Guam Society of CPAs
August 19, 2024
Partnership Taxation

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Tax Court & Board of Tax Appeals Reported Decisions

DAVID A. FOXMAN, 41 TC 535

David A. **Foxman** and Dorothy A. **Foxman**, et al.,Proceedings of the following petitioners are consolidated herewith: Norman B. Jacobowitz and Laura Jacobowitz, docket No. 93460; and Horace W. Grenell and Judith Grenell, docket No. 93472. Petitioners,v. Commissioner of Internal Revenue, Respondent

Case Information:

[pg. 535]

Code Sec(s):	
Docket:	Docket Nos. 93416, 93460, 93472.
Date Issued:	01/16/1964
Judge:	Opinion by RAUM, *J.*
Tax Year(s):	Year 1958.
Disposition:	Deficiency redetermined.

HEADNOTE

1. PARTNERSHIPS — Transfers of interest—sale of partner's interest. Partner "sold" his ⅓ interest in partnership to two remaining partners. Evidence showed partners intended a sale: the agreement indicated a clear intention to carry out a sale; the agreement further showed that the

remaining partners *individually* agreed to purchase the retiring partner's interest; a portion of consideration received by retiring partner was not a partnership asset; a chattel mortgage placed as security by remaining partners stated that retiring partner had sold his interest as partner; remaining partners knew retiring partner was interested only in a sale; and bargaining took place between partners. The fact that retiring partner looked only to the partnership for payment had no effect; the retiring partner wanted partnership assets only as security. The retiring partner was paid out of partnership assets. However, the remaining partners controlled the assets and the payments made by them were in discharge of *their* obligation. Although the promissory notes given the retiring partner were signed on behalf of the partnership, the liability of the partnership was in the nature of a security for the primary obligation of the remaining partners. The gain on the sale of the partnership interest may be reported by the retiring partner as a capital gain. The remaining partners are denied deduction for amounts paid retiring partner.

Reference(s): 1964 P-H Fed. ¶ 15,673-A.

2. PARTNERSHIPS—Partner's distributive share—partnership agreement. Retiring partner properly included amounts of partnership income in 1957 return. Partners agreed in May 1957 that as of March 1 of that year they would not share profits equally. The agreement provided, however, that the retiring partner could retain any sums received from profits from March 1 to the date of the agreement. The amount reported on the retiring partner's return properly reflected his share of profits retained by him during the above period. The remaining partners could thus reduce the partnership income by amount included in retiring partner's income.

Reference(s): 1964 P-H Fed. ¶ 15,546.

3. PARTNERSHIPS — Continuation of. Partnership continued even though the partners transferred all of partnership assets to existing corporation. Up to the time of sale the partnership was solely engaged in the manufacture and sale of phonograph records. After the sale the partnership completely ceased these operations and did not receive sales income nor have any expenses from the manufacture of records. It did however purchase a mortgage and realty, collect interest and rents, and remain liable on certain promissory notes. Partners were thus not required to report in their returns for the year of the sale their distributive shares of partnership income for the short fiscal period just before the sale of the partnership assets.

Reference(s): 1964 P-H Fed. ¶ 15,601.

Syllabus

Official Tax Court Syllabus

1. *Held,* petitioner J on May 21, 1957, "sold" his one-third interest in a partnership to his two partners, petitioners F and G, under section 741, I.R.C. 1954. The transaction did not constitute a "liquidation" of J's interest under sections 736 and 761(d).

2. *Held,* amount of J's share of distributive partnership income for the short fiscal period March 1-May 21, 1957, determined to be $16,790 in accordance with final agreement among partners which modified to that extent the prior partnership agreement. Sec. 761(c).

3. *Held,* partnership did not "terminate" on June 2, 1958, as a result of certain transactions consummated on that day, section 708; F and G were therefore not required to report in their 1958 returns their distributive shares of partnership income for the short fiscal period March 1, 1958-June 2, 1958.

Counsel

Bernard J. Long, for the petitioners in docket Nos. 93416 and 93472.

Sidney L. Cramoy, for the petitioners in docket No. 93460.

Alvin C. Martin, for the respondent.

The Commissioner determined deficiencies in income tax for 1958 in the amounts of $57,754.29, $57,735.46, and $129,092.04 against David A. and Dorothy A. **Foxman**, Horace W. and Judith Grenell, and Norman B. and Laura Jacobowitz, respectively. By amended pleadings the Commissioner revised the first two of these determinations, claiming total deficiencies in the amounts of $144,754.44 against the **Foxmans** and $144,441.45 against the Grenells.

The principal issue common to all three cases is whether an agreement dated May 21, 1957, between petitioner Jacobowitz and petitioners [pg. 536] **Foxman** and Grenell resulted in a "sale" of Jacobowitz's interest in a partnership to the two remaining partners under section 741, I.R.C. 1954, or whether the transaction must be considered a "liquidation" of Jacobowitz's partnership interest under sections 736 and 761(d). A second issue is whether $16,790 received by Jacobowitz represents his share of the partnership earnings for the period March 1-May 21, 1957, in accordance with the partnership agreement, as modified by the foregoing agreement of May 21, 1957, pursuant to section 761(c). The third issue, involving only **Foxman** and Grenell, is whether the partnership "terminated" on June 2, 1958, under section 708, by reason of a certain transaction, so as to render them accountable in their 1958 returns for their respective shares of distributive partnership income during the period March 1-June 2, 1958. If the partnership did "terminate" on June 2, 1958, then a number of other questions are presented involving the determination of the partnership's income for the period March 1-June 2, 1958; these include nonrecognition of gain under section 351 realized upon the transfer of partnership assets to a

corporation, the determination of the amount of that gain if it is to be recognized, and the proper allowance for depreciation of the partnership's assets prior to such transfer.

FINDINGS OF FACT

Some of the facts and exhibits have been stipulated and are incorporated herein by this reference.

The petitioners in each case, David A. and Dorothy A. **Foxman**, Horace W. and Judith Grenell, and Norman B. and Laura Jacobowitz, are husband and wife, all residing in New Jersey. They timely filed their respective 1958 joint income tax returns with the district director of internal revenue, Newark, N.J. The wives are parties herein merely by reason of the joint returns.

Prior to 1954, Abbey Record Manufacturing Co. was a partnership composed of petitioner Jacobowitz and two associates named Zayde and Brody, engaged in the business of custom manufacturing of phonograph records. The enterprise had been founded about 1948, with Jacobowitz as the active principal. Prior to 1954 the partnership, hereinafter referred to as Abbey, manufactured primarily 10-inch 78 r.p.m. records on contract for various companies. Petitioner Grenell purchased the interests of Zayde and Brody on December 31, 1953, and became an equal partner with Jacobowitz on January 2, 1954. Early in 1954 the partners agreed to enter the business of manufacturing 12-inch long playing records, known as LPs. Petitioner **Foxman**, who had been a consultant to the business when it was originally formed in 1948, was hired as a salaried employee in June 1954 to provide the necessary technical assistance for the changeover in machinery and production methods. Thereafter, as a result of certain [pg. 537]agreements dated February 1, 1955, and January 26, 1956, **Foxman**, Grenell, and Jacobowitz became equal partners in Abbey, each with a one-third interest.

Abbey kept its accounts and filed its Federal income tax returns on an accrual basis of accounting and on the basis of a fiscal year ending February 28.

A related venture commenced by Jacobowitz, **Foxman**, and Grenell, individually, was represented by Sound Plastics, Inc., a corporation in which each owned one-third of the stock; it was engaged in the business of manufacturing "biscuits" or vinyl forms used in the making of records.

During the early period of the changeover to LPs, Abbey faced many problems in production and quality control. However, with **Foxman** and Jacobowitz in charge of production and with Grenell responsible for much of the selling, Abbey's fortunes were on the upswing. Its net income for the fiscal year ending February 29, 1956, was approximately $108,000, and for the fiscal year ending February 28, 1957, was approximately $218,000. Grenell, who acted as consultant and repertory director for two mail-order record companies, Music Treasures of the World and Children's Record Guild, was able to get these companies as customers of Abbey and they accounted for approximately 50-75 percent of Abbey's business.

The Agreement of May 21, 1957

Notwithstanding Abbey's success there was considerable disharmony among and between the partners. As a result there were discussions during the spring of 1956 relating to the withdrawal of Jacobowitz from Abbey. These negotiations did not lead to any agreement and the partners continued to work and to quarrel. Early in 1957,**Foxman** and Grenell decided to resolve the conflict by continuing the partnership without Jacobowitz and discussions were resumed again in March 1957. It was at about this time that **Foxman** offered Jacobowitz $225,000 in cash, an automobile which was in Abbey's name, and **Foxman's** and Grenell's interest in Sound Plastics, Inc., for Jacobowitz's interest in Abbey. Jacobowitz prepared a draft of an option agreement providing for **Foxman's** purchase of his one-third interest in the partnership and sent it to **Foxman**. **Foxman** never signed to the option agreement. During the latter part of March or early April 1957, the negotiations of the three partners led to a tentative agreement whereby Jacobowitz's partnership interest would be purchased for $225,000 plus the aforementioned auto and stock in Sound Plastics, Inc. Jacobowitz, who did not trust either **Foxman** or Grenell, initially desired cash. **Foxman** and Grenell explored the possibilities of a $200,000 bank loan from the First National Bank of Jersey City, hereinafter referred to as First National, and informed [pg. 538] First National of their tentative agreement to buy Jacobowitz's interest for $225,000; they had further discussions with First National concerning a possible loan on May 1, 1957, and on May 3, 1957. First National indicated, on the basis of an examination of the financial assets of Abbey, that it would consider a loan of approximately only $50,000.

The negotiations of the three partners culminated in an agreement dated May 21, 1957, for the "sale" of Jacobowitz's partnership interest; the terms of this agreement were essentially the same terms as the terms of the option agreement which **Foxman** did no execute.

