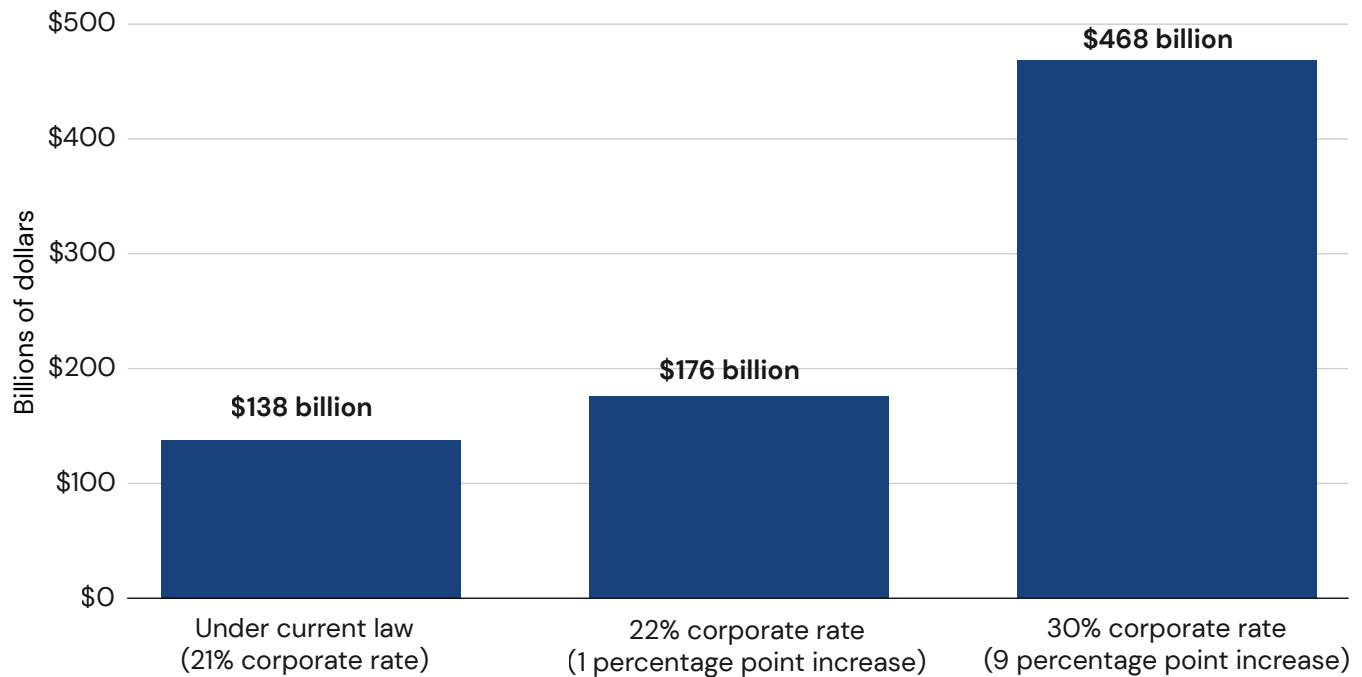
Additional estimates illustrate how revenues raised under the base proposal, and the distribution of those revenues, are sensitive to the following variations.

#### (i) Setting size thresholds at different dollar amounts and/or using an asset test

Table 2 shows how revenue and the share of pass-through entities and pass-through income affected by the proposal varies under alternative gross receipts thresholds or if an asset threshold is used instead.

FIGURE 5

## The base proposal raises additional revenue when paired with increases to the corporate tax rate, 2027–36



Source: Tax Policy Center 2026.

Note: Figure shows revenue estimates for the base proposal, i.e., requiring partnerships and S corporations with gross receipts exceeding \$25 million to be treated as C corporations for federal income tax purposes. Revenue and distribution estimates have been provided by the Urban–Brookings Tax Policy Center.



Unsurprisingly, higher dollar thresholds (e.g., \$50 million or \$250 million rather than \$25 million) capture fewer entities and thus raise less revenue, while lower dollar thresholds (e.g., \$10 million) capture more entities and raise more revenue. All else equal, however, a gross receipts threshold captures fewer entities than an asset threshold but raises more revenue. The pros and cons of an asset threshold are discussed further in Section 5, below.

Additionally, the estimates show that lower gross receipts thresholds capture a greater number of S corporations relative to partnerships. At the highest gross receipts threshold estimated (\$250 million), about 60 percent of the 5,300 total entities captured are S corporations (i.e., 3,200). This proportion increases at each lower threshold—at the lowest receipts threshold estimated (\$10 million), a bit more than 70 percent of the 168,800 total pass-through entities captured are S corporations (i.e., 118,900).

### (ii) Revenue estimates at different corporate and individual tax rates

Figure 5 shows that the revenue potential of the base proposal increases significantly as the corporate tax

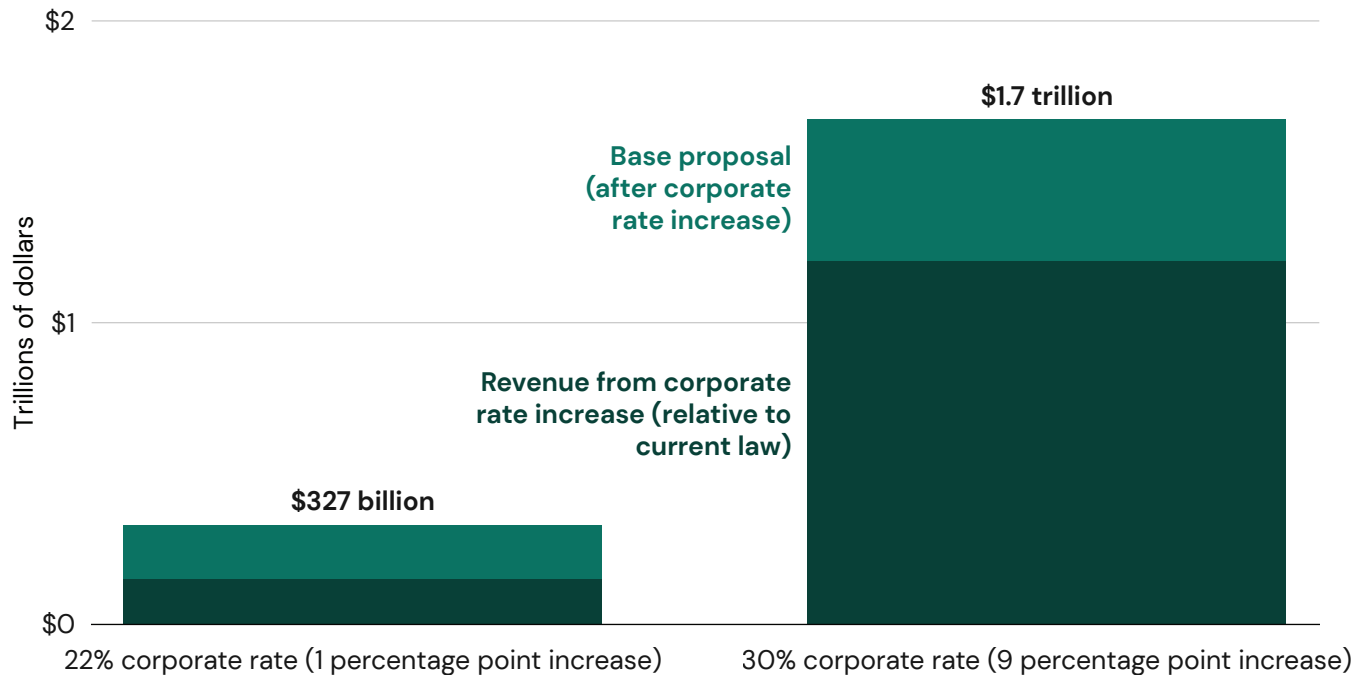
rate increases. The base proposal would raise \$138 billion over 10 years and \$27.5 billion in 2036 at the current corporate rate (21 percent). However, if the corporate rate were increased by 1 percentage point (to 22 percent), the base proposal would raise \$176 billion over 10 years and \$32 billion in 2036. And if the corporate rate were increased to 30 percent, the base proposal would raise about \$470 billion over 10 years and \$67 billion in 2036. (See figure 5.) This would be in addition to the \$151 billion over 10 years (\$18 billion in 2036) raised by increasing the corporate rate to 22 percent on its own, or the \$1.2 trillion over 10 years (\$144 billion in 2036) raised by increasing the corporate rate to 30 percent on its own. (See figure 6.)

The additional revenue reflects both the mechanical effect of applying the higher corporate rate to more income and the impact of the proposal on reducing incentives for businesses to organize or restructure as pass-throughs in response to a corporate rate increase.

Reducing inefficient tax-motivated shifting between entity types is one of the primary rationales for the proposal. Ordinarily, increasing the corporate rate increases the extent of such shifting, which in turn reduces the revenue from the corporate rate increase.

FIGURE 6

## Combining the base proposal with corporate rate increases would raise significant revenue, 2027–36



Source: Tax Policy Center 2026.

Note Figure shows revenue estimates for the base proposal, i.e., requiring partnerships and S corporations with gross receipts exceeding \$25 million to be treated as C corporations for federal income tax purposes. Revenue and distribution estimates have been provided by the Urban–Brookings Tax Policy Center.



The base proposal reduces the ability to engage in such shifting, which helps to address the issue.<sup>68</sup>

While the base proposal would bolster the revenue associated with an increased corporate rate, it would conversely reduce the revenue associated with an increase in the top marginal individual rate. Thus, an increase in the top marginal individual rate from 37 percent to the pre-TCJA top rate of 39.6 percent would raise \$341 billion against current law (over the 10-year window specified above), but it would raise only \$251 billion over that same 10-year window when coupled with the base proposal. In other words, the base proposal would reduce the revenue associated with an increase in the top marginal individual rate by \$90 billion over 10 years. This is because coupling the proposals would narrow the gap between effective tax rates on corporate income and pass-through income, and a higher individual rate would induce some existing entities to convert to corporate classification independent of the proposal. This illustrates the overlap between the base proposal and a simple increase in top marginal rates. That is, for certain pass-through entities, raising individual rates may be a cleaner and simpler way to accomplish the base proposal's goals; however, recent policy has gone in the opposite direction with provisions such as section 199A.

### (d) Reasons to expect larger or smaller revenue impacts

Some aspects of the base proposal either were not modeled for simplicity or could not be modeled based on available information. Likewise, the potential impact of certain behavioral and other responses to the base proposal are particularly uncertain or could not be fully modeled. Below, we discuss these unmodeled (or partially modeled) features and responses. The Technical Appendix explores the implications of many of these choices in further detail.

#### (i) Unmodeled features of the base proposal

##### *Effective date*

As described above, the estimates assume an effective date of January 1, 2027. This ensures that the 10th year of the revenue estimate is useful for understanding the base proposal's long-run revenue effects. However, legislation would almost certainly need to provide a later effective date to allow adequate time for implementation and taxpayer compliance. This would

push the revenue stream out, lowering the amount of revenue that appears in the budget window, though without impacting the long-run revenue gains.

### *Three-year averaging*

The base proposal would measure annual gross receipts based on a three-year average. This approach is not explicitly modeled; however, the revenue estimates account for this in part by adjusting the share of entities and income captured. These adjustments are imprecise, and the exact impact of this element of the base proposal is therefore uncertain, but is likely to have only modest effects on revenue and distribution.

### *Elective conversions back to pass-through treatment disallowed*

Under the base proposal, entities that exceed the gross receipts threshold and trigger corporate tax treatment would generally remain subject to the corporate tax going forward even if gross receipts fell below the threshold. The base proposal would prohibit such entities from later electing pass-through treatment under the check-the-box rules, but most entities would be unlikely to seek a conversion to pass-through treatment anyway. Though this specific feature of the base proposal is not explicitly modeled given available data, the estimates effectively reflect this approach because they do not assume that entities falling below the threshold would convert back to pass-through treatment in any case. Accordingly, alternative approaches that allow elective conversions back to pass-through treatment are unlikely to have a significant effect on revenues.

### *Transition relief*

The rules could provide transition relief by eliminating or deferring any immediate tax liability triggered on a required conversion. Such relief would push revenue later into, or out of, the 10-year budget window. However, while transition relief is not explicitly modeled, the estimates provided here do not assume significant revenue from tax triggered upon conversion. Thus, this type of relief should not generally have a significant effect on these estimates (or, equivalently, this type of relief is already implicitly captured).

### *Aggregation rules*

Any size-based proposal should incorporate aggregation rules, in part to prevent efforts to avoid the size threshold in form but not substance, such as by splitting a single organization into many entities with the same ownership.<sup>69</sup> Rules implementing the base proposal should rely primarily on existing aggregation rules for this, but those existing rules have gaps and inconsistencies in need of reform. For example, they are

often interpreted to allow companies owned and controlled by a private equity fund to avoid aggregation.

The estimates provided here assume that the base proposal would include aggregation rules similar to existing rules. If, as part of the base proposal, aggregation rules were strengthened, they could raise significant revenue on their own and would also increase the revenue raised by the base proposal. Additionally, the tightening of aggregation rules in the context of the base proposal is likely to affect the type and number of entities captured. For example, the number of partnerships captured relative to S corporations may increase from the estimates provided above.

## **(ii) Behavioral responses**

The revenue estimates incorporate behavioral responses by making certain assumptions about how reported incomes change in response to changes in effective tax rates under the proposal. These follow TPC's standard modeling assumptions and are intended to capture various broad dimensions of potential responses, including shifts in business activity across entity types and changes in incentives to report compensation, pay dividends, and claim business losses.

The estimates reflect general responses among affected entities and owners, including shifts in business activity across organizational form. For example, under the base proposal there is a reduced incentive for new firms or activities to choose the pass-through form, and existing pass-throughs may reorganize business activity to remain below the gross receipts threshold as they expand. In addition, the estimates reflect behavioral responses to changes in tax rates across different forms of income. For example, under current law, pass-through owners generally have an incentive to minimize compensation and report more as business profits whereas corporations generally have an incentive to increase compensation (or other deductible payments) in order to reduce tax at the entity level. The estimates assume a general elasticity of 0.4, meaning that, for a 1 percentage point change in the difference between effective marginal tax rates, 0.4 percent of income would shift from a higher-taxed to a lower-taxed form.

The estimates also assume increased incentives among C corporations and their owners to defer taxable dividends and realize capital gains. The estimates assume dividend payout rates and timing of capital gains realizations similar to existing large C corporations.<sup>70</sup> However, many pass-through entities today make cash distributions only to the extent needed to allow their owners to pay taxes on pass-through income (i.e., "tax distributions"); accordingly, once tax is imposed at the entity level, the incentive (and need) to distribute cash may be much lower for many of these entities. If affected entities respond by distributing

less cash as dividends, or by increasing deductible payments, the revenue that the base proposal raises would be lower.

Additionally, the estimates assume a higher utilization of tax losses among pass-through entities relative to C corporations. This reflects the ability of pass-through owners to use losses from one pass-through entity to offset other sources of income in certain cases. It also reflects the greater flexibility found in partnership tax rules for allocating losses among owners. Entities that become C corporations under the proposal are, on average, assumed to utilize about half of their losses in a given year.

The magnitude of these and other possible behavioral responses is a source of uncertainty in the revenue estimates. The assumptions described here are based on historical data and empirical research with respect to prior policy changes and settings. However, because there is no exact antecedent for the specific proposals considered here, and because the modeling must necessarily simplify the policy detail, the actual impact of behavioral responses may differ from what is assumed here.

Specific behavioral responses and similar effects that may or may not be fully reflected by the broad modeling assumptions described above include the following:

### *Non-modeled changes in organizational form (potential to reduce revenue)*

As noted above, the modeling assumptions incorporate some behavioral responses to the proposal with respect to choice of entity. However, there is additional choice-of-entity planning that is not explicitly modeled. For example, instead of accepting C corporation treatment, certain entities may seek to qualify as RICs or REITs and thus maintain a form of pass-through treatment, including by restructuring their assets or investments. Whether taxpayers can and do pursue these routes, and the resulting revenue effects, will depend on each entity's particular circumstances as well as how the proposal is constructed.

### *Restructuring of existing equity arrangements to avoid corporate treatment (potential to reduce revenue)*

As noted above, the estimates make assumptions to incorporate responses based on the retention and payout of corporate earnings, both as dividends and as compensation. However, other specific responses aimed at avoiding corporate treatment in the first place are not explicitly modeled. For example, some businesses may begin structuring what would otherwise be equity interests as loans, licenses, or other contractual arrangements not treated as equity for tax

purposes if doing so could help them avoid being converted into a C corporation under the proposal.<sup>71</sup>

### *Avoiding being large (potential to reduce revenue)*

Relatedly, many entities will have a strong incentive to avoid crossing the size threshold that results in corporate tax. To limit the effect of this incentive, the base proposal would aggregate commonly owned and controlled entities for purposes of measuring size. Taxpayers are likely to respond by seeking to avoid aggregation wherever possible, such as by undertaking changes in ownership that have real economic consequences (e.g., a sale of a significant stake to an unrelated third-party). In other cases, however, taxpayers may attempt more aggressive strategies for avoiding aggregation, including (1) obscuring or recharacterizing ownership on paper to avoid aggregation in form but not substance, (2) manipulating certain business activity (e.g., when revenues arise or when assets are acquired or sold) so that it falls inside or outside a particular tax year, or (3) seeking to manipulate size by measuring receipts or asset values in particular ways.

### *Foreclosing unmodeled avoidance techniques that make use of pass-through tax rules (potential to increase revenue)*

The estimates above generally take pass-through income as given. However, the base proposal may effectively shut down some existing tax planning or avoidance techniques that rely on partnership tax rules, such as related party basis shifting transactions. If that occurs, taxable income could increase as a result of the proposal in ways that are not captured by the estimates. Sizing these potential revenue impacts is extremely challenging (e.g., due to the information challenges noted above and in a prior report published by the Tax Law Center and The Hamilton Project), but they could be significant.<sup>72</sup>

### *Facilitating improved tax enforcement (potential to increase revenue)*

As discussed below, the proposal could make it easier for the IRS to enforce tax laws against certain large or complex pass-through entities. Any revenue raised through this channel is not included in the estimates.

## **(e) Tax administration benefits and challenges of the base proposal**

Tax administration, particularly with respect to partnerships, is in dire straits. IRS budget cuts from 2010 until the passage of the Inflation Reduction Act in 2022 have significantly limited the IRS's ability to understand

and examine large and complex partnership structures. While efforts were made to improve IRS capacity and abilities with respect to partnerships during the Biden administration, those efforts have been rolled back, and capacity has been eroded even further under the second Trump administration. Notably, the IRS has lost a quarter of its staff. This puts a premium on revenue-raising reforms that an under-resourced IRS can administer.

A key administrative benefit of the base proposal is that it would push a significant number of large, and likely complex, partnerships out of subchapter K and into subchapter C. Given the IRS's difficulty in administering subchapter K (as compared to subchapter C), this shift would likely relieve some pressure on the IRS's administrative resources.

At the same time, the shift of entities from pass-through to corporate treatment means that the base proposal would likely require additional resources and expertise in the IRS's corporate divisions. When complex entities that have previously operated as partnerships are converted into corporations, new issues and planning opportunities will undoubtedly arise, creating a need for new guidance as well as robust enforcement. This guidance and enforcement will need to come from Treasury and IRS personnel with experience in both partnership and corporate rules. Furthermore, the shift of a significant number of S corporations into subchapter C may have the countervailing effect of adding more complexity to the system: While S corporations are generally required to have simple ownership and capital structures, no such restrictions would be imposed on such entities once treated as C corporations. However, IRS corporate staffing has generally been deeper than its pass-through staffing, and so meeting these increased demands may be significantly easier to achieve than bolstering the IRS's pass-through capabilities.

The base proposal will impose new administrative and compliance burdens on taxpayers. If the policy is constructed and implemented thoughtfully, however, it is possible that the biggest administrative and compliance burden for taxpayers could be limited to evaluating whether they meet the size thresholds, including under complex aggregation rules. As discussed above, even businesses that remain below the relevant size threshold may experience some administrative burden related to this analysis. While applying such tests can be difficult, the tests will be conceptually and mechanically similar to other complex size-based tests that are familiar to many entities from other existing tax rules, such as the corporate alternative minimum tax (CAMT) or section 163(j). If anything, this conceptual similarity supports pursuing some of the aggregation reforms discussed here more broadly—the more unified existing aggregation, attribution, and related

party rules are, the less taxpayers will be forced to apply many disparate, complex regimes.

Other potential burdens on taxpayers relate to effectuating a tax-efficient conversion of complex pass-through arrangements into complex corporate arrangements. However, the administrative burdens imposed on taxpayers under the base proposal will depend heavily on its design and implementation. Many of the policy design details discussed here and in the Technical Appendix are discussed with a view toward reducing these burdens and constructing a proposal that can be implemented in a workable fashion. These include delayed effective dates (allowing taxpayers to reevaluate and restructure their own arrangements), transition relief (designed to minimize the difficulty and negative tax impact of conversion), and guidance with respect to treating pass-through equity arrangements as corporate stock.

On a go-forward basis, once entities have transitioned to the regime and the rules are in place, the compliance burden of preparing a complex corporate tax return (or joining one as part of a consolidated group) may not be significantly higher than the burden of preparing complex partnership returns. In some cases, the burdens imposed by corporate tax returns may even be lower. This is particularly true for individual partners, for whom partnership tax returns typically create significant additional reporting and filing complexity.

To be sure, constructing and implementing the base proposal in a workable manner will require significant up-front work from Congress, Treasury, and the IRS. But the more that careful consideration can be given to the development of policy details at the outset, such as by working through those discussed in the Technical Appendix, the smoother implementation can be.

For a sense of the scale of the implementation challenge, the base proposal could, if well-constructed, be less burdensome from an administrative and compliance perspective than the recently enacted CAMT, at least on a per taxpayer basis. While the base proposal would apply to a subset of large entities (like CAMT), it would rely (unlike CAMT) on longstanding concepts, rules, and mechanics already in the tax code. Thus, rather than constructing a whole new tax that is based on highly complex nontax (i.e., book) concepts and integrating these nontax concepts across all substantive areas of business and entity taxation, the base proposal simply shifts entities from one existing tax classification to another. Additionally, much of the uncertainty and administrative burden of CAMT was the result of legislators leaving many key design questions to future administrative guidance, but they have the option to resolve more of these questions upfront in future legislation.

# 5. Questions and concerns

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## Is a gross receipts test the best way to measure size?

A gross receipts test may fail to capture some entities that either are large by other standard measures or that engage in other economically significant activities. Examples include entities likely to have significant assets but inconsistent income streams, such as investment entities in the financial and real estate sectors or holding companies. If policymakers wish to capture large pass-through entities regardless of the nature of their activities or the timing and nature of their revenues, they may need to explore alternative ways of measuring size, such as a threshold based on asset values rather than receipts.

An asset test would measure an entity's size based on the value of its aggregate gross assets.<sup>73</sup> Just as the base proposal's gross receipts test would use a three-year average, an asset test should also use a multiyear average for the measurement period.<sup>74</sup> Asset value is an intuitive measure of size, and such a test would capture entities that have significant economic activities but minimal receipts. Moreover, tests based on assets are reasonably widely used throughout the tax system.

This paper focuses on a gross receipts test rather than an asset test for two reasons. First, the gross receipts test is easier to administer. An asset test requires periodic valuations, which can be subject to error and manipulation (particularly in the case of illiquid or nonmarketable assets) and difficult to verify. This could put pressure on IRS enforcement capacity. Second, because gross receipts are more closely correlated with income, a gross receipts test raises more revenue while capturing fewer entities. For example, as shown in table 2, a gross receipts threshold of \$50 million raises modestly more revenue than an asset threshold of \$50 million while impacting far fewer pass-through entities.

## Is size the best way to determine whether pass-through entities should be subject to corporate tax?

More broadly, size alone may not be the best metric for assessing the similarity of entities or imposing more uniform tax treatment. Other metrics not based

on size, such as the nature of an entity's equity ownership arrangements, could be used to determine which entities are subject to corporate tax.

An ownership test is a way to focus the proposal on pass-through entities that have sufficiently complex ownership structures—in other words, those for whom pass-through taxation presents the most acute administrative and enforcement difficulties—and thus could be viewed as better tailored than a size threshold to many of the issues that pass-through entities create.<sup>75</sup> For example, even if very large (by receipts or assets), the significant number of S corporations captured by the base proposal will have simple ownership structures and thus may not present the administrative challenges of pass-through taxation discussed in Section 2. A relatively simple ownership-based test could also avoid the difficulties of determining where to set the size-based threshold and assessing whether particular entities meet it, including under complex aggregation rules that require testing overlapping direct and indirect ownership.

The most straightforward way to implement an ownership-based approach would be to rely on existing rules by incorporating some or all of the existing requirements for S corporation treatment. For example, such an approach could provide that any pass-through entity with (1) 100 or more equity owners,<sup>76</sup> (2) at least one equity owner that is not an individual, and (3) economic ownership that is not proportionate based on capital (i.e., that would not satisfy the functional equivalent of the S corporation one-class-of-stock requirement) would be subject to corporate treatment.<sup>77</sup>

While this type of ownership test is not estimated here, the main difference from the base proposal is that it would capture more partnerships and fewer (or perhaps zero) S corporations. That is, S corporations would generally satisfy the above test while many partnerships would not. This could be seen as an advantage: If a key reason for imposing corporate treatment on large pass-through entities is the increasing administrative impossibility of applying partnership tax rules to highly complex arrangements, then it will generally make sense to exclude S corporations even if large. On the other hand, if a primary goal is to apply similar tax treatment to similar business entities and reduce tax-motivated choice of organizational form, then it could be a disadvantage.

Additionally, because the ownership test above would generally capture any partnership with the slightest complexity in economic or ownership structure, it may be viewed as overbroad. For example, it would capture many partnership arrangements that are relatively simple, and it would not limit uniform corporate treatment to the largest entities. To address some of these issues, the ownership test could be drafted to better capture partnerships that are truly complex (e.g., those that use special allocations or have a particularly complicated distribution or allocation waterfall). However, this would make the test more difficult to draft and implement and would encourage planning aimed at achieving the economics of a disqualified (i.e., complex) capital structure by using loans or other contractual arrangements. Rules that impose a particular tax treatment based on business owners structuring their economic ownership in a particular manner are often viewed as overly restrictive and potentially arbitrary. Finally, adjusting to capture only truly complex economic arrangements, without an additional size-based threshold, may capture too many businesses that are small based on measures more directly related to their operations.