Relevant portions of the May 21, 1957, agreement are as follows:

> AGREEMENT, made this 21st of May 1957, between between NORMAN B. JACOBOWITZ, hereinafter referred to as the "First Party", and and HORACE W. GRENELL, and DAVID A. **FOXMAN**, individually, jointly and severally, hereinafter referred to as the "Second Parties" and ABBEY RECORD MFG CO., hereinafter referred to as the "Third Party", WITNESSETH:
>
> WHEREAS, the parties hereto are equal owners and the sole partners of partners of ABBEY RECORD MFG. CO., a partnership, hereinafter referred to as "ABBEY", and are also the sole stockholders, officers and directors of SOUND PLASTICS INC., a corporation organized under the laws of the State of New York; and
>
> WHEREAS, the first party is desirous of selling, conveying, transferring and assigning of his right, and interest in and to his one-third share and interest in the said ABBEY to the second parties; and

WHEREAS, the second parties are desirous of conveying, transferring and assigning all of their right, title and interest in and to their combined two-thirds shares and interest in SOUND PLASTICS,INC. to the first party;

NOW, THEREFORE, IT IS MUTUALLY AGREED AS FOLLOWS:

FIRST: The second parties hereby purchase all the right title, share and interest of the first party in ABBEY and the first party does hereby ssell, transfer, convey and assign all of his right, title, interest and share in ABBEY and in the moneys in banks,trade names, accounts due, or to become due, and in all other assets of any kind whatsoever, belonging to said Abbey, for and in consideration of the following:

A) The payment of the sum of TWO HUNDRED FORTY TWO THOUSAND FIVE HUNDRED & FIFTY ($242,550.00) DOLLARS, payable as follows:

$67,500.00 on the signing of this agreement, the receipt of which is hereby acknowledged;

$67,500.,00 on January 2nd, 1958;

$90,000.00 in eighteen (18) equal monthly installments of $5,000.00 each, commencing on February 1st, 1958 and continuing on the first day of each and every consecutive month thereafter for seventeen (17) months;

$17,550.00, for services as a consultant, payable in seventy-eight (78) equal weekly installments of $225.00 each, commencing on February 1st, 1958 and continuing weekly on the same day each and every consecutive week thereafter for seventy-seven (77) weeks.

The balance set forth hereinabove is represented by a series of non-interest bearing promissory notes, bearing even date herewith, and contain an acceleration clause and a grace of period of ten (10) days.

Said balance is further secured by a chattel mortgage, bearing even date herewith and contains a provision that same shall be cancelled and discharged upon the payment of the sum of $67,500.00 on or before January 2nd, 1958. [pg. 539]

The right is hereby granted to the second parties to prepay all or part of the balance due to the first party. If repayment is made of both of the sums of $67,500.00 and $90,000.00 set forth above, prior to February 1st, 1958, there shall be no further liability for the balance of $17,550.00 or any of the payments of $225.00 weekly required thereunder. If such prepayment is made after February 1st, 1958, the first party shall be entitled to retain payments made to date of payment of the full sums of $67,500.00 and $90,000.00

(plus any weekly payments as aforesaid to date of payment) and there shall be no further liability for any remaining weekly payments.

B) In addition to the payments required under paragraph "A" hereof, the second parties hereby transfer, convey and assign all of their right, title and interest in SOUND PLASTICS, INC. to the first party. Simultaneously herewith, the second parties have delivered duly executed transfers of certificates of stock, together with their resignations as officers and directors of said SOUND PLASTICS, INC. Receipt thereof by the first party is hereby acknowledged.

C) In addition to the payments required under required under paragraph "A" hereof and the transfer of stock referred to in paragraph "B" hereof, the second parties hereby transfer, convey and assign all of their right, title and interest in and to one, 1956 Chrysler New Yorker Sedan, as evidenced by the transfer of registration thereof, duly executed herewith, the receipt of which by the first party is hereby acknowledged.

SECOND: So as a balance remains due to the first party, the second parties agree to continue the partnership of ABBEY and each of the second parties are to devote the same time, energy, effort, ability, endeavors and attention to furthering the business of said ABBEY and to promote its success as heretofore and will not engage in any other business or effort, except that HORACE W. GRENNEL shall be permitted to continue to create master records for other persons or companies.

The second parties further agree not to substantially change the form of business, engage in a new business, assign or transfer any of the assets or the lease of ABBEY, without the written consent of the first party, unless such new business and/or assignee and/or transferee, by an agreement in writing, assumes all the obligations, terms, covenants and conditions of this agreement and delivers such assumption agreement to the first party in person or by registered mail, within five (5) days from the date of the commencement of such new business and/or assignment and/or transfer. It is expressly understood and agreed that such assumption agreement shall in no wise release the second parties from any of their obligations hereunder.

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FOURTH: All parties do hereby agree that the true and accurate status of ABBEY and SOUND PLASTICS, INC. as to liabilities and assets are reflected in the balance sheets attached hereto and made a part hereof and represent the true condition of the companies as of March 1, 1957. *First party shall not be entitled to any further share of profits that may accrue since March 1, 1957 and may retain any sums received therefrom to date hereof.* [Italicized words inserted by hand.]

> FIFTH: Except as herein otherwise expressly provided, the second parties do hereby forever release and discharge the first party from any and all liability of whatsoever nature, description, character or kind arising out of any transaction or matter connected directly or indirectly between themselves or in connection with ABBEY and/or SOUND PLASTICS, INC.

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> ELEVENTH: The second parties agree that they will forever indemnify and save the first party, free, clear and harmless of and from all debts, taxes (other [pg. 540]than personal income taxes) claims, damages or expenses, upon, or in consequence of any debt, claim or liability, of whatsoever kind or nature due or claimed by any creditor to be due from ABBEY and/or the first party, by reason of the first party having been a member of the partnership of ABBEY, except as set forth in paragraphs "EIGHT" and "FOURTH" hereof. The first party likewise agrees that he will forever indemnify and save the second parties, free, clear and harmless of and from all debts, taxes (other than personal income taxes) claims, damages or expenses, upon, or in consequence of any debt, claim or liability of whatsoever kind or nature due or claimed by any creditor to be due from *Sound Plastics Inc.,* and/or the second parties, by reason of the second parties having been stockholders, officers and directors of said corporation, except as provided in paragraph "FOURTH" hereof.

Paragraph Twelfth of the agreement provides that "The first party [Jacobowitz] hereby retires from the partnership." The part of the agreement designating payment of $17,550 in weekly installments of $225 per week found in paragraph "First: A)" was embodied in a separate document also dated May 21, 1957; it was signed by Abbey, **Foxman**, and Grenell, respectively.

The chattel mortgage mentioned in "First A)" of the agreement, in describing the translation provided for in the agreement of May 21, 1957, stated in part:

> the party of the second part [Jacobowitz] has sold, transferred, assigned and conveyed all his right, title and interest as a partner *** to the parties of the first part [**Foxman** and Grenell, individually and trading as Abbey].

Samuel Feldman, a New York City attorney who represented **Foxman** and Grenell, drafted the agreement of May 21, 1957; at Feldman's suggestion, Abbey was added as a party to the agreement. An earlier draft of the proposed agreement did not include Abbey as a party. During the negotiations leading to the May 21, 1957, agreement, the words "retirement" or "liquidation of a partner's interest" were not mentioned. There was no specific undertaking by the third party (Abbey) any place in the instrument. A sale of a partnership interest was the only transaction ever discussed.

Jacobowitz unsuccessfully tried to obtain guarantees of payment of the notes he held from the wives of **Foxman** and Grenell; he was also unsuccessful in trying to obtain the homes of **Foxman** and Grenell as security on the notes.

The first $67,500 payment due on the signing of the agreement was made by cashier's check. On the promissory note due January 2, 1958, the name of Abbey appears as maker; the signatures of **Foxman** and Grenell appear on the face of the note as signatories in behalf of Abbey and on the back of it as indorsers. The 18 promissory notes, each in the amount of $5,000, also bear the signatures of **Foxman** and Grenell on the face of the instrument as signatories in behalf of Abbey, the maker, and on the back of the instrument as indorsers. [pg. 541]

Payments to Jacobowitz pursuant to the May 21, 1957, agreement were timely made. **Foxman** and Grenell made an election to prepay pursuant to "First A)" of the May 21, 1957, agreement, and Jacobowitz returned the series of 18 promissory notes of Abbey, in the amount of $5,000 each, and the promissory note of Abbey in the amount of $17,550 payable payable in 78 weekly installments of $225. Jacobowitz was paid this $90,000 amount by check with Abbey's name appearing as drawer and the names of **Foxman** and Grenell appearing as signatories in behalf of Abbey; they did not indorse this check. Payments made to Jacobowitz for his interest were charged to Abbey's account. The parties did not contemplate any performance of services by Jacobowitz in order for him to receive the $17,550 under the May 21, 1957, agreement; this amount was considered by the parties either as a penalty or in lieu of interest if **Foxman** and Grenell failed to pay the $90,000 amount prior to February 1, 1958.

Just prior to May 21, 1957, Abbey borrowed $9,000 from each of four savings banks and also borrowed $9,000 from **Foxman** and Grenell. On December 27, 1957, Abbey borrowed $75,000 from First National.

Abbey had no adjusted basis for goodwill as of February 28, 1957, nor at any time subsequent thereto. The balance sheets of Abbey for its fiscal years ending February 28, 1957, and February 28, 1958, do not reflect an account for goodwill. The balance sheet of Abbey as of February 28, 1957, was as follows:

Assets	
Cash	$63.702.30
Notes and accounts receivable	141,521.88
Inventories	16, 630.73
Buildings and other fixed depreciable assets:	
(a) Less: Accumulated depreciation and amortization	73,803.91
Other assets	6,176.91

Total assets	301,835.73

Liabilities and Capital

Accounts and notes payable	97,365.55
Partner's capital accounts	204,470.18
Total liabilities and capital	301,835.73

On May 21, 1957, **Foxman** and Grenell entered into an agreement providing for a continuation of the Abbey partnership which recited that Abbey had purchased the interest of Jacobowitz in Abbey.