Estimates for an ownership-based threshold are not feasible using available public data. The revenue impact of applying such a test, rather than the base proposal's gross receipts threshold, would depend on how the ownership restrictions are formulated—for example, whether they capture enough additional partnerships to make up for the lost revenue from effectively excluding S corporations.

## How does the base proposal compare to alternative proposals to levy a separate entity-level tax on large pass-throughs?

Policymakers may wish to consider alternatives that do not rely on the base proposal's C corporation approach. One such alternative would be to instead impose a new pass-through entity level tax on large pass-through entities. Certain existing proposals (including a 2016 Center for American Progress report) allude to this approach.<sup>78</sup> Additionally, some may view this as a simpler approach than requiring all large pass-through entities to fully convert into C corporations for federal tax purposes.<sup>79</sup>

As discussed above, the base proposal has the advantage of relying largely on existing entity classifications and familiar tax mechanics—moving existing entities from one existing tax regime to another. This alternative proposal would instead need to create an essentially new federal pass-through entity tax base and mechanics. Accordingly, close consideration of both approaches indicates that the base proposal's C corporation mechanics ultimately provide a more

workable starting place for policymakers wishing to impose entity-level tax on large pass-throughs. However, the choice between the two is not entirely clear cut.

Under the alternative proposal, all covered pass-through entities would pay a new entity-level tax but would otherwise continue to be treated as pass-through entities for federal income tax purposes. The threshold used to define which entities are captured could generally be set in the same manner as under the base proposal (including any of the variations discussed above). That is, both approaches would apply only to large or complex pass-through entities.

Implementing the alternative proposal is likely to be more difficult than it sounds. At minimum, it will require crafting new and complex rules to address, among other things (1) how to determine and calculate the tax base, (2) the applicable tax rate (likely a single flat rate applied to the base), (3) how the entity-level tax is allocated and shared among partners or owners, and (4) how the tax should be calculated and paid in tiered entity structures.

None of these issues appears entirely insurmountable, but a particularly complicated aspect of the alternative proposal is how to determine the right tax base. Neither partnerships nor S corporations generally compute a single entity-level net income or loss number under current law, so the base would need to be a new number rather than an existing one. The best approach would be to construct the base from tax amounts that pass-through entities already calculate and report to their owners (e.g., a sum of all entity-level items of income, gain, loss, and deduction), but even this raises several complex questions. These (and many other) complexities are discussed in greater detail in the Technical Appendix.

## How would the base proposal interact with other business tax reforms (aside from increasing the corporate rate)?

Estimates are provided above for pairing the base proposal with certain tax rate increases. However, the proposal could also be paired with, or compared to, many other sound options aimed at broadening the business tax base, including (1) closing gaps in the application of the 3.8 percent Medicare tax on active pass-through income (e.g., by expanding Self-Employed Contributions Act taxes and/or the net investment income tax [NIIT] under section 1411),<sup>80</sup> (2) reforming or repealing the exemption for gains on qualified small business stock under section 1202,<sup>81</sup> (3) curtailing tax benefits for exchange-traded funds (ETFs),<sup>82</sup> (4) eliminating corporate or partnership basis shifting,<sup>83</sup> and (5) improving tax administration and enforcement.

Such reforms are expected to raise significant revenue on their own, and their impact would be

concentrated among high-income filers. They should therefore be considered on their own merits, as discussed in prior analyses of the need for pass-through tax reform.<sup>84</sup> Some specific base-broadening reforms, such as ending partnership related party basis shifting, limiting nonrecognition treatment for ETF redemptions, and closing gaps in the Medicare tax base would have revenue impacts broadly similar to the base proposal (i.e., primarily affecting large and complex entities and generating significant revenue) while being generally simpler to administer than the base proposal. But many such reforms could also be highly complementary to the base proposal for several reasons:

First, a key impact of the base proposal would be to move certain entities from subchapter K to subchapter C. Subchapter K would thus apply to fewer (and likely, simpler and smaller) entities than it does today. This could facilitate reforms aimed at simplifying and rationalizing subchapter K's rules since those rules would now be focused on a set of smaller and generally simpler entities. However, any such reforms would need to be careful not to remove important detailed rules from subchapter K, even if those rules are complex, since many small partnerships still use complex economic arrangements.

Second, some of the reforms above would affect a wider population of pass-through entities than the base proposal, such as proposals to close gaps in the Medicare tax base by tightening Self-Employed Contributions Act and NIIIT rules. Similarly, certain reforms above would impact only particular types of entities—for example, limiting nonrecognition treatment for ETF redemptions, which would directly apply to RICs rather than to partnerships or S corporations. That is, these proposals would address specific problems in existing tax rules and would apply to all entities of a particular type, regardless of size, thus potentially complementing the base proposal's focus on broader revenue losses attributable to large and complex pass-throughs.

Third, under the base proposal many large businesses would be shifted into subchapter C and thus generally would be subject to corporate tax, making reforms that fix the corporate tax base (e.g., restricting corporate basis shifting) even more consequential from a revenue perspective.<sup>85</sup> New subchapter C rules may also be needed to address taxpayer responses to the base proposal itself. Similarly, to the extent the base proposal pushes more large and complex investment entities into RIC or REIT status, it may also increase the need for fixes and reforms to those rules.<sup>86</sup> Some or all of these complementary reforms should be pursued alongside the base proposal; doing so would likely increase and protect the revenue that the base proposal is estimated to raise.<sup>87</sup>

Fourth, the base proposal would serve as a much broader backstop against the use of pass-through treatment to escape increases in the corporate tax

rate than the more targeted proposals, especially given current uncertainty about the breadth and scope of tax avoidance strategies that rely on existing pass-through tax rules.

## What types of firms would be expected to pay more under the base proposal?

According to IRS data, partnership receipts are concentrated in the following industries: (1) finance and insurance, (2) wholesale and retail trade, and (3) manufacturing. Additionally, two industries often closely associated with partnerships—real estate and professional services—have the next largest amount of total partnership receipts after these top three.<sup>88</sup> Similar data show that the majority (more than 60 percent) of large S corporation receipts are concentrated in the following industries: (1) wholesale and retail trade, (2) construction, and (3) manufacturing.<sup>89</sup> The different industry concentrations of S corporations and partnerships in these data matches expectations, since S corporations tend to be operating businesses and are less prevalent than partnerships in the finance and professional services industries. The foregoing statistics provide a general picture of the types of industries likely to be captured by the base proposal.

In addition, the following general summary highlights some particular types of pass-through entities that may be converted into corporations under the base proposal. This area warrants further study and analysis.

### *Large professional services firms (e.g., law and accounting firms)*

These firms are typically organized as partnerships. The largest will have gross receipts well above the base proposal's \$25 million threshold and are thus likely to be captured. These firms represent a core traditional use of the partnership form but also reflect the significant growth in pass-through business income. Many are global operations with hundreds of partners, though their ownership may not otherwise be particularly complex.

For noncomplex but large businesses such as these, a potentially simpler way of reducing their tax advantage relative to corporations would be to simply raise the top individual income tax rates. As discussed above, at the current corporate rate, the base proposal reduces the revenue from an increase in the top individual rate from 37 percent to 39.6 percent. However, this route would also require attention to the ways in which owners of some large but relatively simple pass-through businesses may not face the top individual tax rates—not because of the use of complex subchapter K rules, but because of provisions such as section 199A. Although there are income-based limitations on the

benefits of section 199A for owners of most service businesses, including law and accounting firms, owners of engineering and architecture firms, some of which are very large, are not subject to these limitations.<sup>90</sup>

### *Investment management firms, such as private equity and similar managers*

Also typically organized as partnerships, these businesses should generally make up a portion of the partnership receipts that appear in the “finance and insurance” industry, per the above data. Like large professional service firms, many of the largest investment management firms are likely to have receipts above the \$25 million threshold. These firms are similar to the professional services firms described above in that they primarily earn fees and are generally not capital-intensive businesses. Firms in this industry have become increasingly large and complex over time, including as a result of pursuing public offerings, minority investments, and other liquidity events. Notably, however, some of the largest firms in this group have already opted for either full or partial corporate treatment, particularly after the changes to the corporate and individual rate structures under TCJA.<sup>91</sup>

### *Investment fund partnerships (e.g., private equity funds themselves)<sup>92</sup>*

These entities may be captured under the base proposal, but that is not certain. Private fund vehicles are typically partnerships. The largest funds can be highly complex, with hundreds of partners (including many foreign and tax-exempt partners) spread across multiple partnerships and with equity ownership shared by partners according to complicated rules. The growth of these partnerships and their investors is likely a significant contributor to the complicated network of interconnected partnership entities that makes tax administration difficult.<sup>93</sup> Because the base proposal is not limited to operating businesses, and thus does not carve out pure investment partnerships, these funds could be treated as corporations if they cross the relevant threshold. However, under the base proposal, they would generally be captured only if they have sufficient gross receipts (from investment realizations, dividends, etc.). The timing or nature of receipts may be easier to manipulate here than in other industries, such as by changing the timing or nature of investment realizations. In addition, the fund partnerships themselves are likely to be captured by the base proposal only if: (1) the aggregation rules are reformed as described above and in the Technical Appendix, and (2) the fund partnerships are unable to avoid such treatment by using other available tax classifications, such as validly electing RIC status.

### *Operating pass-through businesses, including fund portfolio companies*

As noted above, pass-through receipts are heavily represented in certain operating business industries, such as wholesale trade and manufacturing. Operating pass-through businesses in these industries are likely to include many entities that are (1) large but relatively closely held businesses and (2) pass-through portfolio companies owned by the investment funds described above. Many pass-through portfolio companies in the latter group may not have sufficient gross receipts to be captured on a standalone basis, and thus may not be reflected in the TPC estimates, but they are much more likely to be captured if the aggregation rules are modified as described above and in the Technical Appendix. Furthermore, these businesses would appear to be a key example of the types of entities the base proposal is aimed at capturing, as they often: (1) are partnerships; (2) have highly complex direct and indirect ownership (e.g., they are not closely held but are owned directly or indirectly by a large and varied group of investors, including other entities); and (3) have complex economic sharing (e.g., to reflect differential sharing among an array of investment funds, direct co-investors, management, and other owners).

### *Real estate businesses*

Many operating businesses in the real estate industry, such as real estate developers, are organized as partnerships. They can have very significant receipts and very complex ownership structures, even if they are family businesses or otherwise closely held. See, for example, the partnership structure in the recent Otay Project case.<sup>94</sup> Firms such as this are likely to be captured by the base proposal.

### *Energy-related businesses and projects*

Similar to real estate, businesses and projects in the energy industry (e.g., clean energy projects, oil and gas ventures, etc.) often organize as partnerships. Historically, some of these entities have organized as “master limited partnerships,” or publicly traded partnerships that are able to avoid corporate treatment under an exception for businesses with sufficient “qualifying income” from natural resource activities. Additionally, certain energy projects are undertaken and financed through “tax equity” partnerships that rely on subchapter K rules to divide the value of tax credits or other tax incentives, which may warrant further consideration.

## Are there economic downsides to preventing large or complex firms from selecting pass-through and, in particular, partnership tax treatment?

Much of the complexity of partnerships arises from the fact that they provide significant flexibility to owners in constructing their business and economic arrangements. This can be highly beneficial to the partners. Rather than forcing owners to fit their desired economic sharing of ownership of the business onto a rigid “share class” model, partnerships prioritize giving business owners a clean slate on which to write the economic ownership of their business. Similarly, partnerships provide more flexibility than corporations to accomplish certain common business transactions tax efficiently, such as transferring assets into or out of the business and granting equity to service providers.

As discussed above, these sources of flexibility generate significant tax planning and revenue loss. However, they also facilitate legitimate business transactions and other real economic activity. As a result, eliminating partnership treatment for certain businesses may impair some valuable economic activity and thus partially offset the administrative and revenue benefits. Limited data make it particularly difficult to quantify these economic impacts.<sup>95</sup>

## How does the base proposal address the cliff-effect that occurs once an entity reaches the size threshold?

Under the base proposal, once an entity crosses the size threshold, it becomes a C corporation and potentially faces a large additional tax liability. Features of the base proposal would ameliorate or mitigate the incentive to avoid crossing that threshold, whether through lawful or unlawful means. These features include measuring receipts over a rolling average of three years, incorporating and strengthening aggregation rules, and prohibiting large entities from electing out of C corporation treatment once they move in.

An additional option could be to phase in the resulting tax increase over some range, such as entity size. Changes in tax law frequently use similar phase-ins, or phase-outs, as applicable. A phase-in would further blunt incentives to avoid the cliff at the margin but would also be very complex. For example, it would mean calculating the difference between tax

liability under corporate treatment and tax liability under pass-through treatment, requiring two sets of tax calculations under very different regimes. This would significantly increase the administrative burdens of the base proposal for both filers and the IRS and could decrease the revenues raised (though the impact on revenue and distribution would depend on the phase-in thresholds and rates).

## Should other pass-through entities be subject to the proposal?

As described above, the base proposal would not apply to certain specific types of entities or arrangements that are commonly thought of as pass-throughs, such as RICs, REITs, and sole proprietorships. As a result, treatment of large or complex entities would not be fully uniform even under the base proposal. Whether these entities should be captured is an issue that any policymakers pursuing a proposal to tax large pass-through entities should consider carefully.

The base proposal carves out RICs and REITs because they are specific tax classifications that reflect a prior policy decision to retain a rigid form of pass-through treatment for certain investment entities with particular types of assets and income. RICs and REITs are subject to detailed income and asset testing to ensure their tax treatment. And the base proposal would not apply to sole proprietorships (including DREs, such as single-member LLCs) because they are not separate entities for U.S. federal income tax purposes. That is, if a DRE’s sole owner is already a corporation, there should be no need to impose corporate treatment, and if a DRE’s sole owner is a partnership or S corporation, then the sole owner would be tested for corporate treatment under the base proposal.

Carving out these, or any other, specific types of entities or businesses results in line drawing and could create distortions. For example, capturing large pass-through businesses with two or three owners (partnerships) but not those with a single owner (DREs) could cause certain businesses to be aggressive in re-characterizing equity arrangements as loans or other contracts to maintain DRE treatment. However, the base proposal’s significant size threshold for corporate treatment, as well as the detailed requirements for satisfying RIC or REIT status under current law, are likely to minimize the impact of any such distortions. Nevertheless, this is an area that warrants further study and analysis.

## 6. Conclusion

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By analyzing a concrete proposal to tax large or complex pass-throughs as C corporations in detail, this project sheds new light on both the attractions and challenges of such an approach. The proposal has the potential to raise substantial revenue (especially in combination with an increase in the corporate rate), reduce tax differentials across different types of entities, and simplify and improve tax administration and enforcement (at least in the long run). At the same time, the implementation and transition challenges associated with the proposal are real and substantial. Even with careful design, the proposal carries risk and a significant up-front burden for Congress, Treasury, the IRS, and taxpayers.

Ultimately, proposals to tax large or complex pass-throughs at the entity level belong on the menu

of options for business tax reform. However, this paper does not unreservedly endorse such proposals. The merits and feasibility of pursuing such a proposal depends in significant part on (1) what other revenue-raising options are politically viable; (2) whether the proposal would be adopted alongside (or instead of) various other pass-through, corporate, and individual reforms and rate changes; and (3) many details of policy construction and implementation. But, given the clear need for additional revenue, the increasing administrative difficulties of pass-through taxation, and potential obstacles to other important tax reforms, the proposal warrants further consideration and development at minimum, and may be worth pursuing.

# Appendix 1: Summary of prior proposals

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The attractions discussed in Section 3 of the paper have generated a long history of tax reform and budget proposals from across ideological lines that would tax only some pass-throughs—particularly large or complex pass-throughs—at the entity level as corporations, including from The Hamilton Project. These include the following, in chronological order:

**Professor Curtis J. Berger’s<sup>96</sup> 1991 proposal** to tax more large pass-throughs as corporations as part of broader business tax reforms.<sup>97</sup> Berger’s 1991 proposal includes a proposal to tax large businesses (i.e., businesses with between \$10 million and \$50 million in gross receipts in 1991 dollars, or approximately \$23.7 million to \$118 million in 2025 dollars) as corporations.<sup>98</sup> Berger’s proposal is notable for the depth at which it explores various threshold and definitional issues key to making the proposal workable.

**Professor Lawrence Lokken’s 1999 proposal**, as part of broader reforms, to tax all non-service firms (i.e., entities “with two or more owners whose capital is a material factor in the production of its income”) under subchapter C unless they satisfy modified criteria for pass-through taxation under subchapter S (including subchapter S’s limitation on the number of owners).<sup>99</sup> This approach essentially imposes corporate taxation on certain pass-through entities based on their size or complexity, using number of owners and nature of activities as the relevant measures of size or complexity.

**The Bush administration’s 2005 President’s Advisory Panel on Federal Tax Reform.**<sup>100</sup> The 2005 Advisory Panel sought “to provide a more uniform and consistent treatment of business activity[,]” including by taxing large pass-through businesses (i.e., pass-throughs with “more than \$10 million in receipts” in 2005 dollars, or approximately \$17 million in 2025 dollars) “at the entity level like corporations.”<sup>101</sup> However, this proposal would also have moved toward a single layer of tax for both corporations and pass-throughs subject to this entity-level tax. That is, the Advisory Panel proposed to provide a 100 percent exclusion for domestic dividends and a 75 percent exclusion of capital gains on sale of corporate stock.<sup>102</sup>

**The Obama administration’s 2010 President’s Economic Recovery and Advisory Board.**<sup>103</sup> Seeking “tax neutrality with respect to organizational form[,]” the 2010 Advisory Board report discussed the option of taxing certain pass-through businesses as corporations.<sup>104</sup> The report noted various criteria that might

warrant corporate treatment. Some of these criteria related to the size of a business (including being over some “income or asset threshold”); others related to complexity (including the number of shareholders); and others related to “corporate” characteristics independent of size and complexity (including whether a business is publicly traded).<sup>105</sup>

**In 2011 former Senate Finance Committee Chair Max Baucus<sup>106</sup> and in 2012 former Treasury Secretary Tim Geithner<sup>107</sup>** encouraged lawmakers to consider whether some large pass-throughs should be taxed as corporations. While they did not flesh out these proposals, their statements stemmed from concerns with distortions caused by choice of business form under the tax code.

**The Center for American Progress’s 2016 report, Ending the Pass-Through Tax Loophole for Big Businesses.**<sup>108</sup> The 2016 report discusses an option to tax large pass-throughs as C corporations in order to “ensure[] stable revenues to fund important public services but also maintain[] fairness in the tax system as a whole.”<sup>109</sup> To do so, the report generally discusses the option of imposing “size thresholds based on level of profits, gross receipts, or assets” to “target less than 2 percent of pass-through firms[.]”<sup>110</sup> It also discusses an alternative, complexity-based option that would tax partnerships that have more than 100 partners as C corporations.<sup>111</sup>

**Professor Jeremy Bearer-Friend’s 2018 white paper**<sup>112</sup> proposing to tax LLCs and LLPs as corporations and repeal subchapter S.<sup>113</sup> This approach can be understood as focusing corporate taxation on legal entities that have corporate characteristics (e.g., limited liability for all owners), irrespective of measures of size or complexity.<sup>114</sup>

**Former Council of Economic Advisers Chair Jason Furman’s<sup>115</sup> 2020 Hamilton Project proposal.**<sup>116</sup> Furman proposed to make five changes to business taxation, including requiring all large businesses (those with approximately \$25 million in gross receipts in 2020 dollars) to be taxed as C corporations, and raising the corporate rate to 28 percent.<sup>117</sup> Furman estimated that taxing large pass-throughs as C corporations would raise \$300 billion.<sup>118</sup>

**Professors Edward Fox, Zachary Liscow, and Michael Love’s 2026 paper** that suggests a reform that would tax “stacked firms” (i.e., partnerships with a partner that is itself a partnership) or otherwise “especially complex firms” as C corporations.<sup>119</sup> The

paper also discusses the option of instead taxing pass-throughs above some “size or scale” as C corporations, and notes concerns about creating a “distortive” size-based “tax cliff,” or of doing so “without also addressing the interconnectedness problem” among firms currently taxed as pass-throughs.<sup>120</sup>

Proposals to tax certain large or complex pass-throughs at the entity level under subchapter C have also been discussed in reports from the Congressional Research Service in 2012<sup>121</sup> and 2014<sup>122</sup> and the Congressional Budget Office in 2012.<sup>123</sup>

# Technical appendix

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This appendix provides additional technical discussion of many key details important to the design and implementation of the proposals discussed in the policy paper. It first focuses on the proposal to treat certain pass-through entities as corporations (the base proposal), and then discusses additional details regarding the proposal to impose a new federal entity-level excise tax on certain pass-throughs (i.e., the alternative proposal).

The gap between discussing these proposals at a high level and developing them into workable policy is large. Given the breadth and scope of both proposals, neither the paper nor this technical appendix can address all the technical design and implementation issues that each proposal will raise. Still, this appendix seeks to provide a starting point for those wishing to go several levels deeper into the details that would be needed for crafting workable policy. It aims to do so by highlighting many key details that will need to be resolved, explaining their stakes, proposing solutions (or options for possible solutions) where feasible, and noting areas where further analysis is needed.

## I. Base proposal: Treating certain pass-through entities as C corporations

The first, and primary, proposal discussed in the paper would treat all large pass-through entities as C corporations, with an entity's largeness defined by reference to its gross receipts. Specifically, the paper's base proposal would apply corporate treatment to pass-through entities with gross receipts exceeding \$25 million. As discussed in this appendix and in the paper, however, alternative thresholds could be used and should continue to be considered. Such alternatives include a gross receipts threshold that uses a different dollar amount (e.g., \$50 million), a different size-based threshold altogether (e.g., asset values), or a non-size-based threshold (e.g., based on features of the entity's equity ownership or even the nature of its activities).

Because corporate treatment under subchapter C is an intuitive and existing mechanic for imposing entity-level tax under our current system, it is the approach most other existing proposals of this nature have suggested. It draws on existing (and, in some

cases, long-standing) rules for both entity conversions and entity taxation, and so represents less of a departure from the current system than some other approaches.

### A. Broadly follows existing US tax law

One reason for the base proposal's appeal is that it leverages existing U.S. tax classifications. That is, U.S. tax rules already include a type of entity that pays federal income tax on its own income (the "association" taxable as a corporation under subchapter C, or C corporation). What's more, C corporations are one of the most well understood and oldest types of entities in the U.S. tax system. As a result, it makes intuitive sense that proposals to impose entity-level tax on certain pass-throughs would do so by imposing C corporation treatment.

Additionally, current U.S. tax law already adopts this approach in certain cases, imposing corporate taxation under subchapter C on certain entities that would otherwise default to pass-through treatment. In particular, section 7704(a) already requires most partnerships with publicly traded equity interests (publicly traded partnerships, or PTPs) to be taxed as C corporations. This reflects a reasonable policy judgment that access to capital through the public equity markets is a hallmark, and historic feature, of corporate treatment that should be reflected in the tax law. It also protects the integrity of the subchapter C tax base by ensuring that large publicly traded entities, which have historically been taxed as C corporations, cannot simply convert to pass-through treatment.

The base proposal would essentially follow the same approach, adopting PTP-style mandatory corporate taxation for covered pass-through entities. The rules and approaches for determining which pass-through entities would be subject to the regime (referred to here as "Covered Entities") are discussed further at Section I.E. of this appendix.

### B. Basic rule: Treatment as a corporation

As a matter of legislative design and drafting, the base proposal's essential mechanic would be relatively simple. For purposes of Title 26 (i.e., the U.S. tax code, or the Code), any entity that qualifies as a Covered Entity would be treated as a corporation. The legislative text

could mirror the language and treatment that already applies to PTPs under section 7704(a).<sup>124</sup>

### C. Interaction with existing PTP rules

Under this approach, the existing rule under section 7704(a) that treats any PTP as a corporation would be retained. That is, the base proposal would not disturb or override the treatment of PTPs under current law, regardless of whether they qualify as Covered Entities.<sup>125</sup>

However, the existing rule under section 7704(c) that provides an exception from corporate treatment for PTPs with certain types of income could be deleted (along with the corresponding rules under sections 7704(d) and (e)). These rules currently allow PTPs whose income consists primarily of “qualifying income” to continue to be taxed as partnerships. Qualifying income for this purpose is generally passive-type income and other income that Congress understood to be earned largely through partnerships at the time the PTP rules were enacted. It includes interest, dividends, real property rents, gains from the sale of real property or other capital assets (such as stocks), and income from certain natural resource activities (e.g., exploration and production of oil and gas and other energy sources).<sup>126</sup>

Deleting the qualifying income exception is not strictly necessary to implement the base proposal. However, it would align with some of the fundamental policy rationales behind the base proposal (e.g., a desire to tax large or corporate-like entities as corporations) and thus is a reform worth considering alongside the base proposal.<sup>127</sup> Similar to an increase in the corporate tax rate, it would also increase the revenue that the base proposal would raise. Depending on how the base proposal is ultimately constructed, PTPs that would otherwise have satisfied the qualifying income exception by virtue of having sufficient passive income could potentially still elect to be treated as regulated investment companies (RICs) and thus maintain a form of pass-through treatment under existing subchapter M rules.

If the base proposal is paired with an elimination of the qualifying income exception, any entity that is either (1) a PTP (determined as under existing law but regardless of the type of income it earns) or (2) a Covered Entity (as defined below) would be treated as a corporation for U.S. federal income tax purposes. Even if the qualifying income exception is retained, a PTP that satisfies the qualifying income exception would remain a partnership for U.S. federal income tax purposes only where it is not also a Covered Entity.<sup>128</sup>

### D. Treatment “as a corporation” and interaction with other tax classifications

The basic rule above would provide that any Covered Entity is “treated as a corporation” (as under section 7704(a)) and, accordingly, it would also need to make clear that Covered Entities could not elect subchapter S treatment under section 1362(a). That is, the possibility that a Covered Entity might still achieve pass-through treatment “as a corporation” would need to be eliminated (unless explicitly contemplated).<sup>129</sup> This could be accomplished by simply including Covered Entities in the list of ineligible corporations under section 1361(b)(2).

Covered Entities would also need to be treated as “per se corporations” under Treas. Reg. § 301.7701-2(b). That is, they would need to be prohibited from filing a check-the-box (CTB) election to be treated as a pass-through entity. Once the basic section 7704-style rule described above is enacted, however, existing Treas. Reg. § 301.7701-2(b)(7) should accomplish this result.

See Section I.E.4. of this appendix, below, for a further discussion of the scope of Covered Entity status.

### E. Defining and measuring Covered Entity status

Implementing any proposal to impose entity-level tax on large or complex pass-through entities will require specifying which pass-through entities are captured. That is, it will need to use some threshold that specifies which entities qualify as large and/or complex.<sup>130</sup> A wide array of metrics could be used for this purpose. The paper’s base proposal would apply a size-based threshold for purposes of determining Covered Entity treatment. However, as discussed in the paper, several other metrics (such as an ownership-based test) could also be used and should be considered. Some existing proposals would also incorporate other features, such as limiting the entity tax to entities engaged in certain types of activities or imposing entity tax based on whether owners have limited liability.<sup>131</sup> These approaches are also worth considering further, but this discussion will focus on the details of a Covered Entity threshold based on size, ownership, or a combination of the two.

#### 1. Covered Entity status based on size

**(a) Choosing the metric and setting the threshold.** The first approach for defining Covered Entities would be a size-based test aimed at ensuring that the regime captures only sufficiently large pass-through entities. This requires (1) determining the appropriate metric for measuring an entity’s size and (2) setting the appropriate threshold for largeness under that metric.<sup>132</sup> Reasonable size-based metrics include net income (of

which there are many types, e.g., taxable income or book income), gross receipts, value of assets, or other measures of the size and scope of an entity's operations (such as employee headcount).<sup>133</sup> A combination of several of these factors could also be used. This section will focus on two metrics already widely used throughout the Code and that are likely to be the most appropriate measures of size in this context: gross receipts and asset values.

**(b) Gross receipts test.** Under a gross receipts test, any entity not already treated as a corporation that has average annual gross receipts equal to or greater than a specified dollar amount (such amount referred to here as the GR threshold) would be treated as a Covered Entity. As discussed in the paper, the base proposal would use a GR threshold of \$25 million, though estimates are also provided for alternative GR thresholds.

In addition to setting the GR threshold, a gross receipts test must establish the period over which the GR threshold is measured (called the "gross receipts measurement period," or GR measurement period). A GR measurement period of one year would mean that the determination of whether an entity is above the GR threshold would be tested annually and would be based on the entity's gross receipts for that year. However, a one-year GR measurement period is likely to result in greater volatility in Covered Entity status; entities will more frequently become (or cease to be) Covered Entities.<sup>134</sup> This would add complexity and administrative burden for both taxpayers and the Internal Revenue Service (IRS) and put pressure on transition rules that address what happens when entities become (or cease to be) Covered Entities.

The better approach is for the gross receipts test to follow other existing tax rules by calculating average annual gross receipts over a multiyear GR measurement period. For example, section 448(c), which identifies corporations or partnerships that are small enough to use the cash method of accounting, measures average annual gross receipts over a period of three taxable years.<sup>135</sup> Mirroring this approach here would mean that an entity would satisfy the gross receipts test, and thus be a Covered Entity, if its average annual gross receipts over a GR measurement period of three taxable years exceeded the GR threshold.

Using a gross receipts test that effectively mirrors section 448(c)'s three-year average approach has the advantages of measuring size based on a well-understood and familiar mechanic and mirroring rules already used throughout the Code to distinguish between large and small businesses.<sup>136</sup> It would also help make the regime more administrable, minimizing entry and exit from Covered Entity status. A longer GR measurement period will do a better job of minimizing volatility by capturing only those entities that can most comfortably be deemed large.

However, the specific choices of where to set both the GR threshold and the GR measurement period will depend on policymakers' revenue goals and on how many existing pass-through entities the regime is intended to capture. A lower GR threshold (and thus a larger number of Covered Entities) will, all else equal, result in more revenue. But by subjecting a greater number of entities to the same tax treatment, a lower threshold comes closer to more far-reaching full integration proposals, which may be at odds with the rationale behind using a size-based approach in the first place. See Section 4(b) of the paper for a discussion of the number of partnerships and S corporations captured, and the revenue raised, under different GR thresholds.

Finally, any gross receipts test will need rules that appropriately aggregate commonly owned and controlled entities for purposes of calculating gross receipts; see section 448(c)(2). Existing aggregation rules, as well as necessary reforms, are discussed in further detail in Section I.E.1.(f) of this appendix, below.

**(c) Asset test.** As an alternative to gross receipts, largeness could instead be measured based on asset values. An asset test would measure the overall value of the relevant entity's assets to determine whether the entity is sufficiently large. This has the advantage of applying an intuitive measure of entity size. It could also avoid distortions caused by applying a gross receipts test to entities that seem large but do not have regular receipts, such as investment vehicles that have significant assets but have no business operations, and that have inconsistent, or somewhat manipulable, streams of income. If it is desirable for the proposal to capture such entities, it may need to incorporate an asset test for largeness.

An asset test is inherently more difficult to apply than a gross receipts test, since the former depends on periodic valuations. Valuations can be onerous to obtain, subject to error or manipulation (particularly in the case of illiquid or nonmarketable assets), and subjective or difficult to verify with certainty.<sup>137</sup> Accordingly, an asset test is likely more vague than a test that measures items reported directly on tax returns or that go into the calculation of taxable income (such as receipts, revenues, or gross or net income). Even so, asset tests are common, and many existing tax rules and definitions apply tests based on asset value.<sup>138</sup> Accordingly, like the gross receipts test, an asset test could mirror generally well understood and widely used metrics already in the Code.

Under an asset test, a Covered Entity would be any entity (a) not already treated as a corporation, and (b) the average aggregate gross assets of which (by fair market value) over a specified period (such period, the asset measurement period) exceeds a specified dollar amount (such dollar amount, the asset threshold). Where to set the two variables—asset threshold and

asset measurement period—raises many of the same basic issues discussed above with respect to the gross receipts test. A lower asset threshold will capture a greater number of entities, and a shorter asset measurement period may result in more frequent entry to, or exit from, the regime.

For this purpose, any such asset test should be crafted to function similarly to other existing asset tests, such as the REIT 75 percent asset test,<sup>139</sup> the RIC diversification tests,<sup>140</sup> or the passive foreign investment company asset test.<sup>141</sup> While these tests are constructed for different purposes, they generally include some measure of an entity's "total" assets and thus provide a framework for this approach. For example, when an entity is testing its ability to qualify as a REIT, it must evaluate whether at least 75 percent of its "total assets" (by value) are qualifying REIT assets.<sup>142</sup> The RIC diversification tests and the passive foreign investment company asset test generally operate similarly.

To the extent an asset test is used for determining Covered Entity treatment, it would make sense for the test to mirror the measurement of an entity's total assets under the rules described above. Thus, as under those tests, an entity's total assets for purposes of Covered Entity status would include intangibles (e.g., goodwill) and the fair market value of assets would be measured on a gross basis (i.e., not net of liabilities). While the above tests are aimed at measuring a percentage of qualifying (or non-qualifying) assets rather than an entity's overall size, it makes sense to mirror their total assets approach for purposes of measuring size based on assets. An alternative approach (e.g., one that measures net asset values rather than gross asset values or that includes only certain types of assets) may facilitate manipulation and be a poor measure of overall size. For example, it seems appropriate to regard an entity with significant gross assets and significant liabilities (and thus only a small amount of net assets) as large; it has simply made use of its significant borrowing capacity.<sup>143</sup>

Notably, some existing asset tests in the Code measure an entity's assets based on their adjusted tax basis rather than fair market value.<sup>144</sup> An asset test for Covered Entity status should avoid this approach. Tax basis often diverges significantly from value and is therefore generally a poor measure of an entity's overall assets or size.

As in the case of the gross receipts test, aggregation rules would need to apply in measuring size based on assets (see discussion of aggregation reforms below).

**(d) Applying both tests: receipts and assets.**

Policymakers may wish to capture the benefits of both the gross receipts and assets tests above. Under such an approach, an entity not otherwise treated as a corporation could be treated as a Covered Entity where it meets (1) both the gross receipts test and the

asset test (the combined approach), or (2) either the gross receipts test or the asset test (the alternative approach).

A combined approach, under which an entity must satisfy both tests, is likely to narrow the number of Covered Entities, perhaps significantly. Accordingly, it could be an option for policymakers seeking to confine the proposal to only a very limited number of truly large pass-through entities. In general, under a combined approach, many taxpayers would be able to evaluate their Covered Entity status by running only one test: If they fail the first test, they would not be captured.

In contrast, under an alternative approach, an entity would be a Covered Entity if it satisfies either the gross receipts or the asset tests. This is likely the better approach for policymakers seeking to incorporate both tests. As discussed above, entities that would be considered large as an intuitive matter might have significant gross receipts with minimal assets or vice versa. This means the alternative approach would be better suited to capturing a greater number of large entities with fewer horizontal inequities between similarly sized entities in different industries. That said, such an approach is likely to result in increased administrative and compliance complexity for taxpayers, many of whom would need to run both tests in full to evaluate whether or not they are captured.

**(e) Safe harbors.** Another consideration for any proposal that uses a size-based test for Covered Entity status is whether, and to what degree, the rules should provide (or direct regulatory guidance to provide) safe harbors to ease compliance. Some other size-based tests found throughout the Code offer a simplified method for entities to determine whether they should be treated as crossing or falling below the relevant threshold.

For example, the corporate alternative minimum tax (CAMT) imposes a 15 percent minimum book tax on corporations that exceed a size-based threshold (i.e., corporations whose average annual "adjusted financial statement income" (AFSI) over a three-year period exceeds \$1 billion). AFSI is a complex calculation, and the statute specifically authorizes regulatory guidance to provide a simplified method for applying this threshold.<sup>145</sup> Pursuant to this authority, current guidance provides a safe harbor under a lower \$800 million threshold and allows several adjustments that simplify the calculation of AFSI.<sup>146</sup> Thus, a corporation with less than \$800 million of average annual "simplified" AFSI can escape CAMT without needing to undertake the more-complex analysis of testing whether its average annual "non-simplified" AFSI exceeds \$1 billion.

Other examples of the use of a simplified safe harbor method for making certain calculations exist throughout the Code and regulations. For instance, Treas. Reg. § 1.897-2(b)(2) allows a corporation to use

a simplified “balance sheet” method for testing its status as a U.S. real property holding corporation under the Foreign Investment in Real Property Tax Act rules. This test is different from the CAMT safe harbor described above, but the concept is fundamentally similar: If a corporation is sufficiently below the statutory threshold under a simplified metric, it can be safely deemed out of scope. In implementing either of the proposals discussed here, policymakers should consider whether it is appropriate to provide (or specifically authorize in the relevant statute) a similar safe harbor or simplified method.

Depending on the method chosen for measuring Covered Entity status, such a safe harbor may not be necessary. For example, unlike AFSI (which is a complicated new metric created by CAMT) or asset values, measuring gross receipts may not be difficult enough to warrant a simplified safe harbor method. If, on the other hand, an asset threshold is chosen, then a safe harbor similar to the balance sheet method for testing U.S. real property holding corporation status may be more appropriate.

If policymakers determine that a safe harbor is appropriate, it should be carefully tailored to lower administrative and compliance burdens without excluding too many entities from the regime. That is, the safe harbor or simplified threshold should not scope out entities that are likely to exceed the threshold under full testing. For this reason, setting any such safe harbor through regulatory guidance, and thus allowing taxpayers to provide input through the notice-and-comment process, is likely the best approach. However, taxpayer comments may be focused primarily on limiting the effects of the proposal and therefore may push such guidance to adopt safe harbors that are too generous or that exclude too many entities.

In any case, policymakers will need to consider carefully both the purpose and the necessity of any safe harbor. If the relevant threshold chosen for Covered Entity status is particularly difficult to apply, a simplified method that allows entities close to the line to choose between simply electing corporate classification or testing under the relevant threshold will be more appropriate.

**(f) Measuring the size threshold: aggregation rules.** Aggregation rules are a critical component of any size-based test. They are needed for both (1) accurate measurement of separate entities that comprise a larger ownership group and (2) anti-abuse purposes (i.e., preventing entities from restructuring to avoid the size thresholds without actually or substantively changing their ownership or economic structures, such as by splitting one entity into several entities with the same or highly overlapping ownership).

This proposal builds on existing aggregation rules in the Code, specifically section 52, which in turn builds on section 1563.<sup>147</sup> However, these existing aggregation

rules are highly complex and contain several gaps and inconsistencies, particularly with respect to their application to pass-through entities. For example, the existing rules provide a relatively simple path to disaggregation for certain groups of commonly owned entities, such as portfolio companies owned by the same private equity fund. This path should be examined and potentially corrected. Additionally, certain other features of existing aggregation rules warrant modification in the context of these specific proposals.

Accordingly, this section provides a brief summary of the relevant existing aggregation rules and then outlines several proposed fixes. Some are general fixes, designed to address general problems with the existing rules; others are specific to these proposals, designed to ensure proper aggregation and workability of the aggregation rules in the context of a proposal to tax large pass-through entities. The general fixes are relevant, and worth pursuing, even outside the proposals discussed here, whereas the proposal-specific fixes may be inappropriate to pursue more broadly. The modeling and revenue estimates provided in the paper assume that the base proposal would include aggregation rules similar to existing rules. Therefore, the estimates reflect neither the revenue impact of reforming aggregation rules for purposes of the proposal itself, or for reforming aggregation rules more broadly.

*(i) Brief background: section 52 aggregation.* Section 52 aggregates certain commonly owned or controlled entities by treating them as a “single employer” for certain tax purposes.

Section 52(a) provides rules for corporate groups, addressing when a group of entities, each of which is treated as a corporation for tax purposes, is aggregated and treated as a single employer. These rules essentially apply the mechanics of section 1563, which defines a “controlled group of corporations.” In general, the section 1563 mechanics aggregate corporations based on overlapping ownership of a sufficient amount of either voting power or value.

Section 52(b) and the regulations thereunder (Treas. Reg. § 1.52-1(b)) then provide rules for determining when a group comprised of corporations and non-corporate entities (such as partnerships), or a group solely comprised of noncorporate entities, will be aggregated. These rules do so by applying the principles and mechanics of section 52(a) to noncorporate entities. In applying these principles to partnerships, the section 52 regulations aggregate partnerships based on overlapping ownership of a sufficient amount of either the capital or profits of such partnerships.<sup>148</sup> That is, when applied to partnerships, the “vote or value” test applicable to a corporation essentially becomes a “capital or profits” test.

*(ii) General fix: aggregation through investment entities.* The proposals discussed in this Technical Appendix and in the paper are generally intended to

apply equally to entities of the same size across industries and regardless of the nature of their ownership (e.g., whether they are owned by the original founders, an investment fund, or another operating business).<sup>149</sup> Additionally, in practice large pass-through entities (particularly partnerships) tend to be concentrated in a few industries, one of which is finance and investment.<sup>150</sup> Thus, to achieve the intent of the proposals, it will be necessary to ensure that entities are aggregated for purposes of measuring their size regardless of whether they are engaged in an operating business or only in investment activities. If entities engaged solely in investment activities (i.e., entities that do not operate a trade or business) can “break” aggregation, then this will provide more favorable treatment for operating companies owned largely by investment entities, as well as to the investment entities themselves, relative to other large pass-through entities.

Current section 52 rules are deficient in this regard. Section 52(b)(1) currently provides for aggregation of “trades or businesses (whether or not incorporated) which are under common control[.]” While this statutory language would not appear to require that every entity in a single employer group is engaged in a “trade or business,” the language of the regulations appears to be stricter, defining each type of single employer group as a group of “organizations conducting trades or businesses.”<sup>151</sup> This apparent requirement that each organization be “conducting” a trade or business has led to a widespread position that investment partnerships (e.g., private equity funds) are not subject to aggregation under section 52, since they are not typically engaged in a trade or business for general tax purposes.<sup>152</sup>

Prior legislative proposals would have clarified the application of section 52(b) to investment funds that are not engaged in a traditional trade or business. Specifically, the Build Back Better Act proposed to amend section 52 so that the term “trade or business,” at least for section 52 purposes, would include the types of for-profit investment activities undertaken by investment funds. This would have caused private equity funds to be treated as engaged in a technical trade or business, at least for purposes of section 52, even if they were not in a trade or business for general tax purposes.<sup>153</sup> This fix ultimately did not survive: It was first narrowed to apply solely in the context of CAMT,<sup>154</sup> and ultimately was removed.<sup>155</sup>

For purposes of implementing the base proposal (or similar proposals for taxing large pass-throughs at the entity level), the aggregation rules should be revised to more clearly capture all commonly owned and controlled entities regardless of whether or not they are engaged in a traditional trade or business. This could be done by adopting the approach in the Build Back Better Act, or through a broader overhaul of the section 52 rules that relies less on “trade or business”

terminology. For example, section 52(b)(1) could be revised to more clearly specify the mechanics by which “principles similar to the principles which apply in the case of [section 52(a)]” apply to pass-through entities.

The estimates accompanying this proposal assume that the base proposal would include aggregation rules similar to existing rules; therefore, they do not purport to score either the effect of a change of aggregation rules on the revenue raised by the proposal, or a change to aggregation rules generally.<sup>156</sup> Ultimately, the change to section 52(b) described above should be pursued across the board rather than solely for purposes of this policy proposal. That is, it should extend to other areas of existing law that rely on section 52 aggregation to measure entity size, such as CAMT,<sup>157</sup> section 163(j),<sup>158</sup> section 448,<sup>159</sup> and numerous others. Conceptually, there is not a good reason that companies owned by investment funds should be treated differently (for aggregation purposes) under some rules but not others, as long as they satisfy the relevant common ownership thresholds.

(iii) *General fix: common “control” test for partnerships.* Making the above change to aggregate entities regardless of whether they have a trade or business or are engaged only in investment activities would take a significant step toward ensuring that companies owned by investment funds can be aggregated. However, that change alone is likely insufficient to ensure such a result. That is, even if investment funds are more clearly captured by section 52(b), the companies owned and controlled by those funds may still not be aggregated under many existing fund structures. Accordingly, policymakers wishing to fully implement the above change—either in connection with a specific proposal to tax large pass-through entities or more broadly—will need to consider additional fixes.

Many investment funds do not consist of a simple single partnership that owns its portfolio companies. Rather, the “fund” is often made up of multiple side-by-side partnerships that invest in parallel. These partnerships generally have minimal overlapping ownership, and generally exist because different fund investors have different preferences and wish to invest through different structures. Typically, the only overlapping ownership across the multiple parallel partnerships that comprise the fund is that of the fund sponsor itself—in other words, the general partner’s (generally small) capital investment and its (typically 20 percent) carried interest. These fund structures are highly prevalent in the market for reasons unrelated to the aggregation rules.

These structures will defeat aggregation in many cases, even if section 52(b) is expanded to include entities without a traditional trade or business. As discussed above, section 1563’s “vote or value” test for evaluating the ownership of a corporation becomes a “capital or profits” test when applied to ownership of

a partnership. In effect, the section 52 regulations aggregate partnerships connected by ownership of more than 50 percent of capital or profits. If an investment fund uses the typical multi-partnership structure described above, it could easily be the case that (1) no fund partnership owns more than 50 percent of an underlying portfolio company, and (2) none of the fund partnerships is connected by overlapping ownership of more than 50 percent of capital or profits. As discussed above, the overlapping ownership of capital or profits across the fund partnerships will almost always be limited to the general partner's small (e.g., 1 percent) capital interest and its 20 percent profits interest—far below the 50 percent (or, in some cases, 80 percent) threshold required for aggregation under section 52.

As a result, to properly aggregate companies owned by investment fund partnerships, the section 52 rules will also need to be updated to incorporate a common “control” test for partnerships. That is, the current rules aggregate partnerships based only on common economic ownership (capital or profits), and not based on common control without regard to economics. This differs from the approach taken under section 1563 with respect to corporations: Whether two corporations are aggregated depends on overlapping ownership of either vote (i.e., control independent of economics) or value (i.e., economic ownership independent of control) of the relevant corporation's stock.

To be sure, partnership rules based solely on capital or profits are longstanding; virtually all other rules that evaluate ownership of a partnership do so based on whether a partner owns a certain amount of capital or of profits (or both).<sup>160</sup> Similarly, “vote or value” tests for corporate ownership are widespread and longstanding. This is likely due, in large part, to historic differences between corporate and partnership ownership and governance structures. But for a rule such as section 52 that purports to aggregate businesses “under common control,”<sup>161</sup> a partnership test that looks only to economic ownership, and not to broader measures of control, is likely to be insufficient.

At minimum, pursuing the change discussed in the preceding section (to expand the section 52(b) rules to apply to investment entities) without incorporating a common control test for partnerships may have little effect. Making the first change alone likely leaves out many existing investment funds that use a multi-fund structure. It also encourages any fund that does not already do so to adopt a parallel partnership structure (and to establish a sufficient number of fund partnerships to avoid aggregation). This could, in certain cases, potentially be challenged under anti-abuse rules such as the economic substance doctrine or the partnership anti-abuse rule of Treas. Reg. § 1.701-2, but it would likely be difficult to do so.

Accordingly, policymakers seeking to implement the proposals discussed here (or changes to

section 52 more broadly) will need to consider including a common control test for partnerships that is not based solely on overlapping economic ownership. At minimum, for example, the rules could be expanded to aggregate partnerships where they have a common general partner (though without an indirect ownership rule this would be insufficient, given the ease of establishing individualized general partner entities for each partnership). In any case, to capture the typical parallel investment fund structure, the rules would need to aggregate partnerships that (1) have minimal overlapping ownership of capital or profits but (2) are managed or controlled by the same (direct or indirect) persons or entities. This seems particularly appropriate in fund structures where the purpose of the multiple funds is to invest in substantially the same assets and otherwise to be as economically similar as possible. If investment funds and their majority-owned portfolio companies should be aggregated, there is no good reason why splitting a single fund into multiple partnerships to achieve tax and other structuring goals should result in disaggregation.

A key difficulty is that, even assuming that some sort of common control test should be adopted for partnerships, it is not clear how such a test should be defined. For many partnerships (e.g., limited partnerships formed under state law), there is not a direct analog to corporate voting power.<sup>162</sup> While a limited partnership is generally controlled by a general partner, the general partner might be more properly analogized to a corporate board of directors than to a shareholder that holds voting power. This might suggest that the limited partners, who “appoint” the general partner by investing in the fund, are properly analogized to corporate shareholders, and therefore that the existing “capital or profits” test is appropriate. At the same time, case law evaluating voting power in the corporate context has held that voting power may extend further than the simple right to vote for, or appoint, directors—in other words, certain shareholders may be treated as holding voting power where they retain authority over certain substantive matters normally left to the board of directors.<sup>163</sup> It may therefore be appropriate to treat the general partner of a typical limited partnership as holding the equivalent of corporate voting power.

Additionally, it is worth considering whether this line of thinking relies too heavily on imperfect analogies. That is, rather than seeking out the partnership version of a corporate shareholder or corporate voting power, perhaps the rules should recognize that different legal entities exist and craft control tests that are based on the substantive features of those different legal entities.

Relying too heavily on analogies to corporate definitions may also fail to appreciate that what constitutes corporate voting power may not be clear given existing divergences between state-law business

entity types and tax classifications. Many noncorporate legal entities that are not managed by a traditional board of directors (e.g., member-managed LLCs or limited partnerships) can and do elect to be treated as corporations under current law. In particular, it is common for foreign limited partnerships to elect corporate classification for U.S. tax purposes. To the extent that taxpayers must already apply existing law to determine who holds the voting power in such a corporation, such analyses may be informative in crafting a control test for entities organized as partnerships that do not elect corporate treatment.

As a result, further consideration and study of this issue is likely needed to develop the appropriate common control test for partnership (and other noncorporate) entities. Options could include the following:

*Create new rules that define “control” for this purpose.* New rules could provide a specific definition of control, either for partnerships specifically or to be applied generally regardless of legal entity type. Certain existing tax rules already take this approach. For example, the term “control” is defined very broadly (and in a manner that can apply across legal entity types) for purposes of section 482—another set of rules that applies to commonly owned or controlled entities.<sup>164</sup> Similarly, recent proposed regulations under section 892 would provide a substantive definition of “effective control” that is based on “control of the operational, managerial, board-level, or investor-level decisions” of an entity and would not depend on economic ownership.<sup>165</sup> An approach that draws on general concepts of “control,” such as these, has the benefit of focusing on the substance of the arrangement. However, it would also require a potentially complex facts-and-circumstances analysis in each situation (and thus would provide less clarity). Further analysis is needed to assess its workability in the section 52 context.

*Enact a rule specifically aimed at parallel investment funds.* An alternative and less-sweeping approach would be to enact a rule specifically focused on the investment fund scenario described above (i.e., multiple entities that invest in parallel and have some overlapping economic ownership, but not enough to trigger normal section 52 aggregation). Such a rule could provide that multiple partnerships are aggregated under section 52 where (1) they own the same (or substantially similar) assets or otherwise engage in the same activities and (2) the same persons own some threshold amount (e.g., 15 percent or 20 percent) of the capital or profits of each partnership. Essentially, for multiple partnerships that invest or act “in parallel,” the capital or profits threshold that triggers aggregation would be lowered significantly. While more targeted, this approach is likely to present its own difficulties, such as how best to define investing “in parallel” given that the fund partnerships may not hold exactly

the same assets or invest through exactly the same structures. Relatedly, existing aggregation rules focus solely on the amount and nature of entity ownership, not on the underlying investments or activities of the entities, and so this would be a particularly novel aggregation approach. Accordingly, as above, its workability in this context should be considered further.

*(iv) General or proposal-specific fix: five-or-fewer persons limitation for brother-sister groups.* Under the definition of a “brother-sister” group in current Treas. Reg. § 1.52-1(d), two or more entities are aggregated where a single group of five or fewer individuals, estates, or trusts own both (1) 80 percent of each entity (taking into account aggregate ownership) and (2) 50 percent of each entity (taking into account only ownership interests that are identical in each entity). That is, for an owner that is in the five-or-fewer ownership group, all of such person’s ownership in both entities counts toward the 80 percent test while only their identical ownership in both entities counts toward the 50 percent test.<sup>166</sup>

This test could be simplified by eliminating the second prong. The identical ownership prong is confusing, and difficult to apply in situations where the two entities being tested for aggregation are not the same type of entity, a situation that section 52(b) expressly contemplates. For example, how should 10 percent of a corporation’s voting power and a 20 percent profits interest in a partnership be tested for identity?