After May 21, 1957, the date of Jacobowitz's termination of his interest in Abbey, improvements were made at Abbey's plant. [pg. 542]

The reported earnings of Abbey for the fiscal year ending February 28, 1958, without reduction for alleged payments to partners, were $303,221.52.

In its tax return for the fiscal year ending February 28, 1958, Abbey treated the sum of $159,656.09 as a distribution of partnership earnings to Jacobowitz in the nature of a guaranteed payment under section 736 of the Internal Revenue Code of 1954. This amount was computed as follows:

Cash payments	$225,000.00
Value of automobile	2,812.82
Share of Jacobowitz's liabilities	32, 455.18

Total partnership payments	260,268.00
Less Jacobowitz's share of partnership property	100,611.91

Balance	159,656.09

Jacobowitz, on the other hand, treated the transaction as a sale in his return for 1957, reporting a long-term capital gain in the amount of $164,356.09.

The $16,790 Item

Jacobowitz received $16,790 from Abbey during the period March 1, 1957, to May 21, 1957; the books and records of Abbey show that $2,790 was debited to an account entitled "Salaries-Partners," and $14,000 was debited to his drawing account. Abbey had earnings before partners' salaries of $39,807.43, $38,164.32, and $27,478.26 for the months of March, April, and May 1957, respectively. This $16,790 amount was reported by Jacobowitz on his 1957 income tax return as ordinary income, and was subtracted from the partnership income for its fiscal year ending February 28, 1958, in determining the distributive shares of **Foxman** and Grenell.

The handwritten insertion in Paragraph Fourth of the May 21, 1957, agreement was made at Jacobowitz's suggestion so that the he could keep the foregoing $16,790 received by him during the period March 1 to May 21, 1957; it was also a waiver of his right to the balance of his share of Abbey's earnings during that period, and thus constituted a modification of the partnership agreement in respect of his distributive share of earnings for that period.

The May 29-June 2, 1958, Transfer of the Record Manufacturing Business to Abbey Record Manufacturing Co., Inc.

For some time prior to May 9, 1958, Richard D. Gittlin, in behalf of himself and two brothers, A.S. Gittlin and B. Morton Gittlin, had been negotiating with **Foxman** and Grenell to acquire a one-half [pg. 543] interest in the Abbey enterprise. These negotiations culminated in an agreement executed May 9, 1958, by **Foxman**, Grenell, and the Gittlins. The agreement contemplated the payment of $300,022.98 by the Gittlins who would emerge as the owners of 50 percent of the stock and debentures of a corporation named Abbey Record Manufacturing Co. Inc., which was to succeed to the entire business and assets of the partnership; the remaining 50 percent of the stock and debentures was to be owned by **Foxman** and Grenell individually. The corporation had been organized on April 11, 1955, with **Foxman**, Grenell, and an employee of the partnership named Ben Goldman, each owning five shares of stock. The corporation had remained dormant since its incorporation and had no assets of any consequence prior to the transaction here under consideration. The agreement of May 9, 1958, contemplated that the 15 outstanding shares would be cancelled and new shares and debentures issued in accordance with the agreement. The agreement provided in form for a sale of the fixed assets of the partnership to the Gittlins for $300,022.98, such fixed assets to be transferred by them, in turn, to the corporation. The agreement read in part as follows:

Transfer of business and assets of Abbey Record Mfg. Co. to Abbey Record Manufacturing Co., Inc. and Related Matters

> 1. May 29, 1958, Abbey Record Mfg. Co., a New Jersey partnership (the "partnership"), will sell all of its fixed assets (including all deposits on equipment and under leases) to Richard D. Gittlin ("R. D. Gittlin") for an aggregate purchase price of $300,022.98. Against such sale to him, R.D. Gittlin will pay $22.98 in cash and R. D. Gittlin, A. S. Gittlin and B. Morton Gittlin will deliver to David A. **Foxman** ("**Foxman** ") and Horace W. Grenell ("Grenell"), trading as Abbey Record Mfg. Co. their three 5% promissory notes each in the amount of $100,000 and each payable jointly to **Foxman** and Grenell, trading as Abbey Record Mfg. Co. The first such note will be due on July 15, 1958, the

second on September 2, 1958 and the third on January 15, 1959 (with provision being made for acceleration of the maturity thereof in the event of default under any of said notes). Payment of the indebtedness represented by said notes will be secured by the capital stock of the below-mentioned Corporation issued to R.D. Gittlin, A.S. Gittlin, and B. Morton Gittlin and all of the Debentures (hereinbelow defined) issued to R.D. Gittlins as herein provided, such stock to be held in escrow until payment in full of said notes provided that on or after July 15, 1958, such Debentures or part thereof may be withdrawn from the escrow and discounted or pledged, provided that the proceeds therefrom shall be applied to payment of any balance remaining on said notes then outstanding.

2. On June 2, 1958, R. D. Gittlin will transfer to Abbey Record Manufacturing Co., Inc., a New Jersey corporation (the "Corporation"), all of the aforesaid fixed assets received from the partnership, after **Foxman** and Grenell will have transferred on May 29, 1958, the balance of the partnership assets subject to all of its liabilities to the Corporation. In exchange therefor, the Corporation will then issue:

(a) to R.D. Gittlin, 498 shares of its capital stock, without par value; to A.S. Gittlin, 1 share of said capital stock; to B. Morton Gittlin, 1 share of said capital stock; [pg. 544]

(b) to **Foxman**, 250 shares of said capital stock;

(c) to Grenell, 250 shares of said capital stock, said shares to constitute all of the outstanding shares of capital stock of the Corporation; and

(d) 6% Debentures of the Corporation maturing in 10 years in the amount of $400,000 (the "Debentures"),one-half of which shall be issued to R.D. Gittlin, one-fourth of which shall be issued to **Foxman**, and one-fourth of which shall be issued Grenell.

3. **Foxman** and Grenell have delivered to R.D. Gittlin an audited balance sheet of the partnership as of March 31, 1958, indicating a net worth of the partnership at said date of $176,082.55. As promptly as practicable, the accountants now servicing the books of the partnership will prepare a certified audit of the partnership as at April 30, 1958.

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The balance sheet of Abbey, as of May 31, 1958 (but before giving effect to the "sale" of assets on May 29, 1958), reflected the following:

Assets

Current Assets:

* * * * * * *

Total current assets				$259,023.01
		Accumulated		
Fixed assets:	Cost	depreciation	Value	
Machinery and equipment	$95,077.32	$39,598.85	$55,478.47	
Dies	29,524.53	22,452.80	7,071.73	
Automobiles	11,730,10	2,720.30	9,009.80	
Leasehold improvements	7,294.06	3,593.02	3,701.04	
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Total fixed assets	143,626.01	68,364.97		75,261.04
	==========	=========		
Other Assets:				

* * * * * * *

Total other assets	8,695.07

Total assets	342,979.12

Liabilities and Net Worth

Current liabilities:

Notes payable--First National Bank of Jersey City due June 2, 1958----------- $58,333.32

* * * * * * *

Total current liabilities $139,810.41

Net worth:

* * * * * * *

	203,168.71

Total liabilities and net worth	342,979.12

On May 29, 1958, Abbey transferred its fixed assets to R.D. Gittlin for $300,022.98, $300,000 of which was in the form of three promissory notes; and R.D. Gittlin, at about the same time, transferred the identical fixed assets to the corporation for 500 shares of its capital stock and $200,000 6-percent 10-year debentures. Also, on May 29, 1958, Abbey transferred its remaining assets, subject to its liabilities, to the corporation in return for 500 shares of the latter's capital stock and $200,000 6-percent 10-year debentures, all of which were distributed to **Foxman** and

Grenell in equal amounts. The original 15 shares of stock which had been issued on April 13, 1955, to **Foxman**, Grenell, and Ben Goldman, were canceled. [pg. 545]

Abbey reported a capital gain of $201,550.40 in a partnership return filed by it for the fiscal year ending February 28, 1959, in respect of the foregoing "sale" of its assets to the Gittlins.

The minutes of a special meeting of the board of directors of the corporation held on May 29, 1958, show that the following resolution was adopted:

> RESOLVED, that it is the judgment of this Board of Directors that:
>
> > (a) the fair value of certain fixed assets to be acquired by this corporation from R. D. Gittlin, as provided in the preceding resolutions, is $300,022.98 in the aggregate, consisting of office equipment, valued at $13,270, automobiles, valued at $6250, dies, valued at $37,550, machinery and equipment, valued at $234,741.44, deposit on lease, valued at $3,411.54 and deposit on machinery, valued at $4,800, all of which assets are more particularly listed together with the value of each on "Schedule A" appended to these minutes; and
> >
> > (b) the fair value of certain assets of Abbey Record Mfg. Co. to be acquired by this Corporation from David A. **Foxman** and Horace W. Grenell, trading as Abbey Record Mfg. Co., as provided in the preceding resolutions, is $439,810.41, consisting of assets valued at $259,506.54, all of which assets are more particularly listed together with the value of each on "Schedule B" appended to these minutes, and good will, valued at $180,303.87, subject to liabilities of Abbey Record Mfg. Co. in the amount of $139,810.41, which are being assumed by this Corporation, the net fair value to this Corporation being $300,000;

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> RESOLVED, that the value of the consideration to be received by this Corporation for the issuance of said 1,000 shares of its Capital Stock, as provided in these resolutions, is found by this Board to be and is hereby determined to be $200,022.98; and that such consideration shall be, and is hereby determined to be, allocated in its entirety to the Capital Stock Account of this Corporation.

In a letter agreement dated May 29, 1958, **Foxman** and Grenell, purporting to act "individually and as partners trading as Abbey Record Mfg. Co.," agreed to pay $15,000 to a man named Lawrence Jasie for his services in bringing about the foregoing transaction with the Gittlins. Jasie appeared as the writer of the letter, and the terms of payment were spelled out therein as follows:

> > (1) $5,000 on the closing of such transaction by check to my order, receipt of which is hereby acknowledged; and

(2) $5,000 on or before July 1, 1959, and $5,000 on or before Jan. 2, 1960, each such payment to be evidenced by the promissory note of David A. **Foxman** and Horace W. Grenell, trading as Abbey Record Mfg. Co., bearing interest at the rate of 5% per annum, one payable on or before July 1, 1959, and the other payable on or before Jan. 2, 1960.