By eliminating the 50 percent identical ownership prong, two entities would generally be aggregated if the same five or fewer persons own, in the aggregate, more than 80 percent of the relevant controlling interests in the two entities. This would provide a simpler, more-administrable test without significantly expanding the entities required to be aggregated. That is, the only entities captured would still be entities with a very high degree (80 percent) of ownership overlap within a relatively small ownership group.

Alternatively, and at minimum, what qualifies as identical ownership should be clarified for this purpose. In this context, it should refer to an identical amount of ownership of the relevant interests. For example, in the above case 10 percent of the profits interest should be treated as identical to the 10 percent corporate voting power and should thus count toward the 50 percent identical ownership prong.

Additionally, policymakers should consider additional reforms to the brother-sister aggregation tests. For example, the rules could be expanded to capture overlapping ownership among a larger ownership group. The current test considers overlapping ownership only by a group of five or fewer individuals, estates, or trusts. Expanding this test to include entities (such as corporations or partnerships) would address, for example, a situation in which four individuals and one corporation together own 80 percent of two

underlying entities but the corporation does not own enough to trigger a parent–subsidiary group under Treas. Reg. § 1.52–1(c). Current rules would not appear to require aggregation in such a case, but they would require aggregation if the corporation were another individual. This result seems illogical.

The test could also be expanded by increasing the relevant group from “five or fewer” to some larger group, such as 10 or fewer, or even a group of any size. Expanding the ownership group to any group of “the same persons” that own 80 percent or more of the underlying entities would more closely track other similar rules that test relatedness and aggregation for tax purposes. For example, section 707(b)(1)(B) provides that two partnerships are related if “the same persons” own more than 50 percent of the capital or profits interests of both partnerships. This would also more accurately achieve the goal of testing whether two entities have sufficiently overlapping ownership or control, such as two entities that are owned by the same persons (whether those persons number 5 or 20) have overlapping ownership.

(v) *Proposal-specific fix: 80 percent threshold for parent–subsidiary aggregation.* Current section 52 rules aggregate entities that are part of a parent–subsidiary group based on a greater–than 50 percent ownership threshold. However, in the context of this proposal (particularly the base proposal, which imposes corporate treatment on Covered Entities), the 50 percent threshold is likely too low. Accordingly, for purposes of implementing any of the proposals discussed here, it would be appropriate to increase the parent–subsidiary aggregation threshold to more than 80 percent instead of more than 50 percent.

This increase would both reflect that a higher bar is appropriate in the context of treating multiple entities as a single organization when imposing entity–level tax, and would alleviate administrative burdens. The primary purpose of the change would be to minimize situations in which entities are required to be treated as C corporations (due to aggregation) but are unable to join a consolidated return with the other corporations in the aggregation group. That is, a group of corporations is permitted to file a single consolidated tax return where it meets the affiliation test under section 1504, which generally requires greater than 80 percent ownership. Accordingly, if a pass–through entity were aggregated with, for example, its 51 percent corporate owner under the proposal, it would be treated as a C corporation but would be unable to join in its owner’s consolidated corporate tax return. This misalignment between the affiliation test and the aggregation test for Covered Entity status could result in greater administrative burdens and additional tax liabilities for entities covered by the regime.

(vi) *Other mechanical reforms and fixes for further consideration.* Finally, some additional potential

updates and fixes to the section 52 rules are worth further consideration but are not addressed in detail here:

- Direct and indirect ownership. Overall, the section 52 rules should take into account both direct and indirect ownership (i.e., ownership should flow up through chains of entities) and should do so in a clear and consistent manner. The current rules are confusing on this point and should be studied and reworked as appropriate to ensure this result. For example, attribution from corporations under Treas. Reg. § 1.414(c)–4(b)(4) is not taken into account in determining a parent–subsidiary group under Treas. Reg. § 1.52–1(c); while this mirrors the mechanics of section 1563(a)(1), it should be reexamined in the context of section 52(b) groups that include both corporations and noncorporate entities. Additionally, under section 1563(e)(2) and Treas. Reg. § 1.414(c)–4(b)(2), attribution from a partnership to a partner is required only where the partner owns more than 5 percent of the capital or profits of the partnership; however, other longstanding tax rules that attribute ownership through partnerships (such as section 318(a)(2)(A) and section 267(c)(1)) do not include any such threshold.
- Incorporation of existing section 1563 rules. Certain other aspects of how section 52 rules incorporate section 1563 should be clarified. For example, the list of “excluded members” in sections 1563(b)(2)(B) through (E) does not apply for purposes of section 52 (i.e., those entities can be part of a section 52 group, but not a section 1563 group). Additionally, the partial year “component member” and “additional member” rules of section 1563 should be more clearly incorporated. Overall, however, these are relatively minor technical clarifications.
- Simplified test for evaluating ownership. Finally, further consideration should be given to whether it is either possible or desirable to modify the existing aggregation and constructive ownership rules to accommodate partnerships (or other entities) that are legitimately unable to produce or determine direct or indirect ownership data sufficient to rebut any presumptions of overlapping ownership.

## 2. Covered Entity status based on ownership

Policymakers seeking to implement one of the proposals discussed here might also consider adopting a Covered Entity definition that is based on the nature of the relevant entity’s ownership arrangements (i.e., an ownership test), either in conjunction with or as an alternative to the size–based test. There are various pros and cons to such an approach, but the primary policy rationale would be to focus the proposal on pass–through entities whose ownership is sufficiently

complex to make pass-through taxation difficult to administer. That is, if the reason for pursuing the proposal is the increasing administrative impossibility of applying partnership tax rules to highly complicated arrangements, then it makes most sense to define Covered Entity in a way that more directly implicates the complexity of a pass-through entity's ownership arrangements and, thus, the resulting administrative and enforcement problems.<sup>167</sup>

Complexity is a broad concept and can be measured in many ways, but one of the primary sources of complexity unique to partnerships comes from the flexible nature of their ownership arrangements. Partnerships can be owned by other entities of essentially any kind and number, which can create a tiered network of ownership that is hard to trace to an actual taxpayer. And their ownership is often divided according to a complex economic "waterfall" that may involve special allocations of particular items of income or loss to particular partners, different economics for different partners, or various other complicated calculations. Thus, for this purpose, the appropriate type of ownership test is likely a test aimed at the complexity of a pass-through entity's ownership arrangements.

To be sure, the size-based tests above may get much of the way there. That is, size may be a relatively good proxy for an entity's ownership complexity in most cases. Very large partnerships (by either receipts or assets) are likely to have more complex ownership arrangements than true small businesses. This will not be true in all cases, though. Some large pass-through entities may also have relatively (or very) simple ownership arrangements. For example, certain S corporations can be very large (by receipts) but are nevertheless required to have simple capital structures. Treating these entities as C corporations under a pure size-based threshold may be inappropriate if they do not present the types of administrative difficulties that the proposal seeks to address. That is, it may not be particularly difficult, from an administrative, compliance, or enforcement perspective, to apply pass-through tax rules to simple entities with pro rata ownership, even if they have significant assets or income.

The most straightforward option for an ownership test is one that leverages ownership requirements that already exist in the Code, namely the S corporation ownership requirements. Under such a test, a Covered Entity would be any entity not already treated as a corporation (1) that has more than 100 partners, shareholders, or other equity owners; (2) that has at least one partner, shareholder, or other equity owner that is not an individual; and (3) in which economic ownership is other than pro rata (i.e., that would not satisfy the functional equivalent of the one-class-of-stock requirement for S corporation treatment).<sup>168</sup> Such a test would incorporate, conceptually or directly, many

of the conditions currently required for S corporation treatment: That is, under current law only entities with simple ownership structures are permitted to elect to be treated as S corporations. It would thus effectively impose Covered Entity treatment only on pass-through entities whose ownership structure is quite simple.

The most difficult aspect of implementing this type of ownership test outside of the S corporation context is incorporating an analog to the one-class-of-stock requirement (i.e., the other-than-pro-rata condition above). Partnerships generally do not have classes of stock in the way corporations do, and their ownership is not required to be denominated in "units," "shares," or any other type of equity interest that can easily map onto a corporate share model. Accordingly, this type of test would need a workable definition for when a partnership effectively has more than one "class of stock." This rule would need to be clear and easily understood so that taxpayers could evaluate with relative certainty whether or not their ownership meets the standard; a vague facts-and-circumstances approach is likely to be inappropriate and unworkable for this purpose.

There is some precedent for such a test. Rules seeking to adopt this approach could draw on other recent proposals that attempt to apply the S corporation one-class-of-stock requirement to partnerships in certain cases. Namely, Senator Wyden's recent partnership reform proposals include a provision that would require certain partnerships with related-party partners to use a "consistent percentage method" for determining allocations.<sup>169</sup> This would effectively require such partnerships to use pro rata allocations, at least as among the related-party partners, and thus would force them to approximate the S corporation one-class-of-stock requirement. Allocations would satisfy the consistent percentage method (and thus be pro rata) where each relevant partner's distributive share of applicable partnership items under section 704(b) is determined in accordance with contributed capital. This could serve as a guideline or starting point for drafting an ownership test for Covered Entity treatment. That is, any partnership that would not satisfy this consistent percentage method (as well as any other prongs of the ownership test) could be treated as a Covered Entity.

However, requiring all allocations to be in proportion to contributed capital to avoid corporate treatment imposes a strict standard. There are relatively common partnership ownership arrangements that many practitioners would regard as quite simple but that would not satisfy the consistent percentage method above. For example, it is highly common for certain partners (e.g., service providers) to be issued partnership interests that participate only in future partnership profits and not in existing capital. It is not

clear why a partnership in which some partners contribute capital (and share in proportion to such capital) and other partners receive profits interests is more deserving of corporate treatment than a partnership in which all partners contribute capital and share in proportion to their capital contributions. Accordingly, while a strict pro rata requirement would generally follow the S corporation rules, it may be overly strict as a measure of the type of complexity that warrants corporate treatment. A slightly broader definition—narrowly tailored to capture more complex arrangements—could be warranted. However, the more complex definition will be more difficult to draft and will still result in drawing a line somewhere on a spectrum of partnership complexity that may seem arbitrary.

### *3. Applying both tests: size and ownership*

As noted above, a combination approach could be used. For example, a Covered Entity could be any pass-through entity that satisfies both (1) the size-based test (gross receipts, asset values, or a combination) and (2) the ownership test. This could increase complexity, since entities would need to run both tests. However, as above, many entities would likely be able to confirm they are not Covered Entities by running only one test.

As discussed above, different thresholds may reflect different policy goals. Accordingly, a combined approach may be appropriate to the extent that policymakers wish to implement at least some of these differing policy goals at once. For example, policymakers seeking to implement a proposal specifically addressing partnerships may wish to adopt an ownership-based test while also including a size threshold to exclude small entities for political reasons.

That is, adopting the ownership-based test described above would generally exclude large but simple arrangements, such as existing S corporations that would not trip the ownership test but that are very large by assets or receipts. However, the ownership-based test could capture small but complex partnerships, such as small business partnerships in which the partners have negotiated a relatively complicated (or even only slightly more complicated than pro rata) economics. Thus, incorporating a size threshold in addition to the ownership-based test could improve the political viability of the proposal by excluding these types of small partnerships.

### *4. Scope of Covered Entity status: which types of entities must be tested?*

Under the base proposal, the Covered Entity thresholds discussed above (based on gross receipts, assets, or ownership) would capture any entity not otherwise treated as a corporation that satisfies the relevant test. However, the rules will need to do slightly more

than simply capture any entity not otherwise treated as a corporation. Our current tax system provides for a wide array of entity types, many of which receive specialized tax treatment, and many of which are, at least technically, corporations.<sup>170</sup> Certain corporations, for example, may effectively achieve a version of pass-through treatment, such as S corporations, RICs, REITs, and some foreign corporations. Accordingly, implementing the base proposal will require the rules to be clear about which entities must be tested for Covered Entity status and which entities are excluded.

The base proposal discussed in the paper contemplates that only the core regarded pass-through entities that exist under the Code today would be tested for Covered Entity status. This would capture entities treated as partnerships for tax purposes (whether organized as limited partnerships, LLCs, etc.) and S corporations.<sup>171</sup> If this is the approach that the rules ultimately take, they will need to incorporate some additional features. For example, rules will be needed to ensure that a Covered Entity cannot opt out of C corporation treatment by electing S corporation status or making an election under the CTB rules. However, these considerations are straightforward and are addressed in Section I.D. of this appendix.

More broadly, implementing the proposal will require further examination of whether there are specific types of entities that should not be captured—that is, whether it is appropriate to capture, at most, partnerships and S corporations, or whether certain other pass-through (or pseudo-pass-through) arrangements should also be captured. The base proposal discussed and modeled in the paper assumes that these other types of entities would be excluded from Covered Entity treatment, but whether this is the appropriate approach warrants further consideration and discussion.

**(a) Sole proprietorships and disregarded entities.** Activities conducted in these forms are afforded pass-through treatment in the sense that only a single level of tax is imposed, at the owner level. However, these arrangements are generally not treated as entities at all from a U.S. federal income tax perspective; rather, U.S. tax law views these arrangements as businesses (or other activities) carried on directly by the sole owner. This is true whether such sole owner is an individual or a regarded entity like a corporation or partnership. Consistent with this treatment, the proposals examined here would not apply to sole proprietorships or to disregarded entities (DREs). Because these are not regarded as separate entities for U.S. federal income tax purposes, they would not be tested for Covered Entity status and thus would not be forced onto subchapter C. Rather, their first regarded entity owner would be tested.

The proposals examined here would thus follow the treatment of DREs and sole proprietorships

as nonentities for U.S. federal income tax purposes. If a DRE's sole owner is a corporation, then its income is already subject to corporate-level tax; separately testing (and imposing corporate treatment on) the DRE itself would be unnecessary. If a DRE's sole owner is a partnership or S corporation, then the sole owner (i.e., the partnership or S corporation) would be tested for Covered Entity status. And if a DRE's sole owner is an individual, then neither the DRE nor the individual would be a Covered Entity since the proposals would not generally test individual taxpayers for Covered Entity status, and there would otherwise be no business entity to test. Thus, the proposal's default framework is consistent with the general approach of imposing Covered Entity tax (CE tax) only on entities and not on individuals.

As the paper discusses, however, a key policy driver of proposals to tax large pass-through entities as corporations is the desire to raise revenue by simply limiting single-layer tax treatment to businesses below a certain size threshold. Scoping DREs and sole proprietorships out of Covered Entity treatment may be inconsistent with this rationale since it could create a new arbitrary dividing line that allows differential tax treatment of similarly sized businesses. That is, under an approach that excludes DREs, a large business owned by a single individual could potentially achieve more favorable tax treatment than the same business owned by two individuals. This preference for DRE treatment (rather than partnership or S corporation treatment) may incentivize business owners to recharacterize arrangements that would otherwise be joint ventures as DREs by replacing equity interests with loans, licenses, or other contractual arrangements. For example, a business comprised of two partners—one providing capital and the other providing services—may be able to achieve a significantly better tax result for the service provider if the capital provider's interest in the venture is structured as a loan. This would essentially be a version of similar tax planning that occurs today as a result of the S corporation one-class-of-stock rule.

A sufficiently high size threshold may address this concern in many, if not most, cases. Planning into DRE treatment is likely to be most relevant, and most feasible, for businesses that have both (1) a small number of owners and (2) significant ownership by individuals. The larger the number of owners, the more difficult it will be to replace all but one of the potential equity owners with non-equity arrangements. And planning into DRE treatment seems less likely to provide a benefit for businesses owned in significant part by other regarded entities (e.g., corporations or partnerships), since those other entities would generally be tested for Covered Entity treatment anyway (or would already be subject to corporate tax).<sup>172</sup> Yet businesses with a small number of (mostly) individual owners

are far less likely to be very large than are businesses with one or more significant entity owners. As a result, limiting Covered Entity treatment to sufficiently large entities may exclude many businesses for whom this type of DRE planning is feasible or relevant as a practical matter.

In any case, policymakers interested in pursuing one of these proposals should study and consider this issue further, particularly in light of their overall policy goals. A more robust approach may be to scope DREs and sole proprietorships into Covered Entity treatment to avoid arbitrary line-drawing and thus minimize planning aimed at avoiding Covered Entity status for certain large joint ventures.

**(b) Entities taxed under subchapter M.** The proposals discussed here would also exclude from Covered Entity treatment entities afforded pass-through treatment under subchapter M. This is primarily relevant to two types of entities—RICs and REITs.<sup>173</sup> RICs are investment companies that (1) are required to register with the U.S. Securities and Exchange Commission (e.g., mutual funds), (2) earn primarily passive investment income, and (3) hold a diversified pool of assets under detailed asset diversification tests.<sup>174</sup> REITs are broadly similar and have “been described as a mutual fund for real estate.”<sup>175</sup> To qualify as a REIT, an entity must satisfy a number of organizational requirements, as well as pass detailed income and asset tests designed to ensure that its assets consist primarily of passive investments in real estate.<sup>176</sup> Both types of entities are effectively afforded pass-through, or conduit, treatment through a deduction for amounts distributed to their owners. Thus, while both types of entities are technically corporations, the income and gains they distribute are largely passed through to their investors without being subject to tax at the entity level.

The proposals examined here would not capture RICs and REITs on the grounds that a modified and specific corporate tax regime already applies to them. These entities are granted specialized treatment under the Code only if they satisfy a set of complex requirements designed to ensure that they are specific types of investment vehicles. Thus, while they are afforded a type of pass-through treatment, they are also subject to strict eligibility rules that limit this treatment to specific activities and investments. This paper does not interpret these proposals as seeking to upend the rationale for providing such treatment and limiting it to these types of investment vehicles, and so it would not subject these entities to Covered Entity treatment.

However, policymakers constructing and implementing one of these proposals may wish to examine this position further, in particular the following:

Excluding RICs and REITs from Covered Entity treatment may be inconsistent with a broad policy goal to impose uniform double-layer corporate taxation on all entities of a particular size regardless of the

nature of their income, assets, or activities. That is, if the proposal is ultimately constructed to capture relatively simple pass-throughs (such as S corporations and DREs) based solely on size, that would seem to reflect an underlying policy rationale consistent with capturing RICs and REITs of a particular size as well.

Excluding RICs and REITs from Covered Entity treatment may be inconsistent with capturing other investment vehicles organized as partnerships (e.g., other private investment funds, such as private equity and hedge funds). Excluding RICs and REITs while capturing these other investment vehicles arguably reflects an arbitrary distinction and could result in some large private equity and hedge funds restructuring their assets and activities to qualify for RIC treatment to avoid the regime. That said, to the extent that RICs and REITs are more-rigid vehicles that do not offer many of the flexibilities of subchapter K, this result could be viewed as a feature rather than a bug.

Relatedly, if RICs and REITs are not captured, that may be viewed as reflecting a policy judgment that the proposal should primarily capture traditional operating business entities rather than investment entities. To the extent RICs or REITs are excluded out of a desire not to disadvantage the tax treatment of investing directly (versus investing through managed funds), that rationale would support excluding partnership investment vehicles from the rules as well.

If policymakers wish to pair the proposal with an elimination of the qualifying income exception to corporate treatment for PTPs (as discussed above), excluding RICs and REITs from the rules could be viewed as inconsistent with this approach. Eliminating the qualifying income exception, at least for passive income, suggests that investment entities should be treated as corporations if they otherwise satisfy the relevant requirements for corporate treatment. If PTPs with passive qualifying income must be treated as corporations, then it would make some sense to treat certain RICs and REITs as C corporations as well.

**(c) Trusts.** The proposals discussed here also would not capture trusts even though many types of trusts are essentially treated as pass-through or conduit arrangements for U.S. federal income tax purposes. Despite their pass-through treatment, trusts are not generally “business entities” under the section 7701 regulations. Accordingly, it makes some sense that a proposal aimed at rationalizing or reforming the tax treatment of large business entities would not apply to trusts. However, certain business trusts are appropriately treated as partnerships (rather than trusts) for tax purposes under existing entity classification rules.<sup>177</sup> As business entities, these trusts should be captured by the proposals discussed here. Rules implementing one of these proposals should take care to incorporate these existing rules rather than creating, for example, a blanket exclusion for all trusts.

Certain trusts, however, may implicate issues similar to those discussed above with respect to both DREs and passive investment vehicles. Under Treas. Reg. § 301.7701-4(c), “investment trusts” are treated as grantor trusts and thus are pass-through entities for U.S. federal income tax purposes. Broadly speaking, an investment trust is an arrangement through which the beneficiaries make and hold investments where the trustee does not have power under the trust agreement to “vary the investment” of the trust.<sup>178</sup> Investment trusts thus have features of both DREs (they are grantor trusts and thus essentially ignored for U.S. federal income tax purposes) and passive investment vehicles like RICs, REITs, and other investment partnerships. Whether large investment trusts should be captured by the proposals discussed here is not immediately clear and will depend on the ultimate policy goals. If policymakers implement the paper’s base proposal, using a pure size-based threshold for Covered Entity treatment, then capturing large investment trusts would be consistent with capturing relatively simple investment partnerships that cross the size threshold. On the other hand, if the proposal excludes RICs and DREs, however large, then it might also make sense to exclude large investment trusts.

**(d) Other considerations.** The proposals discussed here would generally construct the definition of Covered Entity to reflect the scoping discussed above. Thus, as a default, they would capture large partnerships and S corporations and exclude RICs, REITs, and DREs. However, as indicated above, policymakers could take a wide range of approaches. The scoping of the Covered Entity definition should continue to be considered. As the discussion of particular entity types above reflects, implementing the proposal will require making many decisions about whether specific types of existing entities are excluded or captured, and these decisions should be based on the ultimate policy rationale driving policymakers to pursue the proposal.

Thus, for example, if the proposal is designed to address the complexity of pass-through entity ownership arrangements (e.g., proposals that apply the ownership test discussed above), many S corporations are likely to be functionally excluded from Covered Entity treatment. Policymakers might instead choose to take a more direct route and simply exclude S corporations from Covered Entity treatment altogether and impose S corporation style ownership restrictions on partnerships. Although there is no size limit on electing S corporation treatment under current law, existing S corporation rules are less flexible and present far fewer administrative difficulties, and fewer opportunities for avoidance, than partnership rules.

As discussed above, alternative proposals might also make entirely different policy choices about the specific types of entities, businesses, or enterprises

that are excluded from Covered Entity treatment by using a different type of threshold altogether. For example, certain other proposals to tax large pass-through entities as corporations would not carve out all entities taxed under subchapter M.<sup>179</sup> See discussion above.

Policymakers may also wish to examine the broader question of how and whether the proposal should treat pass-through entities that operate a “trade or business” for U.S. federal income tax purposes differently from those that are engaged in mere investment activities. That is, should the proposal impose corporate (or entity) taxation only on operating businesses, or should it pick up some (or all) passive investment entities well? On the one hand, as discussed above, a decision to exclude RICs, REITs, and investment trusts from Covered Entity treatment could be understood as reflecting a policy judgment that the proposal is not meant to capture investment entities. On the other hand, it may be viewed as reflecting only a policy judgment that pass-through treatment should be limited to a specific subset of investment entities (i.e., entities subject to the restrictions of subchapter M or Treas. Reg. § 301.7701-4(c), which provide their own guardrails, but not partnerships). In any case, pass-through entities that do not operate a trade or business could range from very large private equity funds, to small family offices, to pure holding companies formed only to hold and divide up ownership of a single company. Excluding such entities from Covered Entity treatment may significantly narrow the proposal’s reach (and thus its revenue) and should therefore be done only with careful consideration.

Finally, in addition to crafting any carveouts to achieve the specific policy sought, any policymaker considering a proposal to tax certain pass-through entities as corporations will likely wish to structure carveouts to counter any opportunity for avoidance or abuse that arises from excluding certain types of entities. For example, if excluding RICs or REITs causes an aggressive shift of existing investment funds into RIC or REIT status, stronger (and more specific) guardrails may be warranted. Policymakers should also consider including general and directed anti-abuse provisions if they want to provide for avenues to shut down avoidance without expanding the scope of the Covered Entity definition.

### *5. Other effects and considerations with respect to Covered Entity treatment*

Certain additional consequences of corporate treatment for Covered Entities should be considered and may inform how the proposal is constructed and implemented.

For example, most tax consequences that follow from corporate treatment or apply to corporations

would necessarily apply to pass-through entities converted into C corporations under the base proposal. These impacts should generally be unsurprising, since they would all generally apply in the same manner as if the pass-through entity had simply elected corporate treatment under the CTB rules. Accordingly, policymakers may reasonably conclude that these considerations should have no impact on how the proposal is constructed and implemented. These consequences include (but are not limited to) the following:

As a corporation, a Covered Entity could be an “applicable corporation” for CAMT purposes.

As a corporation, a Covered Entity that is organized as a foreign entity could be treated as a controlled foreign corporation or passive foreign investment company, with associated consequences for its owners. Similarly, any such Covered Entity would not, under current law, be permitted to join in the filing of a consolidated tax return with other members of its corporate group.

A Covered Entity that is organized as a foreign entity and that earns income effectively connected with a U.S. trade or business (i.e., ECI) would generally be subject to full U.S. corporate tax on such ECI under section 881 and could also be subject to additional branch profits tax on such income under section 884. As a pass-through entity, the entity generally would not have been subject to U.S. federal income tax (or branch profits tax) on this income before becoming a C corporation—rather, any ECI would have passed through and been subject to U.S. tax (if applicable) at the partner or owner level.

A Covered Entity that is organized as a foreign entity may be subject to U.S. withholding tax (up to 30 percent) on certain U.S. source income, such as dividends and interest, unless eligible for reduction or exemption under domestic U.S. tax law or an income tax treaty. As a pass-through entity, it generally would not have been subject to U.S. withholding itself; rather, any such withholding (or reduction thereto) would have been applied to its partners or owners on a look-through basis.

As a corporation, a Covered Entity could potentially be a personal holding company under section 542. However, this would likely be uncommon under a size-based test for Covered Entity status (unless the size threshold is set particularly low), since larger entities are more likely to have varied ownership inconsistent with personal holding company status.

## F. Transition and other implementation rules and considerations

### 1. Initial transition: effective date and conversion mechanics

**(a) Time period.** The base proposal would apply a delayed effective date for required corporate treatment. For example, the rules implementing the proposal would be effective one to three years after enactment, though taxpayers could elect C corporation treatment sooner as desired. A delayed effective date is necessary to give taxpayers adequate time in which to (1) make an initial evaluation of Covered Entity status (including under complicated aggregation rules); (2) undertake the transition of their ownership arrangements from pass-through to corporate treatment (if anticipating Covered Entity treatment or electing to be treated as a corporation); (3) undertake steps to effectuate a different conversion mechanism than the default approach under the rules, if desired; and/or (4) undertake valid restructuring to avoid Covered Entity treatment, such as the divestment of all or a portion of a business to an unrelated third-party buyer.

Because of complexities involved in these analyses, as well as the fact that new guidance will be needed to smooth this process for taxpayers, a transition period of at least two years is appropriate. A shorter transition period is likely to result in confusion and noncompliance. A longer transition period will generally make transition easier, but it may also make the proposal less attractive because it would lower the revenue raised over the budget window.

**(b) Conversion mechanics and considerations.** Although the translation of pass-through equity into corporate stock may be difficult for some entities (discussed below), the mechanics of the conversion itself should be relatively straightforward. It should rely largely on—and should not be meaningfully different from—existing rules under section 7704 and the CTB regulations. These default mechanics for conversion from pass-through to corporate treatment are well understood.

The default mechanism for initial conversion to C corporate treatment (as of the effective date) would be the same as under existing section 7704(f): the Covered Entity would be treated as transferring its assets and liabilities to a newly formed corporation in exchange for stock (in a section 351 transaction) and subsequently distributing such stock to its owners in complete liquidation. Appropriately, this is the same mechanism that would apply if the Covered Entity had simply elected to be treated as a corporation under Treas. Reg. § 301.7701-3 effective as of the effective date of the proposal.

Income earned by the Covered Entity prior to the conversion date, as well as its starting corporate attributes (including earnings and profits) would be determined in the same manner as if such conversion had occurred via existing mechanics (e.g., CTB election, merger, or state law conversion).

Some required conversions could trigger taxable gains, and thus immediate tax liability, for the Covered Entity or its owners. For example, some conversions may not qualify for nonrecognition treatment under section 351(a). This might occur for various reasons, such as the application of section 351(e), a contribution of liabilities in excess of basis under section 357(c), or transactions subsequent to the conversion that cause section 351(a) not to apply due to a lack of section 368(c) control immediately after the conversion. That said, it is generally unlikely that section 351(e) will apply to trigger gains, since required conversions generally will not result in diversification. Nevertheless, it is likely appropriate to provide transition relief in at least some of these situations and a deferral or installment mechanism would be one relatively simple way to accomplish this.

Existing tax law has provided or proposed similar transition relief for changes in law that trigger immediate tax liability due to a transaction deemed to occur, or imposed by, a change in tax laws. For example, section 965 eliminated the deferral of tax, and thus resulted in immediate taxation, with respect to certain income of specified foreign corporations (including controlled foreign corporations) that had accrued over a period of up to 30 years but had gone previously untaxed by the U.S. In doing so, it allowed taxpayers to elect to pay the resulting tax in installments over eight years.<sup>180</sup> SOI data now shows that most of the tax was paid through such installments.<sup>181</sup> Similarly, recent proposals to modify how partnership liabilities are required to be allocated under section 752 would have allowed tax liabilities arising from any gain triggered to be paid over a six-year period.<sup>182</sup>

An alternative and potentially more generous approach would be to hardwire in the rules that all required conversions would be treated as fully nonrecognition transactions regardless of whether they would qualify for such treatment under existing section 351. At least some of the rationales behind existing exceptions to nonrecognition treatment under section 351(a) may not apply, or may apply differently, in the context of a required conversion. However, there should be a clear reason to provide a different treatment than applies in the PTP context. That is, for partnerships converted into corporations under the existing mechanics of section 7704(f), no such exceptions are provided, and so it is not clear they are appropriate here. Additionally, even under this type of “full nonrecognition” approach to relief, there may be some provisions (such as section 91 branch loss recapture) that will cause tax

upon conversion, so may still require an installment or other approach to provide relief.

Any relief from immediate tax liabilities triggered upon conversion will also need to be carefully crafted to ensure that such relief is available only where the tax liability is the result of the required conversion itself, and not the result of separate transactions undertaken by the relevant taxpayer. For example, it may not be appropriate to extend such relief to taxpayers that affirmatively or strategically undertake transactions that cause a required conversion to be taxable. That is, relief from the tax liability triggered by a conversion could cause taxpayers to seek out how they might use a required conversion to obtain a step-up in the basis of operating assets at a lower (or deferred) tax cost. If a taxpayer can cause its required conversion to be taxable, such as by hardwiring a subsequent transaction that breaks section 368(c) control, the required conversion may become a tax arbitrage opportunity. That is, transition relief should be true relief rather than a route for strategically triggering gains at a lower-than-normal tax cost.

## *2. Ongoing transitions: falling in and out of the regime*

After initial conversion, entities will continue to move into (or out of) Covered Entity status based on their size. Although the threshold for Covered Entity status would be assessed as an amount averaged over a multiyear period, it would still be tested annually—that is, each year an entity would calculate its average annual gross receipts over the past three years to see whether it falls over or under the threshold. Any pass-through entity that meets the threshold for the relevant taxable year would be a Covered Entity for such taxable year (and would be converted into a corporation effective as of the beginning of that taxable year).

If, under this test, a Covered Entity then falls below the size threshold in a later year, it should not be forced to convert back to pass-through treatment. Unless it undertakes some sort of affirmative conversion transaction, the entity should remain a corporation. A regime that forces an entity's tax classification to flip back and forth between corporate and pass-through treatment each year based on whether the entity is above or below a particular size threshold for such year would be unnecessarily complex and overly punitive. It would also be inconsistent with retaining CTB elections at all, and specifically the ability to elect C corporation treatment, for entities below the size threshold. It would not make sense to force an entity to convert back to pass-through treatment if it is then able to elect C corporation treatment anyway.

But implementing the proposal will nevertheless require determining whether a Covered Entity that falls below the size threshold should be eligible to make a

CTB election to be treated as a partnership effective as of the first taxable year it ceases to be a Covered Entity (i.e., whether a conversion back to pass-through treatment is allowed). As under current law, such an election would generally cause a taxable liquidation of the corporation and thus may trigger a significant tax liability. Additionally, any entity making such an election would need to continue testing for Covered Entity status in future years and might be converted back into a C corporation anyway. Thus, it is likely that, even under an elective approach, most Covered Entities would, absent unusual circumstances, simply cease testing for Covered Entity status in subsequent taxable years and effectively choose to remain corporations for U.S. federal income tax purposes.

The base proposal discussed in the paper thus contemplates that Covered Entities later falling below the relevant threshold would not be permitted to elect pass-through treatment under the CTB rules. Allowing such an election seems unlikely to provide a meaningful benefit to taxpayers for the reasons discussed above and seems unlikely to minimize administrative complexity. A Covered Entity that later falls below the relevant size threshold and wishes to convert back to pass-through treatment would, as under existing law, have other options for pursuing such a conversion, such as an actual liquidation, a merger, or some other asset transfer into a pass-through entity.<sup>183</sup> Nevertheless, policymakers implementing the proposal may wish to consider further how Covered Entities that later fall below the size threshold are (or are permitted to be) treated.<sup>184</sup>

## *3. Translating pass-through equity into corporate stock: the classes of stock issue*

One particularly difficult aspect of the base proposal is the complexity of translating economic ownership arrangements from pass-through to corporate treatment. The ownership arrangements of pass-through entities (particularly partnerships) are characterized and treated very differently from those of corporations for U.S. federal income tax purposes. As a result, forcing certain pass-through entities to be treated as corporations will require either (1) taxpayers and the IRS to determine how existing ownership interests in pass-through entities are, or should be, treated under subchapter C; or (2) taxpayers to restructure and rewrite their pass-through economics so that they function as corporate stock. In many cases, this will be a complex process. As a result, implementing the base proposal will require policymakers to consider whether rules are needed to address this translation issue.<sup>185</sup>

Partnerships provide significantly more flexibility than corporations for dividing economic ownership. Unlike corporations, partnerships are not bound to a capital structure that is based on classes (or shares)

of stock. Rather, partnerships essentially have a blank slate to divide their ownership into interests with whatever economic (and other) terms the partners negotiate under the partnership agreement. Partnership interests can more readily, and more frequently, utilize specialized economics, such as special allocations, other mechanics to disaggregate certain partnership items or assets among partners, and ownership that is governed by a complex “waterfall” rather than by separate equity instruments with specific terms.<sup>186</sup> Additionally, unlike corporate shareholders, a partner holds a single unitary partnership interest (with a single tax basis and value) regardless of how the partnership’s economics are described or divided up under the partnership agreement.<sup>187</sup>

These fundamental differences mean that it may be difficult in certain cases to translate complex partnership equity interests into corporate stock in a way that makes sense. For example, turning partnership interests into corporate stock, without modifying their terms, may result in a situation in which each partner holds a completely individualized and separate class of stock—a corporate capital structure that taxpayers would be unlikely to set up from scratch and that could facilitate odd results or tax planning.

For example, suppose a partnership specially allocates a particular type of income (or income from a particular asset) to a partner and this allocation is respected under section 704(b). Because corporate stock does not contemplate special allocations, this may be treated as its own class of stock once the entity converts. Similarly, some complex partnerships use “partner-by-partner” economics to facilitate bespoke economic deals for particular partners; it is possible that, if such a partnership were converted into a corporation (without adjustment), each partner could be treated as holding a separate class of stock.

Relatedly, taxpayers accustomed to partnership-style economic sharing may begin to explore ways in which these types of complicated (and atypical) corporate stock arrangements could be used to replicate or extend the benefits previously available under subchapter K. For example, once an entity is converted into a corporation, it may utilize the resulting (or implement new) unique multi-class share structures to shift shareholder-level income disproportionately to tax-indifferent owners or otherwise separate tax results from economics. These issues, as well as those described in the preceding paragraph, need to be studied further in connection with any effort to implement any version of the base proposal; it is not clear at this stage how significant these issues would be or how much the base proposal should care about fixing them. In particular, any such strategies should be available to existing corporations today, and imposing entity-level corporate tax may significantly lessen the need to police whether the “wrong” owner is taxed on the second layer of

income except in particularly aggressive situations. Furthermore, to the extent entities and shareholders respond to the proposal by retaining earnings and minimizing the second layer of shareholder-level tax, this should minimize the revenue impact of these types of strategies over the budget window.

Fortunately, our tax system must already contend with complex translation issues to some degree due to the CTB and PTP rules. That is, LLCs (which typically use flexible partnership-style economics and may be governed by any number of complicated economic rules) can simply check the box to be treated as corporations, and many of them do. Some LLCs with relatively complex partnership-style economic waterfalls elect to be treated as corporations, with the result that their owners simply hold corporate stock with distribution rights governed by the waterfall. Similarly, as discussed above, section 7704(a) requires certain PTPs to be treated as corporations, which (at least theoretically) forces large and complex partnerships onto subchapter C in a manner similar to the base proposal.

Furthermore, many (if not most) partnership agreements today use a distribution-driven or targeted allocation approach under which the partners’ economic entitlements are governed by a distribution waterfall rather than by complex “layer-cake” allocations. Most partnership allocations are not constructed to comply with the substantial economic effect safe harbor, and capital accounts may not be maintained in technical compliance with section 704(b) rules. This market shift to a distribution-driven model of partnership economics is likely to simplify translation issues. It should generally be easier to map distribution entitlements onto the terms of corporate stock (whose economics are already typically drafted in terms of the right to receive distributions of corporate earnings) than it would be to translate complex allocation rules written for partnership-specific tax rules.

However, these considerations may be insufficient to address all translation issues that arise under the base proposal. While many LLCs can and do elect corporate classification, they often draft and analyze their agreements accordingly. That is, if an LLC plans to elect corporate classification, its economics will often be drafted in a manner that is relatively easy to translate into corporate stock.<sup>188</sup> Similarly, many PTPs either know they will be treated as corporations under section 7704(a) (and thus draft their agreements accordingly) or will maintain pass-through treatment under the qualifying income exception (making the translation issue irrelevant). As a practical matter, it is extremely rare for an entity designed for partnership tax treatment (and thus designed to avoid corporate treatment, whether under section 7704(a) or otherwise), to fall into corporate treatment.<sup>189</sup> That is, under current law, entities are generally permitted to

move between partnership and corporate treatment on an elective basis and instances of required corporate treatment are rare (and planned around). As a result, taxpayers know ahead of time what an entity's tax classification will be, and they draft and operate the entity accordingly, sidestepping any translation complexities.

But the base proposal would go much further than current law in requiring entities intended (and designed) to be treated as partnerships to be treated as corporations. The base proposal is therefore likely to cause many more instances of complex translation issues than arise under current law. As a result, implementing the base proposal will require policymakers to consider (1) whether its rules should (or even could) be written to minimize or address translation issues, (2) whether taxpayers will simply need sufficient time to do the analysis and restructure their economic arrangements (i.e., whether this should be built into the transition period and effective date discussed above), or (3) whether there should be some combination of the two.

Given the breadth and variety of existing partnership economic arrangements, it would be difficult to write detailed prescriptive rules that provide answers about how those arrangements should be translated into corporate stock under subchapter C. Furthermore, such an approach is probably unrealistic and perhaps not even desirable as a policy matter. That is, it is not clear that the goal of the regime should be to adopt an algorithm-type approach under which a partnership governed by complex partnership-style economic rules can simply convert to a corporation with the tax rules telling you what its resulting corporate stock should be. Rather, rules or guidance implementing the base proposal should focus on the following:

Providing broadly applicable and general guidance that clarifies likely gray areas and thus minimizes opportunities for aggressive planning: For example, general rules that clarify when differences in economic rights will create a separate class of stock. For example, rules could seek to specify the amount of differentiation between stock terms that will result in a separate class of stock for a converted entity.

Evaluating the most aggressive potential uses of complicated share class structures to shift the second layer of income between owners (e.g., strategies designed to ensure that a tax-exempt shareholder receives all dividend income while other owners receive a step-up in basis in their shares at death) and providing rules or guidance designed to address these. Again, while taxpayers may pursue these strategies today, they may become more aggressive in doing so in response to the proposal.

Evaluating whether, and to what degree, translation issues should be addressed primarily by rules and guidance or by taxpayer structuring. For example, it

may be appropriate (and consistent with the base proposal's reliance on existing tax classifications) to allow taxpayers to construct (or reconstruct) their economic arrangements as corporate stock in the manner that works best for them.

#### *4. Avoidance, behavioral responses, and related issues*

More broadly, any attempt to implement or estimate one of the proposals discussed here will need to consider the role, prevalence, and validity of techniques to avoid Covered Entity treatment. Some taxpayer responses to the proposal may rely on planning or structuring that complies with technical tax rules but is inconsistent with congressional intent. Such planning or structuring will implicate existing substance-over-form and other anti-abuse doctrines. Consistent with this, the rules that implement the proposal should aim to prevent such techniques to the maximum extent possible. At the same time, U.S. tax law generally allows taxpayers to avoid or minimize the impact of tax rules via transactions or structures that have an actual substantive impact on economics or ownership and are consistent with congressional intent, such as a true restructuring into a type of entity or structure that is not what Congress intended to capture. This is often (but not always) permitted even where the primary or sole motivation for undertaking the substantive change is to avoid or minimize tax.<sup>190</sup>

There are certain ways to avoid the Covered Entity tax that are likely to be valid; one example is effecting a bona fide division of a business among non-overlapping owners in a way that avoids aggregation (even under the revised aggregation rules) and thus brings each relevant entity below the size threshold.<sup>191</sup> Other valid approaches could include (1) undertaking certain other actions or transactions that the entity would have not otherwise undertaken to stay below any applicable coverage or safe harbor thresholds, (2) validly qualifying for RIC or REIT status (to the extent these entities are excluded from Covered Entity treatment), or (3) undertaking bona fide actions that move the entity's business operations outside of the United States (and do not run afoul of anti-inversion or similar rules).<sup>192</sup>

Different responses are likely to have differing implications for the proposal's underlying policy goals. For example, if a primary goal of the proposal is to reduce complexity in the tax system, bona fide restructuring that makes entities smaller or less complex (or that subjects them to greater regulation) may be entirely consistent with the proposal even when it results in less revenue. On the other hand, if the risk of avoidance (and reduced revenue) from businesses moving their activities outside of the United States were high, that is likely to be undesirable to policymakers.

The risk of businesses moving outside of the U.S. in response to the proposal should not be given undue weight, however. While some entities may achieve benefits by re-domiciling as foreign entities, moving an entire business operation outside of the reach of U.S. income taxation is a significant endeavor that will be prohibitively difficult for many U.S.-based businesses.<sup>193</sup> Furthermore, any effort to either re-domicile or move business operations outside of the U.S. will need to contend with existing anti-inversion rules, which are likely to make such strategies difficult. Nevertheless, the proposal will create incentives for some taxpayers to push the boundaries on these and other related strategies. For example, profit-shifting strategies undertaken by large multinational businesses under current law could be adopted by even more entities, placing significant additional pressure on existing tools such as transfer pricing rules.

Furthermore, it may be administratively difficult for the U.S. to assert taxing rights over foreign partnerships that become corporations under the proposal. That is, if a foreign partnership with no ECI or U.S. source income is treated as a Covered Entity, the U.S. would generally have limited ability to impose corporate tax on it. This is true even though U.S. tax could have been imposed on the entity's U.S. owners while it was treated as a partnership. Thus, it is possible that Covered Entity treatment could reduce U.S. tax revenues from certain foreign partnerships that have U.S. partners but foreign income and activities. However, it is unclear how big the effect of this would be. See the discussion of the U.S. taxation of foreign Covered Entities above.

## II. Alternative proposal: imposing a new entity-level tax on applicable pass-through entities

Given the significant complexity of forcing many large and complex pass-through entities onto subchapter C, a potential alternative approach (discussed briefly in the paper) is to impose a new pass-through entity tax on such entities. Rather than changing overall tax classifications and navigating the resulting complexities of converting to subchapter C, this alternative would retain pass-through treatment for Covered Entities and would simply charge them an additional entity-level tax. Instead of imposing entity level tax via the regular corporate tax, it would calculate and impose an entity-level tax on the pass-through entity itself without otherwise changing its overall tax classification. In other words, it would be akin to an excise tax imposed on certain pass-through entities. This section provides

an initial assessment of this alternative—in particular, whether it offers a simpler and more administrable way to raise revenue from Covered Entities.

At first blush, this alternative proposal may seem simpler than full conversion under the base proposal. But further examination shows that it is a much closer call: The alternative proposal raises many of its own complexities, some of which are on par with, if not more complex than, the difficulties of the base proposal. For one, as a general matter the entity tax approach relies much more on constructing novel tax rules that do not exist today. That is, rather than making use of existing tax classifications and conversion mechanics, a new entity-level tax relies on constructing an entirely new tax base, and many new tax mechanics, that are not part of the U.S. federal income tax system today. Thus, while the base proposal raises many complexities and difficulties, it is largely known it relies much more heavily on rules, mechanics, concepts, and transactions that exist (or can exist) under today's laws.

### A. Covered Entity status and transition rules

First, the considerations regarding how to define Covered Entities—what threshold is used, which types of existing pass-through entities are excluded or captured—should largely be the same as those described above. For example, just as the base proposal's C corporation approach could apply to all partnerships and S corporations with average annual gross receipts exceeding a certain dollar amount, the alternative proposal's entity tax approach could apply to the same entities. That said, it is worth considering whether the differences between the two proposals would support using a different definition of Covered Entity status under the alternative proposal.

Second, the considerations described above with respect to transition rules are also broadly similar under both proposals. However, the alternative proposal may warrant a simpler or shorter transition period than the full corporate approach of the base proposal. That is, as long as the relevant rules implementing and imposing the pass-through entity tax are well crafted, transitioning into the alternative regime should be much simpler for most entities than transitioning fully into corporate treatment.

### B. Key components of constructing and implementing the entity tax

To flesh out the complexities of even a relatively basic pass-through entity tax regime, policymakers must address the key components of such a regime and

examine whether they can be constructed to raise revenue from the largest and most complex pass-through entities while remaining administrable. A workable version of the alternative proposal must address five primary components: (1) the tax base, (2) the tax rate, (3) whether the entity level tax is deductible, (4) how the entity level tax is allocated to the partners/owners, and (5) how the tax is applied in tiered entity structures. As discussed below, these components do not stand alone but rather interlock such that choices and trade-offs with respect to one will impact the others.

### 1. *The tax base (CE taxable income)*

As a baseline, the CE tax under the alternative proposal should be a relatively straightforward calculation: Each Covered Entity would be subject to a tax equal to the CE tax rate multiplied by CE taxable income (i.e., the CE tax base).

However, establishing the appropriate CE tax base is a deceptively difficult task. There is currently not one pass-through entity-level income (or loss) amount. Rather, certain items realized at the partnership or S corporation level are required to be separately stated to the partners/owners; thus, these items do not net out at the entity level and do not factor into the entity's bottom-line net income or loss. This generally means that partnerships and S corporations report an assortment of separate (and non-netting) items of income, gain, loss, and deduction items to their partners/owners rather than a single net pass-through income amount. Thus, the most basic question to answer in constructing the CE tax base is how and whether these entity-level items should be combined to reach a single pass-through entity income or loss amount.

**(a) Combination approach.** One option is to apply a simple combination approach. Under this approach, CE taxable income would be a net amount (not less than zero) calculated by subtracting (1) all separately stated and non-separately stated items of loss, and deduction reported to partners/owners from (2) all separately stated and non-separately stated items of income and gain reported to partners/owners. In other words, CE taxable income would be calculated by simply combining all positive and negative entity-level items of income, gain, loss, and deduction, whether or not separately stated and regardless of character, to reach a single net number. This net amount (if positive) would be multiplied by the CE tax rate to determine the entity's CE tax liability. This approach raises a number of additional issues:

*Why not less than zero?* Should CE taxable income be allowed to go negative (i.e., be allowed to create a CE taxable loss)? If so, the rules would likely need to incorporate net operating loss-type mechanics. This would add complexity but would also be fair and is

arguably the correct approach conceptually. These net operating loss-type rules could likely be modeled on existing net operating loss rules, but further study would be needed to determine whether modifications are appropriate. An alternative, and simpler, approach is to view the alternative proposal as more of an excise tax simply aimed at imposing an additional tax in specific situations (and on a specific base), rather than measuring income over time.

*How should tax credits factor in, if at all?* Credits reduce tax liability rather than taxable income. As a general matter, pass-through entities currently determine credits at the entity level and then allocate them to the partners/owners, with the partners/owners then applying the credits to reduce tax on their own tax returns. Constructing the CE tax base thus requires determining how these tax credits should factor in. For example, should they be applied at the pass-through entity level (to reduce CE tax), or should they continue to be applied only for regular income tax purposes (with the CE tax regime unaffected by regular income tax credits)? If an entity's CE tax liability is not reduced by regular tax credits determined at the entity level, this could be viewed as inconsistent with allowing deductions at the entity level to reduce CE taxable income, which may raise concerns about fairness and consistency. At the same time, taking credits into account would add significant complexity. Additionally, specific tax credits are often calculated and applied differently (and to achieve different policy purposes), especially in pass-through entities, and so an approach that attempts to take into account credits may need to do so on a credit-by-credit basis rather than an across-the-board basis.

*How should existing limits on deductibility apply in calculating CE taxable income, if at all?* Various deduction limitations apply under current law (i.e., limits on a taxpayer's ability to deduct certain amounts in calculating taxable income). In pass-through entities, these limits are often applied on a pass-through basis (i.e., at the partner/owner level). For example, under section 212, miscellaneous itemized deductions are currently disallowed for individuals, and a partnership must therefore separately state its miscellaneous itemized deductions. Each individual partner is then prohibited from deducting its distributive share of such deductions. The alternative proposal requires considering how such partner-level limitations should factor in to the calculation of CE taxable income, if at all. For example, should these amounts also be non-deductible for purposes of determining CE taxable income? Such a restriction would add significant complexity: It would diverge from normal pass-through treatment by effectively importing partner-level deduction restrictions into an entity-level calculation. Such an approach would also be inconsistent with

the simplified methodology of disregarding the separate statement of items when calculating CE taxable income.

Note that the question of whether certain deductions should be allowed in computing CE taxable income is similar to questions that arise in constructing alternative minimum tax regimes. That is, an alternative minimum tax generally disallows certain deductions that are allowable for purposes of calculating regular income tax liability. Since the alternative proposal essentially constructs a new tax (with a new base), constructing it requires engaging in a similar analysis about which deductions are allowable and which are not. The most straightforward approach is to rely on existing rules on deductibility, but even this approach raises questions, as discussed immediately above.

Any approach to incorporating existing deductions will also need to consider the degree to which pass-through entities might be incentivized to overstate certain deductions likely to be nondeductible (for regular tax purposes) at the partner/owner level simply because they are allowed as deductions in computing CE taxable income.

*Partner-specific adjustments.* Under existing partnership tax rules, certain adjustments or attributes may apply only to specific partners. For example, a partner may have a specific adjustment that affects only its own share of the partnership's tax basis in an asset (a section 743(b) adjustment), and thus affects only its own share of income, gain, loss, and deduction with respect to the asset. Similar to partner-level deduction limitations, the alternative proposal must consider if and how to incorporate these types of partner-specific adjustments in the calculation of CE taxable income. One approach is to take all such items into account. This would essentially treat the aggregate amount of section 743(b) adjustments (or similar adjustments) as increasing or reducing the partnership's basis in the relevant asset for CE taxable income purposes—in other words, it would import partner-level inside basis into the partnership for the benefit (or detriment) of all partners. This would effectively cause CE taxable income to reflect the aggregate income recognized by the partners. An alternative approach is to ignore these amounts entirely, since they are partner-level items, treating CE taxable income as a pure partnership-level determination. It is not immediately clear which approach is more complicated or more appropriate as a policy matter.

Whichever approach is taken, it would be appropriate to ensure that the allocation of partnership-level CE tax expense lines up. That is, if a section 743(b) adjustment is taken into account in determining CE taxable income, then it will be appropriate for the allocation of the CE tax expense to a particular partner to reflect that partner's section 743(b) adjustment. And if the adjustment is not taken into account in CE taxable

income, it will be appropriate for the allocation of CE tax expense to ignore the partner-level section 743(b) adjustments.

Addressing this issue will also require evaluating the degree to which the rules implementing the alternative proposal can, or should, follow existing law. For example, under subchapter K, section 734(b), adjustments to inside basis are not partner-specific while section 743(b) adjustments are. Does this mean that they should be treated differently for purposes of calculating CE taxable income?