In connection with the transfer of assets to the corporation, Abbey closed out its then existing asset and liability accounts. Abbey, upon receiving the aforementioned notes from the Gittlins in exchange for its fixed assets, recorded their receipt in an entry in its journal. Abbey also set up a liability account, Accrued Commissions Payable, in the amount of $15,000 to accrue the commission due to Lawrence Jasie. [pg. 546]

In recording the transfer of assets from Abbey to the corporation, an account titled Goodwill was set up on the books of the corporation in the amount of $180,303.87. The corporation reflected the acquisition of fixed assets from the Gittlins in its journal dated June 2, 1958, as follows:

Machinery and equipment	$234,741.44
Office equipment	13,270.00
Dies	37,550.00
Automobile	6,250.00
Deposit on lease	3,411.54

The three aforementioned $100,000 notes issued by the Gittlins bore interest at 5 percent and were payable to the order of **Foxman** and Grenell, trading as Abbey; the notes were due on July 15, 1958, September 2, 1958, and January 15, 1959, respectively. On May 29, 1958, **Foxman** and Grenell discounted the $100,000 note due on July 15, 1958, and shared equally the $99,995.74 proceeds of the discounted note. **Foxman** and Grenell redeposited $20,000, in total, to their capital accounts. The remaining $200,000 notes were retained by Abbey until paid; the final payment was received on or about January 15, 1959.

Abbey's sole business activity was the manufacture of phonograph records; prior to June 2, 1958, it never owned any real estate or mortgages. After the transfer of assets to the corporation on May 29, 1958, Abbey did not engage in the manufacture of phonograph records, and did not have any sales income or any expenses from the manufacture of phonograph records.

Upon the advice of an accountant, in an effort to prevent the termination of the partnership, **Foxman** and Grenell began to look for some income-producing property for Abbey prior to June 2, 1958. In furtherance of that objective Abbey purchased a 6-percent mortgage in the face amount of $5,000 on July 28, 1958, and thereafter, on September 16, 1958, it purchased real estate for about $6,500 or $7,000 from the wife of one of the partners in the accountant's firm. The real estate was in a "very low-income housing area," and consisted of land and a frame residential building containing several apartments. The return filed on behalf of Abbey for the fiscal year ending

February 28, 1959, showed rents of $485 from this property, but a net loss of $62.11 after deducting expenses and depreciation. Neither the foregoing mortgage nor the real estate was related in any way to Abbey's previous record manufacturing business. Subsequent to June 2, 1958, Abbey received not only the foregoing rent but also interest on the mortgage and interest on the Gittlin notes. **Foxman** and Grenell had no intention of terminating Abbey during 1958. [pg. 547]

On January 13, 1959, an agreement was entered into between **Foxman** and Grenell whereby Grenell purchased **Foxman's** interest in Abbey, his 250 shares of stock in the corporation, his $100,000 6-percent 10-year debentures of the corporation, and his 220 shares of stock in Arco Recording Corporation, which had been organized to handle sales for the corporation. In return, **Foxman** received $65,000, an automobile belonging to the corporation, and the assumption by Grenell of **Foxman's** deficit in his capital account in Abbey in the amount of $1,200. Various distributions had previously been made by Abbey to **Foxman** and Grenell.

At the time of the sale by **Foxman** there was outstanding the $10,000 liability to Jasie and Abbey had among its assets the then unmatured third Gittlin $100,000 note and the mortgage and property purchased after June 2, 1958.

On January 13, 1959, there was filed with the State of New Jersey a "Cancellation of Business Name, Form 868" which noted the dissolution of Abbey.

On April 11, 1959, the Gittlins sold their 50-percent stock interest in the corporation and the $200,000 face value debentures to Grenell for $410,000. On April 11, 1959, the corporation sold its assets to National Aircraft Corporation for $750,000 cash.

> Respondent, in his Amendment to Answer, alleged:
>
> The assets of Abbey were transferred on or about May 29, 1958 and June 2, 1958 to Abbey Record Manufacturing Co., Inc. (hereafter "Abbey, Inc.").
>
> Since June 2, 1958, no part of any business, financial operation, or venture of Abbey continued to be carried on by any of its partners in the Abbey partnership.
>
> On June 2, 1958, the Abbey partnership was terminated.
>
> The taxable year of Abbey commencing on March 1, 1958 was closed on June 2, 1958.

OPINION

RAUM, *Judge:*

1. *Tax consequences of termination of Jacobowitz's interest in Abbey; the agreement of May 21, 1957.*—On May 21, 1957, Jacobowitz's status as a partner in Abbey came to an end pursuant to an agreement executed on that day. The first issue before us is whether Jacobowitz thus made a "sale" of his partnership interest to **Foxman** and Grenell within section 741[2] of the 1954 Code, as contended by him, or whether the payments to him required by the agreement are to be regarded as "made in liquidation" of his interest [pg. 548]within section 736,[3] as contended by **Foxman** and Grenell. Jacobowitz treated the transaction as constituting a "sale," and reported a capital gain thereon in his return for 1957. **Foxman** and Grenell, on the other hand, treated the payments as having been "made in liquidation"[4] of Jacobowitz's interest under section 736, with the result that a substantial portion thereof reduced their distributive shares of partnership income for the fiscal year ending February 28, 1958.

The Commissioner, in order to protect the revenues, took inconsistent positions. In Jacobowitz's case, his determination proceeded upon the assumption that there was a section 736 "liquidation," with the result that payments thereunder were charged to Jacobowitz for the partnership fiscal year ending February 28, 1958, thus not only attributing to Jacobowitz additional income for his calendar year 1958 but also treating it as ordinary income rather than capital gain. In the cases of **Foxman** and Grenell, the Commissioner adopted Jacobowitz's position that there was a section 741 "sale" on May 21, 1957, to **Foxman** and Grenell, thus disallowing the deductions in respect thereof from the partnership's income for its fiscal year ending February 28, 1958; as a consequence, there was a corresponding increase [pg. 549]in the distributive partnership income of **Foxman** and Grenell for that fiscal year which was reflected in the deficiencies determined for the calendar year 1958 in respect of each of them.

As is obvious, the real controversy herein is not between the various petitioners and the Government,[5] but rather between Jacobowitz and his two former partners. We hold, in favor of Jacobowitz, that the May 21, 1957, transaction was a "sale" under section 741.

The provisions of sections 736 and 741 of the 1954 Code have no counterpart in prior law. They are contained in "Subchapter K"[6] which for the first time, in 1954, undertook to deal comprehensively with the income tax problems of partners and partnerships.

That a partnership interest may be "sold" to one or more members of the partnership within section 741 is not disputed by any of the parties. Indeed, the Income Tax Regulations, section 1.741-1(b), explicitly state:

Sec. 1.741-1 Recognition and character of gain or loss on sale or exchange.

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(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. ***

And it is clear that in such circumstances, section 736 and 761(d), do not apply. See regulations, sec. 1.736-1(a)(1)(i):

Sec. 1.736-1 Payments to a retiring partner or a deceased partner's successor in interest.

(a) *Payments considered as distributive share or guaranteed payment.*(1) (i) Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). *** Section 736 and this section apply only to payments made by the partnership *and not to transactions between the partners.* Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736. [Italics supplied.]

Did Jacobowitz *sell* his interest to **Foxman** and Grenell, or did he merely enter into an arrangement to receive "payments

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in liquidation of [his]

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interest" from the partnership? We think the record establishes that he sold his interest.

At first blush, one may indeed wonder why Congress provided for such drastically different tax consequences, depending upon whether the amounts received by the withdrawing partner are to be classified as the proceeds of a "sale" or as "payments

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in liquidation" [pg. 550]of his interest.[7] For, there may be very little, if any, difference in ultimate economic effect between a "sale" of a partnership interest to the remaining partners and a "liquidation" of that interest. In the case of a sale the remaining partners may well obtain part or all of the needed cash to pay the purchase price from the partnership assets, funds borrowed by the partnership or future earnings of the partnership. See A.L.I., Federal Income Taxation of Partners and Partnerships 176 (1957). Yet the practical difference between such transaction and one in which the withdrawing partner agrees merely to receive payments in liquidation directly from the partnership itself would hardly be a meaningful one in most

circumstances.[8] Why then the enormous disparity in tax burden, turning upon what for practical purposes is merely the difference between Tweedledum and Tweedledee, and what criteria are we to apply in our effort to discover that difference in a particular case? The answer to the first part of this question is to be found in the legislative history of subchapter K, and it goes far towards supplying the answer to the second part.

In its report on the bill which became the 1954 Code the House Ways and Means Committee stated that the then "existing tax treatment of partners and partnerships is among the most confused in the entire tax field"; that "partners

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cannot form, operate, or dissolve a partnership with any assurance as to tax consequences"; that the proposed statutory provisions [subchapter K] represented the "first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws"; and that the "principal objectives have been simplicity, flexibility, and equity as between the partners." H. Rept. No. 1337, 83d Cong., 2d Sess., p. 65. Like thoughts were expressed in virtually identical language by the Senate Finance Committee. S. Rept. No. 1622, 83d Cong., 2d Sess., p. 89. [pg. 551]

Although there can be little doubt that the attempt to achieve "simplicity" has resulted in utter failure,[9] the new legislation was intended to and in fact did bring into play an element of "flexibility." Tax law in respect of partners may often involve a delicate mechanism, for a ruling in favor of one partner may automatically produce adverse consequences to the others. Accordingly, one of the underlying philosophic objectives of the 1954 Code was to permit the partners themselves to determine their tax burdens *inter sese* to a certain extent, and this is what the committee reports meant when they referred to "flexibility." The theory was that the partners would take their prospective tax liabilities into account in bargaining with one another.[10] Nor is this concept before us for the first time. We considered it in the interpretation of some related provisions of section 736 in *V. Zay Smith,* 37 T.C. 1033, affirmed 313 F.2d 16 (C.A. 10), involving payments in respect of goodwill in the liquidation of a partner's interest. We there said (37 T.C. at 1038):

> This interpretation will also make for the flexibility and equity between the partners stressed by Congress. It will allow the partners flexibility in that they may determine the tax consequences of a liquidation payment by the choice of words in the partnership agreement. ***

Recurring to the problem immediately before us, this policy of "flexibility" is particularly pertinent in determining the tax consequences of the withdrawal of a partner. Where the practical differences between a "sale" and a "liquidation" are, at most, slight, if they exist at all,

and where the tax consequences to the partners can vary greatly, it is in accord with the purpose of the statutory provisions to allow the partners themselves, through arm's-length negotiations, to determine whether to take the "sale" route or the "liquidation" route, thereby allocating the tax burden among themselves.[11] [pg. 552]And in this case the record leaves no doubt that they intended to and in fact did adopt the "sale" route.[12]

The agreement of May 21, 1957, indicates a clear intention on the part of Jacobowitz to sell, and **Foxman** and Grenell to purchase, Jacobowitz's partnership interest. The second "whereas" clause refers to Jacobowitz as "selling" his interest and part "First" of the agreement explicitly states not only that the "second parties [**Foxman** and Grenell] hereby purchase

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the

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interest of

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[Jacobowitz]

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in Abbey," but also that "the first party [Jacobowitz] does hereby sell" his interest in Abbey. Thus, **Foxman** and Grenell obligated themselves *individually* to purchase Jacobowitz's interest. Nowhere in the agreement was there any obligation on the part of Abbey to compensate Jacobowitz for withdrawing from the partnership. Indeed, a portion of the consideration received by him was the Sound Plastics stock, not a partnership asset at all. That stock was owned by **Foxman** and Grenell as individuals and their undertaking to turn it over to Jacobowitz as part of the consideration for Jacobowitz's partnership interest reinforces the conclusion that *they as individuals* were buying his interest, and that the transaction represented a "sale" of his interest to them rather than a "liquidation" of that interest by the partnership. Moreover, the chattel mortgage referred to in part "First" of the agreement of May 21, 1957, states that Jacobowitz "has sold

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his

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interest as a partner."

In addition to the foregoing, we are satisfied from the evidence before us that **Foxman** and Grenell knew that Jacobowitz was interested only in a sale of his partnership interest. The record convincingly establishes that the bargaining between them was consistently upon the basis of a proposed sale.[13] And the agreement of May 21, 1957, which represents the culmination of that bargaining, reflects that understanding with unambiguous precision. The subsequent [pg. 553] position of **Foxman** and Grenell, disavowing a "sale," indicates nothing more than an attempt at hindsight tax planning to the disadvantage of Jacobowitz.

Foxman and Grenell argue that Jacobowitz looked only to Abbey for payment, that he was in fact paid by Abbey, that there was "in substance" a liquidation of his interest, and that these considerations should be controlling in determining whether section 736 or section 741 applies. But their contention is not well taken.

Jacobowitz distrusted **Foxman** and Grenell and wanted all the security he could get; he asked for, but did not receive, guarantees from their wives and mortgages on their homes. Obviously, the assets of Abbey and its future earnings were of the highest importance to Jacobowitz as security that **Foxman** and Grenell would carry out their part of the bargain. But the fact remains that the payments received by Jacobowitz were in discharge of their obligation under the agreement, and not that of Abbey. It was they who procured those payments in their own behalf from the assets of the partnership which they controlled. The use of Abbey to make payment was wholly within their discretion and of no concern to Jacobowitz; his only interest was payment. The terms of the May 21, 1957, agreement did not obligate Abbey to pay Jacobowitz.

Nor is their position measurably stronger by reason of the fact that Jacobowitz was given promissory notes signed in behalf of Abbey. These notes were endorsed by **Foxman** and Grenell individually, and the liability of Abbey thereon was merely in the nature of security for their primary obligation under the agreement of May 21,1957. The fact that they utilized partnership resources to discharge their own individual liability in such manner can hardly convert into a section 736 "liquidation" what would otherwise qualify as a section 741 "sale." It is important to bear in mind the object of "flexibility" which Congress attempted to attain, and we should be slow to give a different meaning to the arrangement which the partners entered into among themselves than that which the words of their agreement fairly spell out. Otherwise, the reasonable expectations of the partners in arranging their tax burdens inter sese would come to naught, and the purpose of the statute would be defeated. While we do not suggest that it is never possible to look behind the words of an agreement in dealing with problems like the one before us, the considerations which **Foxman** and Grenell urge us to take into account here are at best of an ambiguous character and are in any event consistent

with the words used. We hold that the Commissioner's determination in respect of this issue was in error in Jacobowitz's case but was correct in the cases involving **Foxman** and Grenell. Cf. *Charles F. Phillips,* 40 T.C. 157; *Karan v. Commissioner,* 319 F.2d 303 (C.A.7). [pg. 554]

2. *The $16,790 received by Jacobowitz from Abbey.*—During the period March 1, 1957, to May 21, 1957, inclusive, Jacobowitz received a total of $16,790 from Abbey, and reported it as ordinary income in his 1957 return. The Commissioner treated this item as reportable by Jacobowitz in 1958, but made a corresponding inconsistent adjustment in the cases of **Foxman** and Grenell by ruling that this amount was improperly subtracted from the partnership income for its fiscal year ending February 28, 1958, in computing the distributive shares of **Foxman** and Grenell. Jacobowitz now contends that this item represented merely a withdrawal of capital. We hold that Jacobowitz correctly reported this amount as ordinary income in his 1957 return, and that it was properly taken into account by **Foxman** and Grenell in the computation of their distributive shares of partnership income in their 1958 returns.

Section 702(a) requires a partner to take into account his distributive share of the partnership's taxable income in determining his income tax.[14] Section 704(a) provides that a partner's distributive share of income shall be determined by the partnership agreement.[15] Under section 761(c) a partnership agreement "includes any modifications of the partnership agreement "includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement." The effect of such modification is that it relates back to the beginning of the taxable year in which the modification occurs. Thus the partners may, by agreement, adjust among themselves their interests in earnings and are taxable accordingly. Cf. *Hellman* v. *United States,* 44 F.2d 83 Ct.Cl.); *Raymond R. Goodlatte,* 4 B.T.a. 165 (acq. VI-2 C.B. 3).

Prior to May 21, 1957, the partners shared profits equally. In paragraph Fourth of the agreement of May 21, 1957, the following handwritten provision was inserted at the request of Jacobowitz:

> First party [Jacobowitz]shall not be entitled to any further share of profits that may accrue since March 1, 1957 and may retain any sums received therefrom to date hereof.

Absent this modification of the partners' agreement to share net profits equally, Jacobowitz would have had to include in his taxable [pg. 555] income for his taxable year ending December 31, 1957, one-third of Abbey's earnings during the period March 1, 1957, to May 21, 1957,[16] since the taxable year of Abbey closed on May 21, 1957, under section 706(c) (2) (A) (i) with respect to Jacobowitz, who sold his entire interest in Abbey at that time,

although it did not close at that time, pursuant to section 706 (c) (1), in respect of the remaining partners.[17]

The language "may retain any sums received therefrom to date hereof" plainly refers to the $16,790, which, the record shows, consists in part of "salary" and in part of "drawings." Jacobowitz's own testimony bears this out. He testified that it was his intention that the $16,790 represented moneys coming out of profits and pursuant to this reported it as ordinary income in his 1957 return. The option letter prepared by Jacobowitz also indicates that this amount was intended to be a charge against profits; it stated, in part: "Pending final settlement, you [Jacobowitz] will continue to draw $225.00 per week. If we consummate the agreement, you [Jacobowitz]relinquish all rights to profits and drawings from March 1, 1957, except those you have already received."

We are satisfied that the $16,790 reflects Jacobowitz's share of Abbey profits for the period March 1, 1957, to May 21, 1957, and was ordinary income to him for his taxable year ending December 31, 1957; **Foxman** and Grenell are entitled to have Abbey's income for the year ending February 28, 1958, reduced by that amount in computing their respective shares of Abbey profits for that fiscal year.[18] [pg. 556]

3. *Whether Abbey "terminated" on June 2, 1958.*—By amendments to the Commissioner's pleadings a number of additional issues are raised, all of them depending in the first instance upon a new major issue as to whether Abbey "terminated" on June 2, 1958, within the meaning of section 708.[19] These new matters do not involve Jacobowitz; they relate solely to **Foxman's** and Grenell's cases.

Abbey was on a fiscal year ending February 28, and **Foxman** and Grenell each reported in his 1958 return his distributive share of Abbey's income for its fiscal year ending February 28, 1958, as reflected in the partnership return for that fiscal year. The first two issues in these cases, dealt with above, relate to a revision of Abbey's reportable income and the distributive shares of the partners for Abbey's fiscal year ending February 28, 1958. The third issue, now under consideration, relates to Abbey's income realized *after* February 28, 1958. A "final" return was filed on Abbey's behalf purportedly for the fiscal year ending February 28, 1959, and **Foxman** and Grenell reported in their own returns for the calendar year 1959 their respective distributive shares of the income shown on that partnership return. The Commissioner, on the other hand, has taken the position in his amended pleadings that Abbey "terminated" on June 2, 1958, with the consequence that **Foxman** and Grenell were charged in 1958 with their distributive shares of Abbey's income for the short taxable year March 1, 1958, to June 2, 1958, in addition to their distributive shares for the full fiscal year ending February 28, 1958. Important subsidiary issues are also raised in this respect by the Commissioner involving the determination of the partnership's income for that short period. These subsidiary issues include the question whether the transfer of Abbey's assets to the

corporation was nonrecognizable under section 351, the amount of gain realized if the transfer were recognizable, the amount of partnership income otherwise realized by Abbey during the period March 1-June 2, 1958, which in turn depends in part upon a proposed revision by the Commissioner of the depreciation allowance claimed on Abbey's behalf. We hold that Abbey did not terminate on June 2, 1958, as urged by the Commissioner. The subsidiary issues in this connection therefore become moot.