**(b) Allocation complexities.** Because the entity's pass-through status remains unchanged under the alternative proposal, the entity's CE tax expense will need to be allocated to its partners/owners, just as any of its other expenses must be allocated. If the calculation of CE taxable income combines separately stated and non-separately stated items to determine a single net amount of CE taxable income, as above, this will raise questions about how to determine the correct allocation of the resulting CE tax liability. That is, the separately and non-separately stated items that go into the calculation of CE taxable income may be allocated differently to different partners.

As discussed below, the substantively appropriate approach is to allocate entity-level CE tax to the partners/owners in proportion to their shares of the items that went into calculating CE taxable income (i.e., in proportion to their shares of CE taxable income). That is, as long as each of the items in the CE tax base is an item that is allocated by the pass-through entity to its owners for regular tax purposes, the logical approach will be to allocate the resulting CE tax expense in the same way. But how should that be accomplished when CE taxable income is calculated as a single amount resulting from the combination of separate amounts that may be allocated in different proportions? Either the entity-level CE tax expense must be allocated first across the separate items of income, gain, loss, and deduction that went into the calculation of CE taxable income, or an overall percentage share of the combined CE taxable income amount must be determined for each partner.

Allocating CE tax liability first across the entity-level items that went into calculating CE taxable income facilitates an accurate allocation of CE tax expense to the partners/owners because it creates a portion of the CE tax expense that can follow each corresponding item of CE taxable income. For example, if \$10 of \$40 total CE tax expense is allocated to the entity's separately stated capital gain, then \$10 of CE tax expense would be allocated in the same manner as such capital gain. However, an allocation of the CE tax across entity-level items may be complicated and may end up eliminating much (if not all) of the simplification benefit of using a combined approach to calculate CE taxable income in the first place.

A simpler approach may be to determine and provide a single combined percentage share of CE taxable income for each partner. That is, instead of allocating the CE tax expense first across the items that went into CE taxable income (and then allocating each such portion of CE tax expense in a manner that follows each corresponding component of CE taxable income), a flat percentage share of CE taxable income could be established for each partner. Each partner would then be allocated that percentage of the CE tax expense. A partner's overall percentage share of CE taxable income could be determined by adding up the partner's share of each component of CE taxable income (positive and negative) and dividing this net number by the entity's total CE taxable income.

**(c) Disaggregation approach.** An alternative that takes into account separately stated and non-separately stated items is a disaggregated approach. Under this approach, a separately (positive or negative) CE tax amount would be calculated for (1) each item of separately stated income, gain, loss, or deduction and (2) for non-separately stated (or, bottom-line) net income or loss. These separate CE tax amounts would then be netted at the entity level, and the resulting number (if positive) would be the entity's total CE tax liability.

This should primarily be mechanical (i.e., this disaggregated approach should reach the same entity-level CE tax liability as the combined approach described above). That is, arithmetically, it should not matter whether the items of income, gain, loss, and deduction are summed first and then multiplied by the CE tax rate or vice versa. Nevertheless, the potential benefit of the disaggregated approach is that it more easily facilitates an allocation of separate CE tax amounts to the partners/owners that simply follows the allocation of each separately stated and non-separately stated item that went into the calculation of CE taxable income. That is, if a partner is allocated a disproportionate amount of capital gain, then the partner is allocated a disproportionate amount of CE tax. See further discussion of allocation of the entity-level tax below.

Note that this approach raises many of the same basic questions regarding calculation of the CE tax base as are highlighted above, such as how to deal with tax credits, whether certain amounts should be allowable as deductions, how (and whether) to account for partner-level adjustments, and so on.

**(d) Reaching the same result?** At a high level, the above alternatives show that different approaches (combined or disaggregated) for calculating CE taxable income are essentially just two sides of the same coin. The difference between the two essentially comes down to ordering: Is it easier to calculate CE tax on a combined basis and then divide it up for purposes of allocating it to the partners/owners, or is

it easier to calculate CE tax on a disaggregated basis, allocate the disaggregated components of CE tax to the partners/owners, and then add those up to reach CE tax liability (and CE tax credits at the partner level)? Broadly speaking, and particularly in simple cases, the approaches should reach the same result and will carry many of the same complexities. Accordingly, the primary goal here should be to pick the methodology that is most intuitive and most administrable.

**(e) Discarding worse alternatives.** Finally, alternative approaches to the CE tax base could be considered, but are likely not worth pursuing.

For example, the above approaches (combined and disaggregated) are two different ways to calculate the CE tax on a base that includes all (or most) of an entity's separately stated and non-separately stated items of income, gain, loss, and deduction (regardless of character). An alternative, and certainly simpler, method would be to simply treat the pass-through entity's non-separately stated (i.e., bottom-line) net income (or loss) as the CE tax base. This approach would avoid many of the calculation, allocation, and apportionment complexities described above (though it will not sidestep all issues, such as deductibility and partner-level adjustments) since it would focus on only one type of entity income or loss. However, it would also result in arbitrary line-drawing and likely leave the CE tax base too small. It would capture only pass-through entities that actually have bottom-line net income or loss (i.e., in general, ordinary business income), leaving entities out of the tax base to the extent of their other income sources, such as capital gains, section 1231 gains, and so on, which may be significant. An investment partnership whose income consists solely or primarily of capital gain and dividend income would not be subject to the CE tax while a partnership that operates a business would be. This would also incentivize pass-through entities to push more income into separately stated buckets to minimize CE tax.

A similar—and similarly arbitrary—middle ground would be to construct CE taxable income so that it captures only bottom-line net income (or loss) and certain specified other items (e.g., the largest of the other sources of entity income, gain, loss, or deduction, such as capital gains). However, this seems like the worst of both worlds. It would be arbitrary while also failing to avoid the complexities of an approach that constructs the base out of both separately stated and non-separately stated items.

## *2. The tax rate*

This is the most straightforward element of the proposal since it would just be a flat percentage rate imposed on CE taxable income. Once the base is constructed, the rate could be set at a level that is expected to raise the desired amount of revenue, such

as at a level that approximates the revenue that would be raised from the base proposal's full C corporation mechanic.

More-complex approaches could be taken, such as a progressive or tiered rate structure, but it is not clear why that would be appropriate or necessary for this proposal.

### *3. Whether the tax is deductible at the entity level*

Effectively, this is a question of whether the tax paid by the entity itself is an expense that reduces the amount of income that passes through to the owners. In other words, should only the after-tax amount of entity-level income pass through to the owners? Because the alternative proposal maintains pass-through treatment but imposes a new expense (the CE tax itself) on the entity, the alternative proposal must address whether this new expense affects the income that passes through to the owners for regular tax purposes. For example, suppose a partnership with \$1,000 of income pays \$10 in CE tax. Should it allocate \$1,000 of income to its partners, or \$990?

For completeness, a third alternative is that it would allocate no further income to its partners. That is, the full \$1,000 was taxed at the entity level and so is not taxed again at the owner level. This would effectively flip the existing pass-through regime upside down: Instead of imposing a single layer of tax at the owner level, this would simply impose a single layer of tax at the entity level. Similar proposals have been offered elsewhere,<sup>194</sup> but are not the focus of this analysis. Such a proposal would also require setting a sufficiently high CE tax rate to ensure that the entity tax does not lose significant revenue compared to regular pass-through taxation.

Note that, regardless of whether the CE tax is deductible in computing the entity's income that passes through to its owners, it will need to be allocated to the owners under regular pass-through tax rules. Accordingly, the deductibility (or nondeductibility) of the CE tax cannot be used as a lever to simplify the complicated allocation questions discussed above or below. For example, if the tax is deductible, only the after-tax income passes through to the owners for regular tax purposes, and determining a partner's distributive share of this after-tax amount would thus require determining its share of the CE tax expense. If a partner were to be allocated too little or too much CE tax expense, then the partner's distributive share of after-tax income will be over- or understated. And if the tax is not deductible, the CE tax will still be an expense that reduces each partner's tax basis in its partnership interest and book capital account. Thus, if a partner's distributive share of CE tax does not line up with its distributive share of the pretax income, its outside

basis and book capital account will be distorted and potentially over- or understated.

As discussed below, this analysis contemplates that a credit would be provided to an upper-tier Covered Entity to minimize the duplication of CE tax on the same amount of income. Accordingly, at least for CE tax purposes, a lower-tier Covered Entity's CE tax expense should not be deducted for purposes of calculating an upper-tier Covered Entity's distributive share of CE taxable income from the lower-tier Covered Entity. If the upper-tier Covered Entity's share of CE taxable income from the lower-tier entity were reduced by the lower-tier CE tax, then the upper-tier entity's CE tax credit would always be overstated. In other words, the upper-tier entity's CE tax credit and its CE taxable income used to calculate its CE tax (against which the credit is applied) need to be calculated apples to apples. However, this does not necessarily answer the question of whether the CE tax should be deducted at the level of the lower-tier entity for purposes of determining the upper-tier entity's distributive share of regular taxable income (rather than CE taxable income).

Notably, existing S corporation rules may provide a useful framework here. In certain cases, an S corporation may be subject to entity-level tax under section 1374 on built-in gains that existed at the time the entity was converted from a C corporation to an S corporation. In such a case, both the S corporation itself and its shareholders are subject to tax on the recognized gains—the S corporation is subject to entity-level tax under section 1374, and the gain also passes through to the shareholders under section 1366. Under these rules, the gain that passes through to the shareholders is reduced by the entity-level tax; section 1366(f)(2) provides that a loss equal to the amount of tax paid by the S corporation itself also passes through to the shareholders, reducing each shareholder's share of the recognized gain that generated the entity-level tax. Thus, existing S corporation rules reflect an "after-tax" or "deductible" approach to the imposition of entity-level taxes on a pass-through entity itself. Rules implementing the alternative proposal could adopt a similar approach, at least for regular income tax purposes. This would add complexity, given that CE tax might be imposed on a broader range of income and gains than section 1374 tax, but would also seem to reflect a fair and logical result.

### *4. How the entity-level tax is allocated to the partners/owners*

The most substantively appropriate approach is to ensure that the CE tax expense is allocated to the entity's owners in proportion to their shares of the amounts that went into the calculation of CE taxable income (i.e., the CE tax base). That is, because the CE tax is

calculated on items of income, gain, loss, and deduction that pass through to the owners, it makes most sense to allocate the tax in a manner that aligns with the allocation of those items. To the extent that CE taxable income is composed of various items that are allocated to different partners in different proportions, this requires some allocation of CE tax expense across those items (or other disaggregation of CE taxable income items) to ensure that the CE tax expense can be divided up and allocated in a manner that follows the separate components. Many of these complexities are discussed above.

**(a) Simpler allocation approaches.** Approaches that do not seek to align the allocation of CE tax expense with the allocation of items that comprise the CE tax base may be simpler but run the risk of creating mismatches that lead to arbitrage and tax planning opportunities. For example, suppose a partnership has two partners, only one of which is a Covered Entity. The upper-tier Covered Entity would benefit from increased allocations of lower-tier CE tax expense while the other partner would be indifferent to such allocations (and may even prefer a lower allocation of CE tax expense to maximize outside basis reduction). In such a case, a simplified allocation that allows CE tax expense to be disproportionately allocated to the upper-tier Covered Entity (as compared to its share of CE taxable income items) will overstate its CE tax credit and could provide other tax benefits. The partners may seek to use flexibility in the allocation of CE taxable income (or items of CE taxable income) under normal subchapter K rules in a manner that facilitates a disproportionate allocation of CE tax expense to the upper-tier Covered Entity.

**(b) Allocation complexities.** However, an allocation rule that seeks to align CE tax expense with CE taxable income raises other complicated questions. As discussed above, one question is how to deal with partner-specific adjustments or allocations that apply under regular subchapter K rules, such as section 743(b) adjustments. The above discussion focused on whether, and how, a partner's section 743(b) adjustment should be taken into account in computing a partnership's aggregate CE taxable income. However, partner-specific adjustments will also affect how the partnership's CE tax expense is, or should be, allocated to its partners. Put another way, this is another case in which it is likely appropriate to cause the CE tax expense (and CE taxable income) to follow regular taxable income calculations. If a partner's section 743(b) adjustment reduces partnership-level CE taxable income, it would make sense for the resulting reduction in CE tax to be allocated to that partner. But the closer the alternative proposal's mechanics follow regular tax rules, such as subchapter K rules, the more complicated they get and the less likely they will be to address the complexity of existing subchapter K rules. Many

other complex subchapter K issues will factor into the calculation and allocation of CE tax, and will need to be considered further. Some examples follow:

*Section 704(c) allocations.* Section 704(c) raises similar issues as described above. For example, section 704(c) provides requires certain items of taxable income or deduction to be allocated to specific partners. Accordingly, a reasonable baseline approach would be to ensure that the allocation of any CE tax imposed on items of CE taxable income that are allocated to a specific partner under section 704(c) would follow those section 704(c) allocations. However, section 704(c) allocations can become incredibly complex to track and determine and so any interaction between the alternative proposal and section 704(c) rules would need further consideration.

*Mixing bowl gain, disguised sales, and guaranteed payments.* The rules will also need to consider the treatment of mixing bowl gain under section 704(c)(1)(B) or section 737, disguised sales (to or from the partnership) under section 707(a), and guaranteed payments made by the partnership under section 707(c). Any approach for implementing the alternative proposal that seeks to impose CE tax on partnership income, and to allocate the CE tax expense in a manner consistent with the allocation of that partnership income, will need to consider and account for these complicated scenarios. As a general matter, a reasonable approach would be to treat these items as only factoring into the calculation and allocation of CE tax to the extent they generate partnership-level items of income, gain, loss, or deduction. Thus, for example, it is likely inappropriate to treat guaranteed payment income of a partner as part of the partnership's CE tax base, but the corresponding guaranteed payment expense deduction that occurs at the partnership level should reduce the partnership's CE taxable income. Similarly, it is likely appropriate to provide that a disguised sale or mixing bowl transaction affects only a partnership's CE tax liability to the extent such transaction generates (or reduces) the partnership's taxable income or gain. If it does, it makes sense for the resulting CE tax to follow how that resulting income or gain was allocated. However, these are highly complicated questions.

*Gross income allocations.* In certain cases, a partnership may allocate gross (rather than net) income items to partners. Rules will need to consider how the allocation of CE tax expense, which is calculated on a net amount at the partnership level, is or should be affected by allocations of gross, rather than net, amounts that form part of the CE tax base. This may be similar to the guaranteed payment considerations described above.

*Partnership liability allocations.* Partnership tax rules contain complicated rules under section 752 that govern how partnership-level liabilities are allocated

to partners and the tax consequences of changes in a partner's share of liabilities. Implementing the alternative proposal will require consideration of whether, and how, these rules should factor into the CE taxable income (or CE tax) calculation or allocation. One potential approach is that they should not factor in, since CE tax is a partnership-level tax amount based on partnership-level income or loss, and liabilities should therefore factor in only to the extent that they actually affect the partnership's income or loss. The allocation of liabilities to partners under section 752 affects certain partner-level calculations (e.g., a partner's outside basis), but it generally will make sense for CE taxable income to follow the allocation of such income for regular tax purposes. Similarly, the treatment of things like partnership minimum gain and the allocation of nonrecourse deductions will need to be considered.

Essentially, implementing the alternative proposal will require detailed consideration of how creating and implementing a new pass-through entity tax base interacts with existing pass-through tax rules. Perhaps this is largely a project for regulatory guidance, but leaving too many unknowns to future regulatory guidance can create a risk that rules are implemented in a manner inconsistent with congressional intent.

### *5. How the tax is applied in tiered structures*

Finally, the alternative proposal will need to address tiers of pass-through entities, which are highly common. In a structure where a partnership owns interests in another partnership and both are Covered Entities, should the CE tax be imposed on the same income at each level? Without any relief in such a tiered structure, CE tax might be imposed on the same CE taxable income multiple times. That is, some or all of an upper-tier partnership's CE taxable income will be its distributive share of CE taxable income from a lower-tier

partnership, on which the lower-tier partnership already paid CE tax. This would result in two layers of CE tax imposed on the same income. In structures with many tiers, imposing a layer of CE tax at each level could result in CE tax that ends up exceeding the total amount of CE taxable income (i.e., an effective CE tax rate greater than 100 percent). It is not clear why such an approach would be an appropriate policy result unless a policy goal of the proposal is specifically to discourage tiered entity structures by taxing them more heavily. But tiered entity structures often address business or commercial needs, and this discussion assumes that discouraging tiers is not a specific aim of the proposal.<sup>195</sup>

Accordingly, in implementing the alternative proposal, it seems appropriate to provide relief for CE taxable income in tiered pass-through structures. While the CE tax is a pass-through entity-level tax, it would make sense to impose only a single level of CE tax on pass-through entity income. In a tiered structure such as that described above, therefore, it would make sense to ensure that the upper-tier pass-through entity does not pay CE tax again on any portion of its income that was already subject to CE tax at a lower-tier Covered Entity.

One relatively straightforward way to accomplish this is through a crediting mechanism. Essentially, the upper-tier entity would be allocated both its distributive share of the lower-tier entity's CE taxable income and CE tax expense (as discussed above), and its share of CE tax expense would then be applied as a credit against the upper-tier entity's own CE tax. Under such an approach, the credit would presumably be non-refundable. However, it would be reasonable to allow excess CE tax credits to be carried over to reduce an upper-tier entity's CE tax in future years. Such a mechanism would need further refining in any actual rules.

# Endnotes

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1. David Kamin, *Tax Reform After the One Big Beautiful Bill Act*, 120 *Tax Notes International* (November 5, 2025); Kathleen Bryant & Chye-Ching Huang, *Carving Holes and Shrinking the Base: How OBCCA Weakens the Tax System*, at 1-2, *The Tax Law Center at NYU Law* (December 2025); *The Tax Law Center, Breaking out of the "Revenue Box,"* (January 8, 2026).
2. Partnership tax rules were developed when partnerships were largely simple entities: When the bulk of current subchapter K was written, "most partnerships were closely held enterprises whose partners were exclusively U.S. taxpayers that were active in the partnership business." McKee, Nelson, Whitmire & Brodie: *Federal Taxation of Partnerships & Partners (WG&L)* at ¶ 1.03. The pass-through taxation of partnerships was drawn from "the historical picture of the general partnership"—an aggregate of owners in which each owner is personally liable for partnership obligations and authority to manage and control the partnership. *BNA Portfolio, Partnerships—Conceptual Overview*, No. 710-3rd, Section I (Introduction). Similarly, the S corporation rules were developed specifically for small corporations with simple capital structures—i.e., small businesses that were conceptualized at the time as "little more than chartered partnerships." Eustice, Kuntz & Bogdanski: *Federal Income Taxation of S Corporations (WG&L)* at ¶ 1.02.
3. In 1984, the American Law Institute stated in its overview of subchapter K reform proposals that partnerships remained quite distinct from traditional corporations: "what is probably the most important type of business subject to corporate tax, the large heavily capitalized entity which relies for a major source of investment capital on equity money, has no real analogue in the partnership field." American Law Institute, *Federal Income Tax Project, subchapter K: proposals on the taxation of partners*, adopted by the American Law Institute at Philadelphia, Pennsylvania, May 20, 1982 (1984). This assertion may be less true today.
4. Eligibility for various tax benefits (especially whether owners are eligible for the full section 199A deduction) will change the calculus for certain businesses. See, e.g., Edward G. Fox, Zachary D. Liscow, & Michael Love, *How to Tax Business? Economic Rents, Legibility, and the Corporate-Pass-Through Divide*, *Columbia Public Law Research Paper No. 6206239*, at 6-7 (February 5, 2026). Additionally, whether and when corporate income will be taxed at the shareholder level is also particularly important in determining the revenue effect of pass-through versus corporate taxation over a 10-year budget window, as discussed further below.
5. See, e.g., Fox, Liscow & Love, *supra* note 4, at 2, 5-6. At the federal level, the Tax Reform Act of 1986 made C corporation treatment less desirable by setting the top individual income tax rate below the corporate tax rate and repealing a mechanism that corporations previously used to avoid taxation on the appreciation of their assets. See, e.g., Bret Wells, *Pass-Through Entity Taxation: A Tempest in the Tax Reform Teapot*, 14 *Hous. Bus. & Tax L. J.* 1, 10-11 (2014). Congress took some steps shortly thereafter to limit the availability of pass-through treatment for certain categories of entities, including by taxing certain publicly traded partnerships as corporations. Omnibus Budget Reconciliation Act of 1987, Pub. L. 100-203, § 10211, 101 Stat. 1330-403-7 (1987). However, the overall trend by the end of the decade was toward greater availability of pass-through treatment for federal income tax purposes. See Rev. Rul. 88-76, 1988-2 C.B. 360.
6. Wyoming was the first state to create LLCs, in 1977, see Heather M. Field, *Checking in on "Check-the-Box,"* 42 *Loy. L.A. L. Rev.* 451, 460 & n.48 (2009) (citing Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 577), and the IRS ultimately blessed the classification of Wyoming LLCs as partnerships for federal tax purposes in 1988. Rev. Rul. 88-76, 1988-2 C.B. 360. This IRS decision increased uptake of the LLC form and spurred the adoption of similar laws in other states. Field, *supra*, at 462. In 1991, another new form of pass-through entity providing limited liability for all owners, the LLP, emerged in Texas and subsequently spread to other states. Eventually, the check-the-box regulations ensured that these entities would default to pass-through tax treatment without an examination of their legal and other characteristics. *Simplification of Entity Classification Rules*, TD 8697, 61 *Fed. Reg.* 66584 (1997).
7. Miles Johnson et al., *Modernizing Partnership Taxation* 2-3, 15, *The Tax Law Center and The Hamilton Project*, September 2024.
8. See, e.g., *Simplification of Entity Classification Rules*, TD 8697, 61 *Fed. Reg.* 66584 (1997); *Check-the-box elections (CTB)*, *The Tealbook*, Tax Law Center at NYU Law.
9. *Treas. Reg. § 301.7701-2* (prior to amendment by TD 8697, Dec. 17, 1996); T.D. 6503, 1960-2 CB 409, 25 *Fed. Reg.* 10928 (Nov. 17, 1960).
10. But see, e.g., Eric Toder, *The Incidence of the Corporate Tax*, *Tax Policy Center*, at 44-46 (February 5, 2025) (discussing the increasing fraction of shareholders not subject to U.S. tax on corporate stock); Jane G. Gravelle, *Corporate Tax Integration and Tax Reform*, R44638, *Congressional Research Service*, at 2-5 (September 16, 2016) (same); Staff of J. Comm. on Tax'n, *Overview of Approaches to Corporate Integration*, JCX-44-16, at 2-3, 15-18 (May 17, 2016) (same).
11. Employment taxes on active pass-through income, *The Tealbook*, Tax Law Center at NYU Law. Certain other pass-through owners also take the position that they fall within a gap between self-employment tax and the NIIT, arguing that they are too active to be subject to the NIIT but are simultaneously eligible for an exception from self-employment tax for limited partners. *Id.*
12. Miles Johnson et al., *Modernizing Partnership Taxation*, *supra* note 7, at 11, 18-20.