Upon consummation of the so-called Gittlin transaction on June 2, 1958, all of Abbey's assets had been transferred to the corporation, [pg. 557] and the stock and debentures allocable to Abbey had been distributed to **Foxman** and Grenell. Also, the first of the three $100,000 Gittlin notes had been discounted and the proceeds distributed to **Foxman** and Grenell. Nevertheless, **Foxman** and Grenell promptly redeposited an aggregate of $20,000 of such proceeds to their capital accounts in Abbey, and Abbey continued to own the two remaining $100,000 Gittlin notes, one due on September 2, 1958, and the other on January 15, 1959. Moreover, there were still outstanding the two Jasie notes in the amounts of $5,000 each, due July 1, 1959, and January 2, 1960. The evidence further shows that in an effort to prevent the termination of Abbey, **Foxman** and Grenell began looking for income-producing property prior to June 2, 1958, to be purchased in behalf of Abbey. Two such items were in fact purchased by Abbey, a mortgage in July and rental property in September of 1958. While it is true that these items were of comparatively minor character in contrast to the enterprise previously carried on by Abbey, the fact that they were actually acquired by Abbey cannot be ignored. Abbey did receive interest on the Gittlin notes after June 2, 1958, as well as interest on the mortgage and rents from the real estate. It continued to be liable on the Jasie notes. Its affairs were not wound up on June 2, 1958. Cf. Income Tax Regs., sec. 1.708-1(b)(i)(iii). The situation is similar to that in *Emmette L. Barran,* 39 T.C. 515. The Commissioner attempts to distinguish Barran on the ground that a comparatively minor piece of real estate was not included among the assets that the partnership transferred to the new owner in that case. We think that, notwithstanding this circumstance and notwithstanding the different manner in which *Barran* arose, the cases are not fairly distinguishable. The Court in *Barran* could not find that the partnership had terminated under any part of section 708. We reached the same result. We hold that the Commissioner has failed to establish that Abbey "terminated" on June 2, 1958. Accordingly, the various proposed adjustments based upon such alleged termination cannot be approved.

Decisions will be entered under Rule 50.

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1 Proceedings of the following petitioners are consolidated herewith: Norman B. Jacobowitz and Laura Jacobowitz, docket No. 93460; and Horace W. Grenell and Judith Grenell, docket No. 93472.

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SEC. 741. RECOGNITION AND CHARACTER OF GAIN OR LOSS ON SALE OR EXCHANGE.

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

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SEC. 736. PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST.

(a) PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT.—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) PAYMENTS FOR INTEREST IN PARTNERSHIP.—

(1) GENERAL RULE.—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary or his delegate, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) SPECIAL RULES.—For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

Section 707(c), made applicable by section 736(a) (2), *supra,* provides as follows:

SEC. 707. TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP.

(c) GUARANTEED PAYMENTS.—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

4 "Liquidation" of a partner's interest is defined in section 761(d) as follows:

SEC. 761. TERMS DEFINED.

(d) LIQUIDATION OF A PARTNER'S INTEREST.—For purposes of this subchapter, the term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.

5 The Government has undertaken, on brief for the first time, to support Jacobowitz's position.

6 "Subchapter K" is a subdivision of "Chapter 1" of "Subtitle A" which contains the income tax provisions of the Code.

7 If the transaction were a "sale" under section 741, Jacobowitz's gain would be taxed as capital gain (there being no section 751 problem in respect of unrealized receivables or inventory items which have appreciated substantially in value), and would be reportable in 1957 rather than in 1958. On the other hand, if the transaction were a section 736 "liquidation," the amounts received by him (to the extent that they were not for his "interest

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in partnership property" pursuant to section 736(b) (1)) would be taxable as ordinary income and would be reportable by him in 1958, rather than in 1957. The tax liabilities of the remaining partners, **Foxman** and Grenell, would be affected accordingly, depending upon whether section 736 or 741 governed the transaction.

8 The only difference suggested by counsel for **Foxman** and Grenell, for the first time in their reply brief, is that in the event of bankruptcy of the partnership the liability to the withdrawing partner might be subject to a different order of priority depending upon whether there is involved the liability of the partnership itself, as in the case of a "liquidation," or the liability of the purchasing partners, as in the case of a "sale." However, it stretches credulity to the breaking point to assume that any such consideration motivated the parties in determining to enter into a "sale" rather than a "liquidation," or vice versa, where the only immediate matter of economic consequence was the substantial difference in tax liability depending upon which course was followed.

9 The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. Cf. *Thomas G. Lewis,* 35 T.C. 71, where we had occasion to comment (p. 76) upon the exasperating efforts required to deal with certain other provisions of the 1954 Code. See also *Van Products, Inc.,* 40 T.C. 1018, 1028. If there should be any lingering doubt on this matter one has only to reread section 736 in its entirety, footnote 3, *supra,* and give an honest answer to the question whether it is reasonably comprehensible to the average lawyer or even to the average tax expert who has not given special attention and extended study to the tax problems of partners. Surely, a statute has not achieved "simplicity" when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries. For a critical discussion of the complexities of the 1954 Code see, generally, Cary, "The ALI Tax Project and the Code," 60 Col. L. Rev. 259.

10 Whether this was a realistic assumption in view of the large number of small partnerships that may not have the benefit of the highly specialized tax advice required, or whether, in view of the almost incomprehensible character of some of the provisions in subchapter K, the parties could with confidence allocate the tax burden among themselves—these are matters on which we express no opinion. The point is that Congress did intend to provide a certain amount of "flexibility" in this respect.

11 See S. Rept. No. 1616, 86th Cong., 2d Sess., in respect of the proposed "Trust and Partnership Income Tax Revision Act of 1960" (H.R. 9662):

"under present law even though there is no economic difference it is possible for partners to arrange different tax effects for the disposition of the interest of a retiring or deceased partner, merely by casting the transaction as a sale rather than a liquidating distribution (p. 76).

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Under present law, if the transaction is in the form of a sale of an interest, then section 741 (rather than section 736) would govern, even though the interest of the selling partner is transferred to the other member of a two-man partnership (p. 103)."

12 In *Bolling* v. *Patterson,* — F. Supp. — (N.D. Ala.), 7 A.F.T.R. 2d 1464, 1465, 61-1 U.S.T.C. par. 9417, the judge, in his charge to the jury, instructed it that the one question it must answer is did "the partners

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intend to liquidate Ramsey's interest in the partnership or did the two partners

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intend to buy and did Ramsey intend to sell

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his partnership interest."

13 Various items of evidence support this conclusion. Of particular interest is the fact that the first payment to Jacobowitz, $67,500, was computed so as to enable him to report his gain as having been derived from an installment *sale*. However, a miscalculation (by failing to take into account the Sound Plastics stock and the Chrysler automobile) resulted in Jacobowitz's receiving more than the permissible 30 percent in 1957 (sec. 453(b)(2)(A)(ii), 1954 Code), and he therefore reported his entire gain in his 1957 return. The point remains, nevertheless, that a "sale" was planned and executed.

14

SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

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(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

15

SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

16 Abbey had earnings, before partners' salaries in the amounts of $39,807.43, $38,164.32, and $27,478.26 for the months of March, April, and May 1957, respectively.

17

SEC. 706. TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

(c) CLOSING OF PARTNERSHIP YEAR.—

(1) GENERAL RULE.—Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

(2) PARTNER WHO RETIRES OR SELLS INTEREST IN PARTNERSHIP.—

(A) DISPOSITION OF ENTIRE INTEREST.—The taxable year of a partnership shall close—

(i) with respect to a partner who sells or exchanges his entire interest in a partnership, and

(ii) with respect to a partner whose interest is liquidated, except that the taxable year of a partnership with respect to a partner who dies shall not close prior to the end of the partnership's taxable year.

Such partner's distributive share of items described in section 702(a) for such year shall be determined, under regulations prescribed by the Secretary or his delegate, for the period ending with such sale, exchange, or liquidation.

See Income Tax Regs., sec. 1.706-1(c)(2).

18 A superficially similar situation was present in *Ray H. Schulz,* 34 T.C. 235, 250, 251, affirmed 294 F.2d 52 (C.A.9), where, however, the problem arose under the 1939 Code and where the facts were critically different. There, we regarded the retiring partner's membership in the firm as having in fact terminated at the close of the prior fiscal year. He did not in fact participate in the operation of the partnership nor was he entitled to share in its profits after

that date. Here, there can be no question as to Jacobwitz's status as a full partner until May 21, 1957.

19

SEC.708. CONTINUATION OF PARTNERSHIP.

(a) GENERAL RULE.—For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) TERMINATION.—

(1) GENERAL RULE.—For purposes of subsection (a), a partnership shall be considered as terminated only if—

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

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American Federal Tax Reports

CRANE v. COMMISSIONER OF INTERNAL REVENUE, Cite as 35 AFTR 776 (67 S.Ct. 1047), Code Sec(s) , (S Ct), 04/14/1947

CRANE v. COMMISSIONER OF INTERNAL REVENUE.

Case Information:

[pg. 776]

Code Sec(s):	
Court Name:	U.S. Supreme Court.
Docket No.:	No. 68.
Date Argued:	12/11/1946
Date Decided:	04/14/1947
Disposition:	
Cites:	35 AFTR 776, **331 US 1**, 67 S Ct 1047, 91 L Ed 1301, 47-1 USTC P 9217.

HEADNOTE

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Reference(s):

[pg. 777]

OPINION

Mr. Edward S. Bentley, of New York City, for petitioner.

Mr. J. Louis Monarch, of Washington, D. C., for respondent.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

Petition by the Commissioner of Internal Revenue to review an order of the Tax Court, 3 T.C. 585, expunging a deficiency assessed against Beulah B. Crane in her income tax for the year 1938. To review a judgment of the Circuit Court of Appeals, 153 F.2d 504, which reversed the order of the Tax Court, Beulah B. Crane brings certiorari.

Affirmed.

Judge: Mr. Chief Justice VINSON delivered the opinion of the Court.

The question here is how a taxpayer who acquires depreciable property subject to an unassumed mortgage, holds it for a period, and finally sells it still so encumbered, must compute her taxable gain.

Petitioner was the sole beneficiary and the executrix of the will of her husband, who died January 11, 1932. He then owned an apartment building and lot subject to a mortgage,[1] which secured a principal debt of $255,000.00 and interest in default of $7,042.50. As of that date, the property was appraised for federal estate tax purposes at a value exactly equal to the total amount of this encumbrance. Shortly after her husband's death, petitioner entered into an agreement with the mortgagee whereby she was to continue to operate the property—collecting the rents, paying for necessary repairs, labor, and other operating expenses, and reserving $200.00 monthly for taxes—and was to remit the net rentals to the mortgagee. This plan was followed for nearly seven years, during which period petitioner reported the gross rentals as income, and claimed and was allowed deductions for taxes and operating expenses paid on the property, for interest paid on the mortgage, and for the physical exhaustion of the building. Meanwhile, the arrearage of interest increased to $15,857.71. On November 29, 1938, with the mortgagee threatening foreclosure, petitioner sold to a third party for $3,000.00 cash, subject to the mortgage, and paid $500.00 expenses of sale.

Petitioner reported a taxable gain of $1,250.00. Her theory was that the "property" which she had acquired in 1932 and sold in 1938 was only the equity, or the excess in the value of the apartment building and lot over the amount of the mortgage. This equity was of zero value when she acquired it. No depreciation could be taken on a zero value.[2] Neither she nor her vendee ever assumed the mortgage, so, when she sold the equity, the amount she realized on the sale was the net cash received, or $2,500.00. This sum less the zero basis constituted her gain, of which she reported half as taxable on the assumption that the entire property was a "capital asset".[3]

The Commissioner, however, determined that petitioner realized a net taxable gain of $23,767.03. His theory was that the [pg. 779]"property" acquired and sold was not the equity, as petitioner claimed, but rather the physical property itself, or the owner's rights to possess, use, and dispose of it, undiminished by the mortgage. The original basis thereof was $262,042.50, its appraised value in 1932. Of this value $55,000.00 was allocable to land and $207,042.50 to building.[4] During the period that petitioner held the property, there was an allowable depreciation of $28,045.10 on the building,[5] so that the adjusted basis of the building at the time of sale was $178,997.40. The amount realized on the sale was said to include not only the $2,500.00 net cash receipts, but also the principal amount[6] of the mortgage subject to which the property was sold, both totaling $257,500.00. The selling price was allocable in the proportion, $54,471.15 to the land and $203,028.85 to the building.[7] The Commissioner agreed that the land was a "capital asset", but thought that the building was not.[8] Thus, he determined that petitioner sustained a capital loss of $528.85 on the land, of which 50% or $264.42 was taken into account, and an ordinary gain of $24,031.45 on the building, or a net taxable gain as indicated.

The Tax Court agreed with the Commissioner that the building was not a "capital asset." In all other respects it adopted petitioner's contentions, and expunged the deficiency.[9] Petitioner did not appeal from the part of the ruling adverse to her, and these questions are no longer at issue. On the Commissioner's appeal, the Circuit Court of Appeals reversed, one judge dissenting.[10] We granted certiorari because of the importance of the questions raised as to the proper construction of the gain and loss provisions of the Internal Revenue Code.[11]

The 1938 Act,[12] §111(a), 26 U.S.C.A. Int.Rev.Code, § 111(a), defines the gain from "the sale or other disposition of property" as "the excess of the amount realized therefrom over the adjusted basis provided in section 113(b)

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." It proceeds, § 111(b), to define "the amount realized from the sale or other disposition of property" as "the sum of any money received plus the fair market value of the property (other than money) received." Further, in § 113(b), 26 U.S.C.A. Int.Rev.Code, § 113(b), the "adjusted basis for determining the gain or loss from the sale or other disposition of property" is declared to be "the basis determined under subsection (a), adjusted

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[(1) (B)]

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for exhaustion, wear and tear, obsolescence, amortization

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to the extent allowed (but not less than the amount allowable)

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." The basis under subsection (a) "if the property was acquired by

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devise

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or by the decedent's estate from the decedent", § 113(a) (5), is "the fair market value of [pg. 780]such property at the time of such acquisition."

Logically, the first step under this scheme is to determine the unadjusted basis of the property, under § 113 (a) (5), and the dispute in this case is as to the construction to be given the term "property". If "property", as used in that provision, means the same thing as "equity", it would necessarily follow that the basis of petitioner's property was zero, as she contends. If, on the contrary, it means the land and building themselves, or the owner's legal rights in them, undiminished by the mortgage, the basis was $262,042.50.

[1] We think that the reasons for favoring one of the latter constructions are of overwhelming weight. In the first place, the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.[13] The only relevant definitions of "property" to be found in the principal standard dictionaries[14] are the two favored by the Commissioner, i. e., either that "property" is the physical thing which is a subject of ownership, or that it is the aggregate of the owner's rights to control and dispose of that thing. "Equity" is not given as a synonym, nor do either of the foregoing definitions suggest that it could be correctly so used. Indeed, "equity" is defined as "the value of a property

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above the total of the liens.

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"[15] The contradistinction could hardly be more pointed. Strong countervailing considerations would be required to support a contention that Congress, in using the word "property", meant "equity", or that we should impute to it the intent to convey that meaning.[16]

[2] In the second place, the Commissioner's position has the approval of the administrative construction of § 113(a) (5). With respect to the valuation of property under that section, Reg. 101, Art. 113(a) (5)-1, promulgated under the 1938 Act, provided that "the value of property as of the date of the death of the decedent as appraised for the purpose of the federal estate tax

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shall be deemed to be its fair market value.

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" The land and building here involved were so appraised in 1932, and their appraised value—$262,042.50—was reported by petitioner as part of the gross estate. This was in accordance with the estate tax law[17] and regulations,[18] which had always required that the value of decedent's property, undiminished by liens, be so appraised and returned, and that mortgages be separately deducted in computing the net estate.[19] As the quoted provision of the Regulations has been in effect since 1918,[20] and as the relevant statutory provision has been repeatedly reenacted since then in substantially the same form,[21] the former may itself now be considered [pg. 781]to have the force of law.[22]

Moreover, in the many instances in other parts of the Act in which Congress has used the word "property", or expressed the idea of "property" or "equity", we find no instances of a misuse of either word or of a confusion of the ideas.[23] In some parts of the Act other than the gain and loss sections, we find "property" where it is unmistakably used in its ordinary sense.[24] On the other hand, where either Congress or the Treasury intended to convey the meaning of "equity," it did so by the use of appropriate language.[25]

A further reason why the word "property" in § 113(a) should not be construed to mean "equity" is the bearing such construction would have on the allowance of deductions for depreciation and on the collateral adjustments of basis.

Section 23(*l*) permits deduction from gross income of "a reasonable allowance for the exhaustion, wear and tear of property

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." Sections 23(n) and 114(a), 26 U.S.C.A. Int.Rev.Code, §§ 23(n), 114(a), declare that the "basis upon which depletion exhaustion, wear and tear

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are to be allowed" is the basis "provided in section 113(b) for the purpose of determining the gain upon the sale" of the property, which is the § 113(a) basis "adjusted

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for exhaustion, wear and tear

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to the extent allowed (but not less than the amount allowable)

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Under these provisions, if the mortgagor's equity were the § 113(a) basis, it would also be the original basis from which depreciation allowances are deducted. If it is, and if the amount of the annual allowances were to be computed on that value, as would then seem to be required,[26] they will represent only a fraction of the cost of the corresponding physical exhaustion, and any recoupment by the mortgagor of the remainder of that cost can be effected only by the reduction of his taxable gain in the year of sale.[27] If, however, the amount of the annual allowances were to be computed on the value of the property, and then deducted from an equity basis, we would in some instances have to accept deductions from a minus basis or deny deductions altogether.[28] The Commissioner [pg. 782]also argues that taking the mortgagor's equity as the § 113(a) basis would require the basis to be changed with each payment on the mortgage,[29] and that the attendant problem of repeatedly recomputing basis and annual allowances would be a tremendous accounting burden on both the Commissioner and the taxpayer. Moreover, the mortgagor would acquire control over the timing of his depreciation allowances.

[3] Thus it appears that the applicable provisions of the Act expressly preclude an equity basis, and the use of it is contrary to certain implicit principles of income tax depreciation, and entails very great administrative difficulties.[30] It may be added that the Treasury has never furnished a guide through the maze of problems that arise in connection with depreciating an equity basis, but, on the contrary, has consistently permitted the amount of depreciation allowances to be computed on the full value of the property, and subtracted from it as a basis. Surely, Congress' long-continued acceptance of this situation gives it full legislative endorsement.[31]

[4] We conclude that the proper basis under § 113(a) (5) is the value of the property, undiminished by mortgages thereon, and that the correct basis here was $262,042.50. The next step is to ascertain what adjustments are required under § 113(b). As the depreciation rate was stipulated, the only question at this point is whether the Commissioner was warranted in making any depreciation adjustments whatsoever.

[5] Section 113 (b) (1) (B) provides that "proper adjustment in respect of the property *shall in all cases be made*

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for exhaustion, wear and tear

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to the extent allowed (but not less than the amount allowable

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." The Tax Court found on adequate evidence that the apartment house was property of a kind subject to physical exhaustion, that it was used in taxpayer's trade or business, and consequently that the taxpayer would have been entitled to a depreciation allowance under § 23 (*l*), except that, in the opinion of that Court, the basis of the property was zero, and it was thought that depreciation could not be taken on a zero basis. As we have just decided that the correct basis of the property was not zero, but $262,042.50, we avoid this difficulty, and conclude that an adjustment should be made as the Commissioner determined.