13. This is not to say that the TCJA had no effect on choice of entity form. Rather, there is evidence that “[o]n net, the TCJA [] appears to have reduced—but not eliminated—the general tax preference for pass-through status” and that, “[c]onsistent with this assessment, although entity-type switching remains rare in absolute terms, the amount of switching to C corporation status jumped after the TCJA.” Fox, Liscow, & Love, *supra* note 4, at 7.
14. See, e.g., Gregg D. Polsky & Adam H. Rosenzweig, *The Up-C Revolution*, 71 *Tax L. Rev.* 415 (2018); Gladriel Shobe, *Supercharged IPOs and the Up-C*, 88 *U. Colo. L. Rev.* 913 (2017); Phillip W. DeSalvo, *The Staying Power of the Up-C: It’s Not Just a Flash in the Pan*, *Tax Notes* (August 8, 2016).
15. One example of this is section 704(c), which seeks to ensure that deferred tax gains and losses are recognized in a manner that aligns with economic (i.e., book) results and thus are not shifted between partners. See *Modernizing Partnership Taxation*, *supra* note 7, at 10. In seeking to accomplish this broadly desirable goal, the section 704(c) rules have become difficult for many taxpayers to understand and administer, providing multiple elective allocation methods that achieve different results (without fully eliminating shifting) and including specific and highly complex rules aimed at particular abuses. As a result, they are burdensome to apply in complex partnerships and create planning opportunities as well as traps for the unwary.
16. Much of this also stems from the entity vs. aggregate debate regarding the treatment of partnerships. A partnership, given its unique characterization as both a conduit (an aggregation of its owners) and a separate regarded entity, carries features of both. Certain subchapter K rules embody an entity theory of partnerships, and others embody an aggregate theory, without much principled guidance on when one or the other should apply.
17. *Modernizing Partnership Taxation*, *supra* note 7, at 13.
18. See *Modernizing Partnership Taxation*, *supra* note 7; Jane G. Gravelle & Mark P. Keightley, *Marginal Effective Tax Rates on Investment and the Expiring 2017 Tax Cuts*, CRS Report R48153, Congressional Research Service, August 13, 2024. Compare, e.g., the 2017 (pre-TCJA), 2018, and 2024 columns for corporate and noncorporate entities shown in Tables 4 and 5 (pp. 8–11). These tables not only show that marginal effective tax rates on investments made through pass-through (i.e., noncorporate) entities are generally lower than those made through corporate entities, but also that marginal effective tax rates within the noncorporate category vary greatly across both asset and financing types both pre- and post-TCJA. See also Lucas Goodman, Quinton White, & Andrew Whitten, *Taxing S Corporations as C Corporations*, at 2–3, Office of Tax Analysis Working Paper Series, September 12, 2024 (examining the revenue implications of taxing S corporations as C corporations, and finding that the average tax rate gap between C corporations and S corporations “would shrink, but remain positive, if the Section 199A deduction were eliminated”).
19. See William S. McKee, William F. Nelson, Robert L. Whitmire, & Sarah Brodie, *Federal Taxation of Partnerships and Partners* (Thomson Reuters/Tax & Accounting, 5th ed. 2024, with updates through June 2024) at ¶ 1.03.
20. See, e.g., Gregg D. Polsky & Emily Cauble, *The Problem of Abusive Related-Partner Allocations*, 16 *Fla. Tex. Rev.* 479 (2014).
21. See Michael Love, *Who Benefits from Partnership Flexibility?*, *Journal of Public Economics*, Volume 251, November 2025, 105493; David S. Mitchell, *Tax avoidance among large, complex partnerships in the United States*, Washington Center for Equitable Growth, February 2025. Notably, much of this flexibility results from the attempt to allow partners a blank slate on which to write their economic deal and then have tax allocations follow that economic deal. The more complicated and varied economic arrangements become, the more complicated it must become to apply tax rules that follow those economic arrangements.
22. See, e.g., *Otay Project LP v. Commissioner*, T.C. Memo. 2026-21 (Feb. 23, 2026).
23. See Michael Love, *Where in the World Does Partnership Income Go? Evidence of a Growing Use of Tax Havens*, 79 *National Tax Journal* 1 (2026).
24. See Fox, Liscow, & Love, *supra* note 4.
25. See *Modernizing Partnership Taxation*, *supra* note 7, at notes 120–22.
26. See Fox, Liscow & Love, *supra* note 4, at 26–29.
27. See IRS Research, Applied Analytics & Statistics, *Tax Gap Projections for Tax Year 2022*, Pub. 5869 (Rev. 10-2024), at 15. IRS projections “do not fully represent noncompliance in some components of the tax system, particularly as relates to corporation income tax, income from flow-through entities, foreign or illegal activities, digital assets, and pandemic credits, because data are lacking.” *Id.* at 6 (emphasis added).
28. See Government Accountability Office, *Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships* 22, Fig. 9, GAO-23-106020, July 2023.
29. Pass-through taxation in general has long been recognized as difficult to implement in practice. For example, the American Law Institute’s partnership tax reform project, while generally concluding that pass-through treatment was appropriate for partnerships, also stated that a “pure pass-through model can only be achieved in practice at an intolerable cost in complexity.” American Law Institute, *supra* note 3, at 7.
30. See also, Fox, Liscow, & Love, *supra* note 4, at 30 (pointing out that entity-level taxation [(such as under subchapter C)] cuts off much of the administrative complexity of pass-through entities by making tax collection simpler: “. . . entity-level taxation performs a critical corrective function. It breaks the chain of complexity by forcing information to consolidate at a fixed point: the entity’s own return. An entity-level tax requires the entity to compute and pay tax on its own income, regardless of the structure or identity of its owners, and this provides a natural administrative foothold”).
31. *Modernizing Partnership Taxation*, *supra* note 7.
32. See *Employment taxes on active pass-through income*, The Tealbook, Tax Law Center at NYU Law; *Pass-through deduction—§ 199A*, The Tealbook, Tax Law Center at NYU Law.
33. See Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 *Tax L. Rev.* 105 (1991) (proposing that all large business entities should be taxed at the entity level, while small entities should continue to receive pass-through treatment); Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 *Tax Law.* 229 (1998) (proposing to preserve pass-through treatment only for simple privately held entities, and subject complex private entities and public firms to an entity-level tax); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 *Fla. Tax Rev.* 249 (1999) (limiting subchapter K to firms in the service sector, limiting subchapter S to firms in capital-intensive industries, and subjecting all other business entities to subchapter C).
34. See, e.g., George K. Yin & David J. Shakow, *Reforming and Simplifying the Income Taxation of Private Business Enterprises* (1999); George K. Yin, *The ALI Reporters’ Study on the Taxation of Private Business Enterprises*, *Tax Notes* (1999) (special report adapted from the “Introduction and Summary” of the “ALI Reporters’ Study on the Taxation of Private Business Enterprises) (endorsing a “system whereby all private business firms, no matter what their form of organization and organizational characteristics, are taxed as [pass-throughs]”). See also Edward D. Kleinbard, *Rehabilitating the Business Income Tax*, The Hamilton Project (June 2007); Alan J. Auerbach, *A Modern Corporate Tax*, Center for American Progress and The Hamilton Project (December 2010). While the term “integration” in

this context can refer to the integration of the pass-through and corporate tax system into a single system, the term “corporate integration” typically refers to the related but distinct concept of integrating corporate entity- and shareholder-level tax into a single level of tax. Some proposals seek to achieve both of these ends—and thus to provide for a uniform system of business taxation with a single level of tax—but many other proposals strive to do only one or the other (i.e., to integrate corporate taxation into a single level of tax that is still distinct from pass-through taxation, or to integrate business taxation into a single tax system that broadens the reach of, rather than removes, dual layers of tax).

35. These statistics and the accompanying text are drawn from Modernizing Partnership Taxation, supra note 7, at 3 & ns. 13–14, but updated for 2022 statistics of income and to provide figures for S corporations. See IRS, SOI Tax Stats—Individual statistical tables by size of AGI for tax year 2022, at Table 1.4.
36. These statistics and the accompanying text are drawn from Modernizing Partnership Taxation, supra note 7, at 3 & ns. 13–14, but updated for 2022 statistics of income. See IRS, SOI Tax Stats—Individual statistical tables by size of AGI for tax year 2022, at Table 1.4. Dividends includes ordinary and qualified dividends.
37. These statistics and the accompanying text are drawn from Modernizing Partnership Taxation, supra note 7, at 3 & ns. 13–14, but updated for 2022 statistics of income. See IRS, SOI Tax Stats—Individual statistical tables by size of AGI for tax year 2022, at Table 1.4.
38. These statistics and the accompanying text are drawn from Modernizing Partnership Taxation, supra note 7, at 3 & ns. 13–14, but updated for 2022 statistics of income and to provide figures for S corporations. See IRS, SOI Tax Stats—Individual statistical tables by size of AGI for tax year 2022, at Table 1.4.
39. See, e.g., The President’s Framework for Business Tax Reform, at 10, February 2012 (noting that, in “[e]stablishing greater parity between large corporations and large non-corporate counterparts[,]” “[i]t is essential that any changes in this area should not affect small businesses.”); Mark P. Keightley, *The Corporate Income Tax System: Overview and Options for Reform*, Pub. No. R42726, at 29, December 1, 2014.
40. Cf. Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform, Hearing Before the Committee on Ways and Means, No. 112-23, March 7, 2012 (Comm. Print) (remarks of Mr. Tucker) (discussing the fact that pass-through “owners are taxed irrespective of whether they receive distributions”).
41. Not all proposals to tax certain pass-throughs at the entity level do so for only large entities. Indeed, current law taxes most publicly traded partnerships at the entity level, see section 7704, and such entities are not required to be large. See, e.g., Berger, supra note 33, at 162 (explaining that whether an entity is publicly traded “is both underinclusive and overinclusive, as well as inefficient, as a standard for ‘bigness.’”). An alternative option discussed in Section 5 (Questions & concerns) and the Technical Appendix is adopting an ownership-based test (which could be similar to the criteria necessary to qualify for S corporation treatment) rather than a size-based threshold to determine which entities should be covered. Finally, certain proposals determine whether entities should be taxed on an entity level based in part on the activities of the entity. E.g., Lokken, supra note 33 (taxing only non-service firms that meet certain additional criteria under subchapter C); Berger, supra note 33, at 106, 164, ns. 3, 253 (discussing which subchapter M pseudo pass-through regimes to maintain), or one of the corporate characteristics of the entity. E.g., Jeremy Bearer-Friend, *Restoring Democracy Through Tax Policy*, The Great Democracy Initiative, at 5–7 (December 2018) (proposing to tax LLCs and LLPs as corporations and to repeal subchapter S “so that entity-level tax applie[s] to all incorpo- rated firms whose owners enjoy limited liability”). In any case, the base proposal discussed here would impose an entity-level tax (via corporate treatment) on a pass-through entity only when it is large (by a certain metric).
42. Subchapter K dates to 1954, Pub. L. 83-591, 68A Stat. 3, 239–254, and Subchapter S dates to 1958, Technical Amendments Act of 1958, Pub. L. 85-866, 72 Stat. 1606, 1650–57. However, even before subchapter K, individuals were taxed on their share of partnership income. See, e.g., George K. Yin, *The Future Taxation of Private Business Firms*, 4 Fla. Tax Rev. 141, 145–48 (1999).
43. See, e.g., Yin, supra note 42, at 144–53; see also, e.g., Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform, supra note 40 (Remarks of Ranking Member Levin) (“It used to be that pass-throughs were a reasonable proxy for small businesses. But with the growth both in number and size of S corporations and especially LLCs, this identity is breaking down”).
44. Under section 7701(a)(3), “associations” are taxable as corporations. A 1935 Supreme Court case, *Morrissey v. Commissioner*, established four factors for determining when an unincorporated entity was taxable as a corporation. 296 U.S. 344, 359 (1935). These factors were continuity of life, centralized management, free transferability of interests, and limited liability for all owners. See id.; see also, e.g., Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. Rev. 185, 216 (2004). Although *Morrissey* originally applied a “facts and circumstances standard” for this determination, Treasury entity classification adopted in 1960 (the Kintner regulations) adopted these same factors but applied a “mechanical, bright-line test”. Polsky, supra, at 216–17; T.D. 6503, 1960–2 CB 409, 25 Fed. Reg. 10928 (Nov. 17, 1960). As discussed in notes 6–9 and the accompanying text, the formalism of these regulations allowed entities to plan around corporate treatment. Furthermore, as new entity types arose that blurred the traditional lines between incorporated and unincorporated entities, Treasury and the IRS ultimately chose to replace the Kintner regulations with the CTB regime, which is largely elective by design, not just as a practical matter. Because of these changes in both entity form and law, it is unsurprising that many modern pass-throughs have many hallmarks that would traditionally be associated with corporations; for the most part, both state law and federal tax law now allow this. But cf. Polsky, supra (questioning whether the check-the-box regulations are valid under section 7701(a)(3)).
45. Cf. Christopher H. Hanna, *Corporate Tax Integration: Past, Present, and Future*, 75 Tax L. 307, 310–11 (2022) (“Although corporate integration was a substantial part of the discussion leading up to the enactment of the Tax Cuts and Jobs Act, given the 14–percentage point reduction in the corporate tax rate and a substantially revised U.S. international tax system, integration ideas simply fell by the wayside.”); id. at 313 (discussing the “graveyard near the White House full of prior [corporate] integration proposals”) (quoting Senator Orrin Hatch); id. at 320 (discussing lack of benefit to most corporations from corporate integration).
46. See, e.g., S.1624, 110th Cong. (as referred to S. Comm. on Fin., June 14, 2007); U.S. Senate Committee on Finance, *Baucus-Grassley Bill Addresses Publicly Traded Partnerships* (March 14, 2007); The President’s Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August 2010, at 75–76.
47. See Congressional Budget Office (CBO), *Taxing Businesses Through the Individual Income Tax*, Pub. No. 4298, at 25, December 2012 (suggesting that subjecting “all publicly traded firms” to the corporate income tax “would affect few firms not already subject to the corporate tax.”); Berger, supra note 33, at 161.
48. See Katarzyna Bilicka and Sepideh Raei, *Output distortions*

and the choice of legal form of organization, *Economic Modelling*, Volume 119, February 2023; see also David S. Mitchell, Factsheet: What the research says about taxing pass-through businesses, Washington Center for Equitable Growth, April 30, 2024 (providing a discussion of emerging research in this space more generally).

49. Martin A. Sullivan, *Economic Analysis: Why Not Tax Large Passthroughs as Corporations*, Tax Notes (June 6, 2011). Sullivan was until recently the chief economist and a contributing editor for Tax Analysts. He previously taught economics at Rutgers University and served as a staff economist at the U.S. Department of the Treasury (Treasury) and the Joint Committee on Taxation (JCT).
50. The President's Framework for Business Tax Reform, *supra* note 39, at 7 & n.10 (citing Austan Goolsbee, *The Impact of the Corporate Income Tax: Evidence from State Organizational Form Data*, 88 J. Pub. Econ. 2283 (2004); Jeffrey K. MacKie-Mason & Roger H. Gordon, *How Much Do Taxes Discourage Incorporation?*, 52 J. Fin. 477 (1997); Roger H. Gordon & Jeffrey K. MacKie-Mason, *Tax Distortions to the Choice of Organizational Form*, 55 J. Pub. Econ. 279 (1994). To be sure, a solution short of full integration—and especially one that maintains some electivity—cannot fully solve distortions caused by choice of entity form. Nonetheless, the proposal could still result in significant improvement relative to the current-law baseline.
51. Fox, Liscow, & Love, *supra* note 4.
52. But see Lily L. Batchelder, *The Shaky Case for a Business Cash-Flow Tax Over a Business Income Tax*, *National Tax Journal*, December 2017.
53. See *Modernizing Partnership Taxation*, *supra* note 7.
54. See *Modernizing Partnership Taxation*, *supra* note 7, at 8–13; see also Love, *supra* note 21. Note, however, that not all pass-through compliance concerns are limited to businesses large enough to meet the thresholds for the proposals discussed in this paper. Certain tax planning may be especially concentrated among pass-through entities that are large enough (or that have wealthy enough owners) to support sophisticated tax planning but that may lack the risk aversion of most of the largest pass-through businesses, which often have a clear business purpose divorced from tax-planning. Similarly, the webs of pass-through entities that can support money laundering and other crimes are, in some cases, unlikely to consist of large pass-throughs covered by this proposal, cf. 31 U.S.C. § 5336(a)(1)(B)(xxi) (carving out most large, domestic entities from the Corporate Transparency Act's beneficial ownership information reporting provision); Tax Law Center, *Comments on Beneficial Ownership Information Reporting Requirement Revision*, Docket No. FINCEN-2025-0001, OMB Control No. 1506-0076, RIN 1506-AB49, at 15–21 (May 27, 2025)—though, in some cases, robust aggregation rules might mean that certain large criminal operations reliant on pass-throughs could be covered entities under this proposal.
55. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, at 129 (November 2005).
56. Some commentators theorize that much of the complexity and revenue loss from current partnership tax rules arises from the application of a regime initially intended to apply mostly to small and simple entities to much more complex ones. However, in some cases, the most aggressive tax planning (and even tax evasion) may not be by the largest taxpayers, but rather medium-sized taxpayers with resources to afford sophisticated tax-planning but less risk-aversion than the largest entities. See note 54, *supra*. To the extent that this is true, it may mean that, even after taking the largest entities out of the pass-through tax regime, there is still need for fairly complex rules to prevent avoidance and abuse. On the other hand, to the extent that rules needed to make the regime workable for larger entities were what created the grounds for avoidance and abuse, simplification and preventing any on-going opportunities for avoidance and abuse may go hand in hand.
57. E.g., Berger, *supra* note 33.
58. Fox, Liscow, & Love, *supra* note 4, at 35–36.
59. See, e.g., Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform, *supra* note 40 (remarks of Mr. Smetana) (suggesting that a proposal to tax more pass-throughs as corporations would “decrease [] opportunities in terms of reinvestment and growth”).
60. Determining entity tax treatment based solely on size creates significant complexity. Imposing uniform tax treatment of similar businesses based on a different measure of similarity could reduce some of this complexity (and may reduce other distortions) but would present other trade-offs. This is discussed further below and in the Technical Appendix. Accordingly, the base proposal adopts a size-only threshold to align with many existing proposals of this nature, because it can be tailored to more directly exclude small businesses, and because of the infeasibility of estimating the revenue effects of proposals based on certain other criteria from public data.
61. Certain prior proposals have examined some of these questions in detail, but these are in need of updating. See, e.g., Berger, *supra* note 33. Other proposals make certain determinations in order to provide revenue estimates but examine fewer legal details. See, e.g., Jason Furman, *How to Increase Growth While Raising Revenue: Reforming the Corporate Tax Code*, The Hamilton Project, January 2020, The Hamilton Project, at 302 (building on the President's Advisory Panel on Federal Tax Reform, *supra* note 55, recommendation as to which types of entities should be covered, and at what size, but suggesting revising the gross receipts threshold upwards to \$25 million based on inflation).
62. The base proposal would not apply to some specific entities or arrangements commonly thought of as pass-throughs, such as REITs, RICs, and sole proprietorships. See Section 5 (Questions & concerns), below, and the Technical Appendix.
63. See section 448(c).
64. In applying corporate treatment, the base proposal would not treat the two entities as a single corporation, but rather as two separate corporations that may be aggregated together in circumstances where relatedness rules apply. Additionally, a modification to the aggregation rules under the base proposal means that if both entities are domestic, the two entities now treated as corporations will generally be eligible for consolidated group treatment (i.e., to file consolidated rather than separate tax returns).
65. See, e.g., section 965(h) and S. 2095, § 1(c), 119th Cong., as introduced in Senate (June 17, 2025) (providing or proposing a similar installment payment mechanism for similar tax liabilities arising as a result of a change in law).
66. As under current law, a covered entity could undertake an actual liquidation or other asset transfer (e.g., a merger) to effectively convert back into a pass-through entity. However, there are often significant business or other nontax obstacles to such transactions, and, where such a transaction is feasible, it would generally be fully taxable.
67. See Tax Policy Center n.d., *Microsimulation Model FAQ*.
68. See, e.g., Furman, *supra* note 61, at 310.
69. Some commentators have suggested that it impossible to do this in a workable way, however. See, e.g., Hearing on the Treatment of Closely-Held Businesses in the Context of Tax Reform, *supra* note 40 (Remarks of Mr. Nichols) (suggesting that structures with, “let's say, two dozen affiliated entities” could result in rules “at least as complicated and probably many more times more complicated” than the already complex consoli-

dated return rules for corporations).

70. Specifically, the estimates assume that about 45 percent, on average, of after-tax profits are distributed in the year earned among entities that become C corporations under the base proposal. They further assume that about 60 percent of retained earnings are realized in the form of capital gains over the 10-year budget window.
71. This would be similar to some planning that occurs today around the S corporation one-class-of-stock requirement. That is, to remain eligible for S corporation treatment, entities today may engage in creative planning to characterize what might otherwise be treated as a second class of stock as a loan or other contractual arrangement. Under the base proposal, some entities may engage in similar planning designed to treat an entity as having only a single owner for tax purposes (i.e., planning that turns all but one owner's equity interests into non-equity arrangements) to remain a sole proprietorship or DRE.
72. Modernizing Partnership Taxation, *supra* note 7.
73. Note that certain existing tax rules evaluate an entity's size based on an asset test that looks to the tax basis of assets rather than their fair market value. See section 1202. However, tax basis generally does not reflect any untaxed gain or loss in asset value and is thus generally a poor measure of current asset value, especially for start-up businesses. Thus, an asset test for Covered Entity status should in any case avoid following section 1202's lead.
74. See, e.g., section 856(c)(4)(A) (the asset test for REIT qualification); sections 851(b)(3) and 851(c) (the diversification test for RIC qualification); sections 1297(a)(2) and 1297(e) (the passive asset tests for PFIC status). REITs also must satisfy additional asset tests under section 856(c)(4)(B)); what is most relevant here, though, is not the criteria to qualify for REIT status, but rather the existing method for measuring total assets.
75. To be sure, number of partners is correlated with size, though there are large partnerships with as few as two partners, as well as partnerships with more than 100 or even 1,000 partners that do not meet certain measured size thresholds. See Partnership Returns, Tax Year 2023, at 3.
76. "Partnerships with 100 or more partners accounted for only 0.4% of all partnerships, but 35.5% of all partners in 2023." See Ron DeCarlo et al., Partnership Returns, Tax Year 2023, at 1, IRS Statistics of Income Bulletin, Fall 2025.
77. The requirement that ownership be proportionate, or pro rata, would be somewhat difficult to draft for partnerships, but existing proposals provide a starting point. For example, Senator Wyden's recent proposal to require certain partnerships with related party partners to use a "consistent allocation" method, see PARTNERSHIPS Act, S. 2095, § 2, 119th Cong. (as referred to S. Comm. on Fin., June 17, 2025), is conceptually similar to imposing an S corporation-style one-class-of-stock requirement on a partnership.
78. The report states that Congress could require large pass-throughs "to pay a separate entity-level tax, without necessarily requiring them to alter their organizational form if they choose to keep it for other reasons." Alexandra Thornton & Brendan V. Duke, Ending the Pass-Through Tax Loophole for Big Businesses, Center for American Progress, August 2016, at 21. This may just be a reference to the fact that the entity need not change its organizational form for state-law purposes, or it may be alluding to the fact that Congress could impose an entity-level tax on certain pass-throughs but otherwise allow them to remain within subchapter K or S.
79. Furthermore, certain other taxes or proposals either are, or initially seem like they may be, helpful in designing such a tax. For example, certain states and localities have long had—and many states and localities now have, as a workaround to the federal cap on deductions for state and local taxes—entity-level taxes on pass-throughs. These taxes are somewhat informative here in that they define a tax base for a pass-through entity-level tax and in that they make determinations about how to apply the tax in tiered entity structures. However, these taxes do not depend on the size of the entity, so they do not require a determination of how to define size or what threshold to set, and, furthermore, do not require aggregation rules to determine when that size threshold is met or to prevent entities from splitting apart to avoid that threshold. Similarly, fundamental business reform proposals that propose to tax all entities, including pass-throughs, once at the entity level, see, e.g. Fox, Liscow, & Love, *supra* note 4, at 39 (discussing proposals to tax "all businesses . . . as entities and on a cash flow basis"), must make certain determinations that are relevant here but do not implicate certain of the design questions relevant to imposing an entity-level tax on a business that otherwise remains a pass-through.
80. See Tax Law Center, Employment taxes on active pass-through income, The Tealbook: Options to Broaden the US Tax Base.
81. See Tax Law Center, Qualified Small Business Stock, The Tealbook: Options to Broaden the US Tax Base.
82. See section 852(b)(6); Tax Law Center, Exchange-traded funds (ETFs), The Tealbook: Options to Broaden the US Tax Base; Tax-free swap fund exchanges, The Tealbook: Options to Broaden the US Tax Base.
83. See Miles Johnson, Taxing the Step-up: A Logical Approach to Related-Party Basis Shifting, Tax Notes (July 7, 2025); Tax Law Center & Miles Johnson, How large businesses use partnerships to create tax deductions out of thin air: An explainer on related party basis shifting (July 26, 2024); Duncan Hardell, How some corporations manipulate losses using Granite Trust transactions to avoid tax, Tax Law Center (December 2, 2024), Duncan Hardell et al., *Uncovering the Cracks in Granite Trust Transactions*, Tax Notes (November 18, 2024); Duncan Hardell, Michael Kaercher, & Thalia T. Spinrad, *More Cracks in the Bedrock: Section 304 Tactics Beyond Granite Trust*, Tax Notes (June 2, 2025).
84. See, e.g., Modernizing Partnership Taxation, *supra* note 7.
85. The literature proposing reforms to the corporate tax is large, including longstanding debate on the merits of reforms that move toward or away from cash-flow taxation.
86. For example, the desire to qualify for pass-through treatment under the RIC or REIT rules could push a greater number of existing investment vehicles, currently structured as partnerships, to take aggressive positions on whether they satisfy the asset and income tests for RIC or REIT treatment. This could require a further tightening of the RIC or REIT qualification rules or could require the IRS to devote further administration and enforcement resources to RICs and REITs.
87. Note however that some of the complementary pass-through reforms may raise less revenue after implementation of the base proposal, which narrows the pass-through base, than they do under current law. This is similar to how an increase in the top individual rate raises less revenue after implementation of the base proposal.
88. Derived from IRS SOI data for 2022 found here: SOI Tax Stats—Partnership statistics by sector or industry | Internal Revenue Service.
89. Derived from IRS SOI data for 2022 found at Table 6.1, here: SOI Tax Stats—Corporation Income Tax Returns Complete Report (Publication 16) | Internal Revenue Service. This distribution appears to be largely consistent over time, since data for 2013 (found here: SOI Tax Stats—Table 4—Returns of active corporations, Form 1120s | Internal Revenue Service) also indicate that the gross receipts of the largest S corporations are concentrated in the industries of (1) wholesale and retail trade, (2) manufacturing, and (3) construction.

90. See section 199A(d)(2)(A); Justin Elliott & Robert Faturechi, *Secret IRS Files Reveal How Much the Ultrawealthy Gained by Shaping Trump's "Big Beautiful Tax Cut,"* ProPublica (August 11, 2021) (discussing lobbying by a large pass-through entity for the treatment engineering and architecture firms receive under section 199A).
91. Large private equity firms that have converted to full or partial corporate treatment before or after the TCJA include Blackstone, KKR, Ares, the Carlyle Group, TPG, and Blue Owl. See Blackstone, *Blackstone Completes Conversion to a Corporation* (July 01, 2019); Reuters, *Private equity firm KKR opts to become C-Corps after U.S. tax reform* (noting that KKR was listed on the NYSE in 2010, and on Euronext Amsterdam in 2009); Axios, *Ares to convert from partnership to C-Corp* (February 16, 2018); Carlyle, *The Carlyle Group Announces Conversion to Full C-Corporation, Reports Second Quarter 2019 Financial Results* (July 31, 2019); TPG Partners, LLC, SEC Form S-1 (Dec. 16, 2021); Blue Owl Capital Inc., SEC Form S-1 (Oct. 4, 2021).
92. Private equity funds are one type of investment fund that primarily invests in the equity of operating companies, often under a "buyout" strategy that is focused on acquiring majority or control positions in such companies. The private equity funds themselves are typically organized as partnerships for tax purposes. Other types of investment funds, such as hedge funds (which invest primarily in public securities) and private credit funds (which primarily make loans or otherwise invest in debt instruments) are also often organized as partnerships and could therefore be captured by the proposal if they satisfy the relevant threshold.
93. Ryan Hess et al., *The Spiderweb of Partnership Tax Structures*, Washington Center for Equitable Growth, Working Paper (February 2025).
94. *Otay Project LP v. Commissioner*, T.C. Memo. 2026-21 (Feb. 23, 2026); Walter D. Schwidetzky, *The Otay Sham*, Tax Notes (Aug. 19, 2025).
95. See *Modernizing Partnership Taxation*, supra note 7, and appendix thereto for a more detailed discussion of the information gaps with respect to partnership taxation, including the lack of information and concrete data regarding the broader economic benefits or detriments of existing partnership tax rules.
96. Professor Berger was a Columbia Law School professor, who specialized in real estate and property law, but who also taught (and wrote a textbook about) partnership taxation.
97. Berger, supra note 33, at 161-70.
98. Id. at 165. Berger arrives at a gross receipts test for large businesses, after considering in some depth, but ultimately rejecting, a number of other options, including shareholder contribution, number of owners, profitability, whether a firm is publicly traded, and total assets. Id. at 161-65. Berger's proposed range is motivated by the "strong intuition that somewhere within this range a business no longer can consider itself small." Id. at 165.
99. Lawrence Lokken, supra note 33, at 282.
100. President's Advisory Panel on Federal Tax Reform, supra note 55, at 129.
101. Id. The Advisory Panel's proposal allowed certain "[p]assive investment vehicles," including RICs and REITs, to receive the same treatment they currently receive under subchapter M. Id.
102. Id. Other proposals driven by similar concerns as those described in this paper have suggested a similar approach. For example, see Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses*, Tax Lawyer, Vol. 69, No. 2, 2016 (proposing a regime in which (1) subchapters K and S are repealed, (2) all privately held businesses are subject to a single layer of tax at the entity level, and (3) publicly held businesses remain taxed under the rules of subchapter C). McMahon's proposal is driven in large part by "decades-long problems with the administration of Subchapter K, governing the taxation of partnerships, and the incoherence of having three separate regimes — Subchapter C, Subchapter K, and Subchapter S — apply to privately held businesses depending of the form of organization and available elections"—considerations very similar to those that have driven many of the proposals examined here).
103. The President's Economic Recovery Advisory Board, supra note 46, at pp. 74-76; see also The President's Framework for Business Tax Reform, supra note 39, at pp. 10.
104. The President's Economic Recovery Advisory Board, supra note 46, at 75.
105. Id. In 2010, publicly traded partnerships (PTPs) were already taxed as corporations under section 7704. However, the 2010 report discussed the option of removing some of the PTP exemptions that exist under current law. Specifically, the report discussed two alternatives: (1) "end[ing] the current law exemptions for entities with certain types of income (natural resource or portfolio-type income);" or (2) removing the "exception for partnerships with passive-type income derived from providing investment adviser and related asset management services." Id.
106. See Nicola M. White & Drew Pierson, *Baucus Says Congress Should Look at Taxing Passthroughs as Corporations*, Tax Notes, May 5, 2011 ("We're going to maybe have to look at passthroughs—say they've got to be treated as corporations if they earn above a certain income."); Baucus Examines Ways to Reduce Distortions in Business Caused by the Tax Code, United States Senate, Committee on Finance, Chairman's News, August 1, 2012.
107. See Senate hearing testimony by Treasury Secretary Timothy Geithner, U.S. Senate Committee on Finance, *The President's Budget for Fiscal Year 2012*, 112th Cong., February 16, 2011.
108. Thornton & Duke, supra note 78, at 4, 20-22.
109. Id. at 20.
110. Id. at 4. The report specifically discussed prior estimates related to a \$10 million gross receipt threshold, a \$25 million average annual gross receipt threshold, and a \$50 million asset threshold. Id. at 21. If the goal is to capture below 2 percent of pass-through entities as of the time of the proposal, it would be possible to tailor the threshold to achieve that.
111. Specifically, the report suggested the possibility of adopting the Bipartisan Budget Act of 2015's 100-partner threshold for large partnerships for auditing purposes as a threshold for which partnerships should face an entity-level tax. Id. at 20-21.
112. Professor Bearer-Friend is a tax law professor at George Washington Law School.
113. Bearer-Friend, supra note 41.
114. Id. (in explaining the rationale for repealing subchapter S, Bearer-Friend explains that this would mean that "entity-level tax" would apply "to all incorporated firms whose owners enjoy limited liability[.]")
115. Professor Furman was the chair of the Council of Economic Advisers from 2013 to 2017. He currently is professor at Harvard, with a joint appointment at the Harvard Kennedy School and the Department of Economics, as well as a nonresident senior fellow at the Peterson Institute for International Economics.
116. Jason Furman, supra note 61, at 299, 301-2.
117. Id. at 286, 302. The proposal builds on the \$10 million gross receipts threshold from the 2005 Bush Advisory Panel proposal, which would be an approximately \$13 million threshold in 2020 dollars. However, Furman states that "[a] higher threshold, say \$25 million, might be more reasonable." Id. at 302.

118. *Id.* at 306. Furman estimated, however, that a steady-state version of the proposal would raise only \$200 billion over the budget window. *Id.*
119. Fox, Liscow & Love, *supra* note 4, at 35–36. This option is one of the paper’s four options to address “the rising complexity of partnerships”; the other three are increasing IRS staffing; instituting a complexity fee; and enhancing information reporting. See also Edward G. Fox, Zachary D. Liscow, and Michael Love, *The Case for Corporate Tax: Two Trends Make Pass-Through Taxation Harder To Defend*, Tax Policy Center TaxVox, February 10, 2026.
120. *Id.* at 36.
121. Mark P. Keightley, *Taxing Large Pass-Throughs as Corporations: How Many Firms Would Be Affected?*, CRS Report R42451, Congressional Research Service, March 30, 2012.
122. Keightley, *supra* note 39, at 28–29.
123. CBO, *supra* note 47, at 24–29.
124. The easiest way to accomplish this is likely to incorporate the new rule directly into section 7704. This would require conforming changes to the section heading and text—a Covered Entity under the proposal should not be incorporated into the definition of PTP when it is not a PTP; rather, corporate treatment should apply to a Covered Entity in the same way that it applies to a PTP.
125. That is, PTPs below the size threshold in this proposal would continue to be subject to corporate treatment, and PTPs would not need to do anything new to continue to be taxed as corporations.
126. See section 7704(d)(1).
127. Accordingly, some prior proposals have adopted an approach that would curtail or limit the qualifying income exception for certain PTPs in the investment management sector. See, e.g., S.1624, 110th Cong. (as referred to S. Comm. on Fin., June 14, 2007); U.S. Senate Committee on Finance, *Baucus–Grassley Bill Addresses Publicly Traded Partnerships* (March 14, 2007); The President’s Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, August 2010, at 75–76. But cf. CBO, *supra* note 47, at 25 (suggesting that subjecting “all publicly traded firms” to the corporate income tax “would affect few firms not already subject to the corporate tax.”); Berger, *supra* note 33, at 161 (rejecting basing corporate treatment on whether a firm is publicly traded, including because “the standard would deter some firms from gaining liquidity where doing so would eliminate the firm’s pass-through treatment”). Removing the qualifying income exception aligns with the policy goals of raising revenue from large and complex business entities, treating entities with fundamentally corporate characteristics (and that would have historically been formed as corporations) as corporations, and ensuring that similar entities are taxed similarly.
128. The difference between these two approaches, then, would only be for an entity that is publicly traded but not treated as a corporation under section 7704(a) due to qualifying income and that is not large enough (or complex enough) to be a Covered Entity. Such entities would be taxed as C corporations if the qualifying income exception is deleted but would not be taxed as C corporations if PTP taxation is expanded only when the otherwise-expected entity is a Covered Entity.
129. Note that such a clarification is unnecessary in the PTP context: For a PTP, the term “corporation” will almost always mean “C corporation” as a practical matter, since PTPs will rarely (if ever) satisfy the ownership conditions for making a subchapter S election and will rarely (if ever) be able to collect the consent of all public shareholders as required under section 1362(a)(2). Additionally, such a clarification may be unnecessary under the alternative version of the proposal that imposes ownership requirements for Covered Entity treatment (discussed in Section I.E.2. of the Technical Appendix). Under such a proposal, entities that meet the criteria for S corporation election under section 1361(b)(1) would not be Covered Entities.
130. The estimates in the main paper focus on taxing large pass-through entities. That is in part due to the difficulty of estimating the revenue for a proposal that is based on complexity of an entity’s ownership (e.g., number of owners). However, some existing discussion of this issue explores the possibility that such an ownership criterion (or something similar) is most appropriate. See, e.g., Lokken, *supra* note 33, at 282. A proposal fully based on complexity of an entity’s direct ownership provides the advantages of being potentially easier to assess, and, in some cases, harder to avoid. Additionally, certain proposals take the position that policy of this nature should be focused on reaching either (1) complexity of ownership or (2) corporate characteristics, and that reforms should thus be tailored at decreasing complexity or aligning treatment between corporations and pass-through entities that are corporation-like in some respect other than size (e.g., LLCs). On the other hand, proposals based solely on corporate characteristics would, without additional exclusions, generally include some small businesses.
131. See, e.g., Lokken, *supra* note 33 (proposing to restrict subchapter K to service firms—i.e., firms for which capital is not a material income-producing factor).
132. Setting that threshold may turn on the distinction between large and small, but it may also be adjusted for revenue- or other policy-related reasons.
133. Taxable income is not a particularly good measure of size, since it can fluctuate significantly from entity to entity (or even industry to industry) due to various tax preferences in the Code. Book income may be a better measure of size as a general matter, but may be too difficult to incorporate and harmonize with existing tax rules and concepts for this purpose. Other metrics such as employee headcount may also be good measures of business size as a general matter, or for certain purposes, but are likely inappropriate here, particularly if the goal is to capture certain large entities that may have no or few employees (or even no active business operations).
134. As discussed below, a one-way ratchet such that an entity cannot get back out of Covered Entity status once scoped in may be another approach to combating volatility.
135. Other recent size-based regimes, though not based on gross receipts, also use a multiyear averaging approach. For example, CAMT imposes a 15 percent minimum tax on the book income of “applicable corporations,” defining applicable corporation as a corporation with average annual book income of \$1 billion over the prior three years. Section 59(k)(1)(B). An annual average computed over a three-year period is thus a well-established method for measuring size.
136. See, e.g., sections 163(j)(3), 263A(i), 447(c)(2), 460(e), 471(c); OBBBA, Pub. L. 119–21, Title VII, § 70302(f)(1)(B); cf. section 45F(c)(4) (measuring over five years rather than three).
137. See, e.g., IRS, *Dirty Dozen tax scams for 2026: IRS reminds taxpayers to watch out for dangerous threats*, IR-2026-30 (March 5, 2026) (listing charitable schemes “involv[ing] inflated appraisals” of “syndicated conservation easements or art” as one of the “annual Dirty Dozen list of tax scams[.]”); Tax Law Center, *Valuation & family limited partnerships*, *The Tealbook*.
138. Additionally, in some cases, businesses may have nontax reasons to avoid understating asset value—or even to attempt to overvalue assets—such as for the purpose of reporting financial results or soliciting investors. This could potentially counteract the tendency to undervalue assets for tax purposes in some cases.
139. Section 856(c)(4)(A). REITs also must satisfy additional asset tests under section 856(c)(4)(B), but what is most relevant

here is not the criteria to qualify for REIT status but rather the existing method for measuring “total assets.”

140. Section 851(b)(3), (c).
141. Section 1297(a)(2); see also section 1297(e).
142. Section 856(c)(4)(A); Treas. Reg. § 1.856-2(d)(3).
143. This is similar to some of the considerations above regarding the use of gross receipts versus net income. Note also that certain existing guidance incorporates a dual measure of both gross and net assets. For example, certain reorganizations under section 368 require a transfer of “substantially all” of a corporation’s assets. Long-standing IRS guidance has defined the term “substantially all” for this purpose as at least 90 percent of the fair market value of the corporation’s net assets and 70 percent of the fair market value of the corporation’s gross assets. See Rev. Proc. 77-37, 1977-2 C.B. 568, and related guidance.
144. See, e.g., section 1202(d)(2).
145. Section 59(k)(3)(A).
146. See Notice 2025-27.
147. See section 52(a).
148. See Treas. Reg. § 1.52-1(c)(2)(iii).
149. However, note that, as discussed in the paper and below, the paper’s base proposal would exclude certain entities even if they were large enough to cross the size threshold, such as large RICs taxed under subchapter M or very large sole proprietorships.
150. See Section 5 (Questions and concerns), above.
151. See, e.g., Treas. Reg. §§ 1.52-1(c)(1), (d)(1) (emphasis added).
152. Peter Richman, *All for One or None for All: Aggregating Entities for the Corporate Minimum Tax*, Tax Law Center (August 17, 2022) (highlighting that “[t]he PE [private equity] industry commonly takes the position that PE funds are not engaged in a trade or business and thus not subject to aggregation under section 52(b)”). Regarding whether private equity funds operate a “trade or business” more generally, there has been some debate on this issue over the years. See, e.g., Steven M. Rosenthal & Andrew W. Needham, *Taxing PE Funds and their Partners: A Debate on Current Law*, Tax Notes (June 10, 2013) (transcribed from ABA tax section May meeting, May 10, 2013, Washington). Additionally, some funds (and fund strategies) seem likelier to produce “trade or business” treatment than others. See, e.g., YA Global Investments, LP v. Commissioner, 161 T.C. 173 (2023); YA Global Investments, LP v. Commissioner, T.C. Memo. 2024-78 (August 8, 2024). Trade or business treatment depends on the specific nature of their “investment” activities. However, broadly speaking, there is general consensus that a typical private equity fund that makes majority or “buyout” investments in corporate stock is not engaged in a “trade or business” for U.S. federal income tax purposes.
153. H.R. 5376, § 138151, 117th Cong. (as passed by the House, November 19, 2021).
154. S. Amdt. 5194 (proposed August 6, 2022), amending H.R. 5376, 117th Cong., 2d Sess.
155. S. Amdt. 5472 to S. Amdt. 5194 (adopted August 7, 2022), amending H.R. 5376, 117th Cong., 2d Sess.; see also Alan Rappeport, *How a Last-Minute Lobbying Blitz Watered Down a Climate Tax Bill*, New York Times (August 8, 2022).
156. The Joint Committee on Taxation (JCT) estimated that the changes to rules relating to common control in H.R. 5376, 117th (as passed by the House, November 19, 2021), would raise \$16.0 billion over 10 years. See JCT, *Estimated Budget Effects of the Revenue Provisions of Title XIII—Committee on Ways and Means*, of H.R. 5376, The Build Back Better Act, as Passed by the House of Representatives, JCX-46-21, at 6 (November 19, 2021).
157. Section 59(k)(1)(D).
158. See section 163(j)(3) (incorporating section 448(c) by reference).
159. See section 448(c)(2) (incorporating sections 52(a), (b) by reference).
160. See Sheldon I. Banoff, *Identifying Partners’ Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, 85 Taxes 197 (March 2007), for an in-depth exploration of partners’ interest in profits and capital, the limitations of these approaches, and other possible approaches to ownership and relatedness.
161. See section 52(b)(1); Treas. Reg. § 1.52-1.
162. See Banoff, *supra* note 160, at 254-55, 260, 299.
163. See *Alumax Inc., et al. v. Commissioner*, 109 T.C. 133 (1997), *aff’d*, 165 F.3d 822 (11th Cir. 1999).
164. Section 482 applies to taxpayers “owned or controlled directly or indirectly by the same interests.” For this purpose, Treas. Reg. § 1.482-1(i)(4) defines the word “control” broadly as including “any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose.”
165. See Prop. Treas. Reg. § 1.892-5(c)(2).
166. See Treas. Reg. § 1.1563-1(a)(3)(iii), Example (1) (providing an example of how to assess the 50 percent identical ownership prong in the context of a controlled group of corporations under section 1563).
167. See Michael Love, *Taxing Complexity*, Columbia Public Law Research Paper No. 625783 (February 4, 2026); Fox, Liscow, & Love, *supra* note 4.
168. Cf. sections 1362(b)(1)(A)–(B), (D).
169. See PARTNERSHIPS Act, S. 2095, § 2, 119th Cong. (as referred to S. Comm. on Fin., June 17, 2025).
170. See Donald E. Rocab & Russell S. Light, *The Mixed-up World of Pseudo Passthroughs*, Taxes: The Tax Magazine, Vol. 85, Issue 3 (March 2007).
171. Taxing additional “pass-through” entities as corporations may not share the same rationale as doing so for partnerships and S corporations. As such, many scholars considering similar proposals have opted to carve out many of these other entities. However, policymakers considering these proposals may decide that certain of the carveouts—most particularly the carveouts for entities eligible for pseudo-pass-through treatment under subchapter M, discussed below—do not in fact align with their particular policy goals and thus modify the Covered Entity definition to cover such entities. Alternatively, if a particular carveout would give rise to an opportunity for avoidance and abuse, it can and should be modified to prevent this. In making the below carveouts, we have considered opportunities for avoidance but may not have accurately assessed the true risk. See further discussion below.
172. There is some nuance here, and this will not always be the case. For example, even where the underlying business (i.e., the potential DRE) is large enough to be a Covered Entity under the size threshold, it may have a significant owner that is (1) another partnership, (2) not large enough to be a Covered Entity itself, and (3) not required to be aggregated with the underlying business if the underlying business were treated as a partnership. For example, the tested entity may have a 40 percent owner that is a partnership that is itself not a Covered Entity. In such a case, allowing the underlying business to be a partnership likely triggers Covered Entity (and thus corporate) treatment, but ensuring the underlying business is a DRE (and the partnership owner is not the sole owner) may provide a better tax result for all owners.
173. Subchapter M also addresses the taxation of real estate

mortgage investment conduits (REMICs). See sections 860A–860G. These are not discussed here. But see Berger, *supra* note 33, at 106 n.3.

174. See sections 851(a) and (b).
175. See BNA Portfolio 742–4th at Section I.A.
176. See section 856.
177. Treas. Reg. § 301.7701–4(b).
178. Treas. Reg. § 301.7701–4(c)(1).
179. See, e.g., Berger, *supra* note 33, at 106, 164, ns.3, 253 (1991) (tentatively suggesting that RICs and REMICs should not be Covered Entities but that REITs and publicly traded real estate partnerships should be covered entities).
180. Section 965(h).
181. See Melissa Costa & Caitlin McGovern, Effect of IRC Section 965 Transition Tax on Domestic Corporations, Tax Year 2017, at 2, IRS Statistics of Income (“For Tax Year 2017, just over 3,200 corporations reported a total net IRC section 965 tax liability totaling \$140.8 billion. Approximately 1,750 corporations elected to pay their tax liability in installments for a total of \$126.5 billion in deferred payments.”)
182. See PARTNERSHIPS Act, S. 2095, § 11, 119th Cong. (as referred to S. Comm. on Fin., June 17, 2025).
183. Actual liquidations, mergers, and asset transfers are typically more difficult from a nontax perspective than a deemed liquidation via CTB election. But, given the low likelihood that former Covered Entities would be rushing to convert back into partnerships anyway, it seems unnecessary to maintain the administrative simplicity of a check-the-box election in this context. However, the rules should consider whether it makes sense to treat partnerships and S corporations differently in this regard, as they are treated under current law. That is, converting back into an S corporation may be more desirable, and more feasible, than converting to a partnership, given the effective deferral of built-in gains tax under section 1374.
184. Another possible approach could be to require (or allow) a conversion back to pass-through treatment but defer the associated tax liability in some manner—e.g., an approach similar to the application of the section 1374 built-in gains tax to C corporation assets that are carried over into S corporations or REITs. Cf. note 183, *supra*. However, such an approach seems needlessly complex and unlikely to provide meaningful benefits (administrative or otherwise) to taxpayers.
185. This question will be most relevant and most difficult for complex partnerships, whose agreements often reflect highly detailed, bespoke, and flexible sharing of economic ownership among the partners. S corporations should present far fewer, if any, translation issues given that they (1) are corporations, and thus their ownership is already structured as corporate stock, and (2) are required to have the type of simple, pro rata ownership that simplifies the analysis.
186. Corporations have some ability to do versions of this as well—e.g., through “tracking stock.” See, e.g., Stuart M. Finkelstein & Benjamin Handler, Chapter 466: Tracking Tracking Stock, in *The Corporate Tax Practice Series: Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* (Second Edition), PLI (August 2020; supplement April 2026).
187. Each share of corporate stock, by contrast, is treated as a separate item of property with its own tax basis and value. Accordingly, whereas a corporate shareholder holding multiple shares can choose to sell only its high-basis shares (and thus trigger less tax), a partner that sells a portion of its partnership interest will trigger a proportionate amount of its gain regardless of how those interests are denominated in the agreement; it cannot choose to sell only the high-basis portion of its partnership interest.
188. Alternatively (or additionally), the entity may be of a nature that the translation of its economics into corporate stock is irrelevant—e.g., an internal holding company or “blocker” corporation that is not expected to make distributions or impute subchapter C rules that depend on evaluating the vote or value held by shareholders.
189. Similarly, the transition at the beginning of the PTP regime likely does not fully reflect the difficulties here. To facilitate public trading, publicly traded partnerships that are officially publicly traded on an exchange have certain features that make that transition to taxation as a C corporation easier (e.g., the partnership’s equity is divided into units that can actually be traded by the public).
190. Often significant litigation arises over whether something actually goes beyond what Congress intended to capture, whether the taxpayer has a principal purpose of avoidance, etc. For example, for certain principal purpose tests, even if a taxpayer has a legitimate business purpose and the new structure would not otherwise generally be captured, the fact that the principal purpose was to avoid tax may keep the taxpayer within scope of the relevant rule. See, e.g., Tax Law Center, Comments Regarding Stock Repurchase Excise Tax Proposed Regulations, at 6 & n.22 (June 21, 2024) (providing examples of statutory principal purpose rules); *id.* at 4 (describing a transaction, which may or may not have been covered by the proposed stock buyback excise tax funding rule—ultimately not adopted in the final rules—depending on its principal purpose); *id.* at 5–8. In other cases, there may be some authority delegated to Treasury or the IRS to craft rules that capture additional entities or structures (i.e., to be overinclusive rather than underinclusive) to make sure that there are not unforeseen avoidance routes. See, e.g., section 4501(f); Comments Regarding Stock Repurchase Excise Tax Proposed Regulations, *supra*, at 5–8.
191. E.g., because neither the ownership nor control of the resultant entities would be sufficiently overlapping to meet the test for aggregation (and in some cases, not overlapping at all).
192. While all of these “avoidance” techniques seem like ones that can be undertaken in a bona fide manner, as above, certain taxpayers will likely engage in more aggressive, legally questionable, or even blatantly unlawful techniques to avoid corporate treatment. Again, this is the kind of avoidance or evasion that existing anti-abuse doctrines may shut down and that the rules should seek to eliminate to the extent possible.
193. It would, for example, generally involve both re-domiciling the relevant entity and ensuring that its actual business operations were occurring outside the U.S. such that the entity no longer had a U.S. trade or business under existing U.S. tax law (e.g., sections 864, 881, and related rules). This would mean ensuring, among other things, that the entity no longer had a U.S. office, key employees were moved outside of the U.S., etc. This may be impossible for many businesses that have been operating in the U.S. for any significant period.
194. See, e.g., President’s Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System, at 129, November 2005 (proposing to impose an entity-level tax on large pass-throughs along with a 100 percent exclusion for domestic dividends and a 75 percent exclusion of capital gains on sale of corporate stock).
195. Certain proposals have specifically aimed to discourage tiering, however, or at least to make tiered entities internalize more of the costs of complexity. See, e.g., Love, *supra* note.

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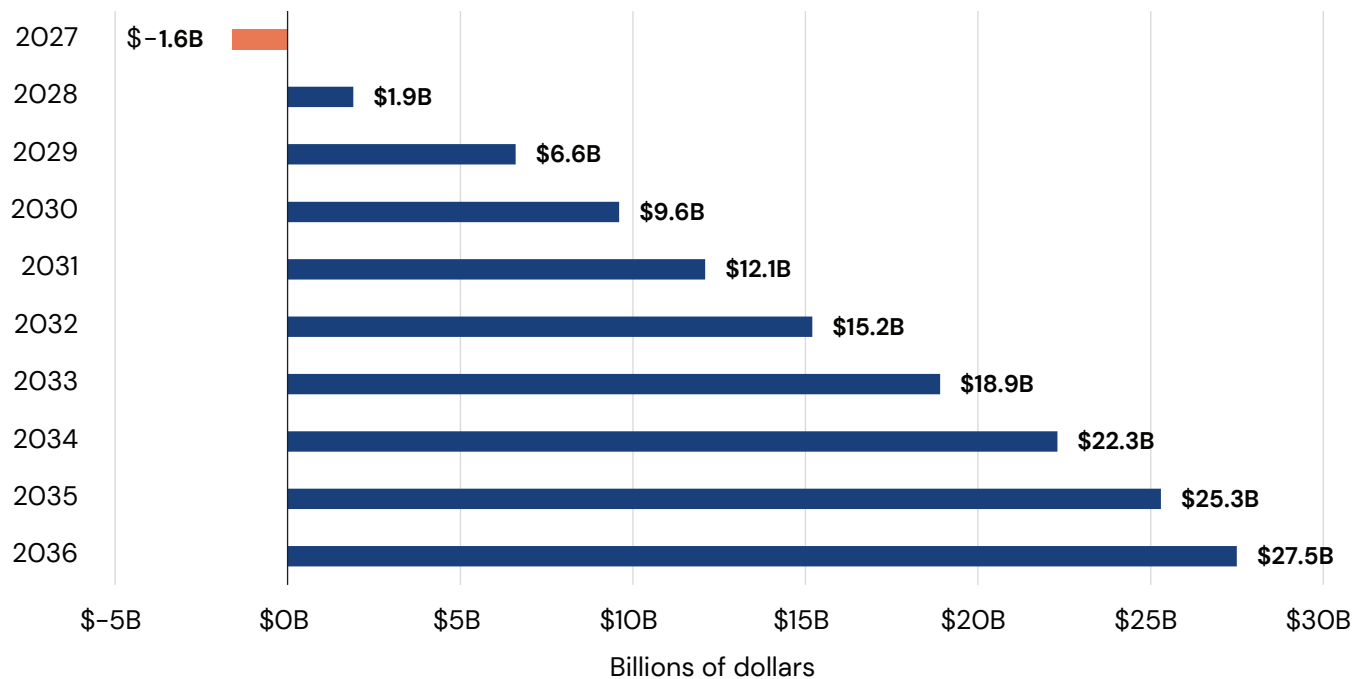
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The U.S. tax system raises insufficient revenue to meet national needs. The erosion of taxes on business income, including as a result of both the increasing use of pass-through entities and the growth in size and complexity of such entities, has been a significant driver of these revenue losses. Furthermore, applying pass-through taxation to an increasing number of complex arrangements has created substantial challenges for tax administration, compliance, and enforcement. This paper examines an approach that many policymakers have offered to address these issues: requiring large or complex pass-through entities to pay federal income tax at the entity level, as corporations do. This paper outlines the challenges that the current system presents and the reasons such an approach has been attractive. It then develops and evaluates a concrete proposal to treat certain pass-through entities as corporations, examining how such a proposal could be constructed and implemented and its revenue and distributional impact. Revenue and distribution estimates have been provided by the Urban-Brookings Tax Policy Center.

## Revenue raised by base proposal, 2027–36



Source: Tax Policy Center 2026.

Note: Figure shows revenue estimates for the base proposal, i.e., requiring partnerships and S corporations with gross receipts exceeding \$25 million to be treated as C corporations for federal income tax purposes. Revenue and distribution estimates have been provided by the Urban-Brookings Tax Policy Center.



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