Petitioner urges to the contrary that she was not entitled to depreciation deductions, whatever the basis of the property, because the law allows them only to one who actually bears the capital loss,[32] and here the loss was not hers but the mortgagee's. We do not see, however, that she has established her factual premise. There was no finding of the Tax Court to that effect, nor to the effect that the value of the property was ever less than the amount of the lien. Nor was there evidence in the record, or any indication that petitioner could produce evidence, that this was so. The facts that the value of the property was only equal to the lien in 1932 and that during the next six and one-half years the physical condition of the building deteriorated and the amount of the lien increased, are entirely inconclusive, particularly in the light of the buyer's willingness in 1938 to take subjec to the increased lien and pay a substantial amount of cash [pg. 783]to boot. Whatever may be the rule as to allowing depreciation to a mortgagor on property in his possession which is subject to an unassumed mortgage and clearly worth less than the lien, we are not faced with that problem and see no reason to decide it now.

[6] At last we come to the problem of determining the "amount realized" on the 1938 sale. Section 111(b), it will be recalled, defines the "amount realized" from "the sale

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of property" as "the sum of any money received plus the fair market value of the property (other than money) received," and § 111(a) defines the gain on "the sale

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of property" as the excess of the amount realized over the basis. Quite obviously, the word "property", used here with reference to a sale, must mean "property" in the same ordinary sense intended by the use of the word with reference to acquisition and depreciation in § 113, both for certain of the reasons stated heretofore in discussing its meaning in § 113, and also because the functional relation of the two sections requires that the word mean the same in one section that it does in the other. If the "property" to be valued on the date of acquisition is the property free of liens, the "property" to be priced on a subsequent sale must be the same thing.[33]

[7] Starting from this point, we could not accept petitioner's contention that the $2,500.00 net cash was all she realized on the sale except on the absurdity that she sold a quarter-of-a-million dollar property for roughly one per cent of its value, and took a 99 per cent loss. Actually, petitioner does not urge this. She argues, conversely, that because only $2,500.00 was realized on the sale, the "property" sold must have been the equity only, and that consequently we are forced to accept her contention as to the meaning of "property" in § 113. We adhere, however, to what we have already said on the meaning of "property", and we find that the absurdity is avoided by our conclusion that the amount of the mortgage is properly included in the "amount realized" on the sale.

Petitioner concedes that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the "amount realized" within the meaning of § 111(b).[34] The cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of "money" or "other property", in their narrowest senses. It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole,[35] and that the taxpayer was the "beneficiary" of the payment in "as real and substantial [a sense] as if the money had been paid it and then paid over by it to its creditors."[36]

[8] Both these points apply to this case. The first has been mentioned already. As for the second, we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot.[37] If a purchaser pays boot, it is immaterial as to our problem [pg. 784]whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or

whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations.[38] If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

Therefore we conclude that the Commissioner was right in determining that petitioner realized $257,500.00 on the sale of this property.

[9] The Tax Court's contrary determinations, that "property", as used in § 113 (a) and related sections, means "equity", and that the amount of a mortgage subject to which property is sold is not the measure of a benefit realized, within the meaning of § 111 (b), announced rules of general applicability on clear-cut questions of law.[39] The Circuit Court of Appeals therefore had jurisdiction to review them.[40]

[10] Petitioner contends that the result we have reached taxes her on what is not income within the meaning of the Sixteenth Amendment. If this is because only the direct receipt of cash is thought to be income in the constitutional sense, her contention is wholly without merit.[41] If it is because the entire transaction is thought to have been "by all dictates of common-sense

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a ruinous disaster", as it was termed in her brief, we disagree with her premise. She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain.[42] We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment [pg. 785]does not require that result any more than does the Act itself.

Affirmed.

Judge: Mr. Justice JACKSON, dissenting.

The Tax Court concluded that this taxpayer acquired only an equity worth nothing. The mortgage was in default, the mortgage debt was equal to the value of the property, any possession by the taxpayer was forfeited and terminable immediately by foreclosure, and perhaps by a receiver pendente lite. Arguments can be advanced to support the theory that the taxpayer received the whole property and thereupon came to owe the whole debt. Likewise it is argued that when she

sold she transferred the entire value of the property and received release from the whole debt. But we think these arguments are not so conclusive that it was not within the province of the Tax Court to find that she received an equity which at that time had a zero value. Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248; Commissioner v. Scottish American Investment Co., Ltd., 323 U.S. 119, 65 S.Ct. 169, 89 L.Ed. 113. The taxpayer never became personally liable for the debt, and hence when she sold she was released from no debt. The mortgage debt was simply a subtraction from the value of what she did receive, and from what she sold. The subtraction left her nothing when she acquired it and a small margin when she sold it. She acquired a property right equivalent to an equity of redemption and sold the same thing. It was the "property" bought and sold as the Tax Court considered it to be under the Revenue Laws. We are not required in this case to decide whether depreciation was properly taken, for these is no issue about it here.

We would reverse the Court of Appeals and sustain the decision of the Tax Court.

Mr. Justice FRANKFURTER and Mr. Justice DOUGLAS join in this opinion.

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1 The record does not show whether he was personally liable for the debt.

2 This position is, of course, inconsistent with her practice in claiming such deductions in each of the years the property was held. The deductions so claimed and allowed by the Commissioner were in the total amount of $25,500.00.

3 See § 117 (a) (b), Revenue Act of 1938, c. 289, 52 Stat. 447, 26 U.S.C.A. Int.Rev.Code, § 117. Under this provision only 50% of the gain realized on the sale of a "capital asset" need be taken into account, if the property had been held more than two years.

4 The parties stipulated as to the relative parts of the 1932 appraised value and of the 1938 sales price which were allocable to land and building.

5 The parties stipulated that the rate of depreciation applicable to the building was 2% per annum.

6 The Commissioner explains that only the principal amount, rather than the total present debt secured by the mortgage, was deemed to be a measure of the amount realized, because the difference was attributable to interest due, a deductible item.

7 See supra, note 4.

8 See § 117 (a) (1), Revenue Act of 1938, supra.

9 3 T.C. 585. The Court held that the building was not a "capital asset" within the meaning of § 117 (a) and that the entire gain on the building had to be taken into account under § 117 (b), because it found that the building was of a character subject to physical exhaustion and that petitioner had used it in her trade or business.

But because the Court accepted petitioner's theory that the entire property had a zero basis, it held that she was not entitled to the 1938 depreciation deduction on the building which she had inconsistently claimed.

For these reasons, it did not expunge the deficiency in its entirety.

10 2 Cir., 153 F.2d 504.

11 328 U.S. 826, 66 S.Ct. 980.

12 All subsequent references to a revenue act are to this Act unless otherwise indicated. The relevant parts of the gain and loss provisions of the Act and Code are identical.

13 Old Colony R. Co. v. Commissioner, 284 U.S. 552, 560, 52 S.Ct. 211, 213, 76 L.Ed. 484.

14 See Websters' New International Dictionary, Unabridged, 2d Ed.; Funk & Wagnalls' New Standard Dictionary; Oxford English Dictionary.

15 See Webster's New International Dictionary, supra.

16 Crooks v. Harrelson, 282 U.S. 55, 59, 51 S.Ct. 49, 50, 75 L.Ed. 156.

17 See §§ 202 and 203 (a) (1), Revenue Act of 1916; §§ 402 and 403 (a) (1), Revenue Acts of 1918 and 1921; §§ 302, 303 (a) (1), Revenue Acts of 1924 and 1926; § 805, Revenue Act of 1932, 26 U.S.C.A. Int.Rev.Code, §§ 811, 812.

18 See Reg. 37, Arts, 13, 14 and 47; Reg. 63, Arts. 12, 13, and 41; Reg. 68, Arts. 11, 13, and 38; Reg. 70, Arts 11, 13, and 38; Reg. 80, Arts. 11, 13, and 38.

19 See City Bank Farmers' Trust Co. v. Bowers, 2 Cir., 68 F.2d 909, certiorari denied, 292 U.S. 644, 54 S.Ct. 778, 78 L.Ed. 1495; Rodiek v. Helvering, 2 Cir., 87 F.2d 328; Adriance v. Higgins, 2 Cir., 113 F.2d 1013.

20 See also Reg. 45, Art. 1562; Reg. 62, Art. 1563; Reg. 65, Art. 1594; Reg. 69, Art. 1594; Reg. 74, Art. 596; Reg. 77, Art. 596; Reg. 86, Art. 113(a) (5)-1 (c); Reg. 94, Art. 113 (a) (5)-1 (c); Reg. 103, § 19.113 (a) (5)-1 (c); Reg. 111, § 29.113(a) (5)-1 (c).

21 § 202 (a) (3), Revenue Act of 1921; § 204 (a) (5), Revenue Act of 1924; § 204 (a) (5), Revenue Act of 1926; § 113 (a) (5), Revenue Act of 1928; § 113 (a) (5), Revenue Act of 1932; § 113 (a) (5), Revenue Act of 1934; § 113 (a) (5), Revenue Act of 1936; § 113 (a) (5), Revenue Act of 1938; § 113 (a) (5), Internal Revenue Code, 26 U.S.C.A. Int.Rev.Code, § 113 (a) (5).

22 Helvering v. R. J. Reynolds Co., 306 U.S. 110, 114, 59 S.Ct. 423, 425, 83 L.Ed. 536.

23 Cf. Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87, 55 S.Ct. 50, 51, 79 L.Ed. 211.

24 Sec. 23 (a) (1), 26 U.S.C.A. Int.Rev.Code, § 23 (a) (1), permits the deduction from gross income of "rentals

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required to be made as a condition to the continued use

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for purposes of the trade or business, of *property*

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in which he [the taxpayer] has no *equity."*

Sec. 23 (*l*) permits the deduction from gross income of "a reasonable allowance for the exhaustion, wear and tear of *property* used in the trade or business

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See also § 303 (a) (1), Revenue Act of 1926, c. 27, 44 Stat. 9; § 805, Revenue Act of 1932, c. 209, 47 Stat. 280.

25 See § 23 (a) (1), *supra,* note 24; § 805, Revenue Act of 1932, *supra,* note 24; § 3482, I.R.C., 26 U.S.C.A. Int.Rev.Code, § 3482; Reg. 105, § 81.38. This provision of the Regulations, first appearing in 1937, T.D. 4729, 1937-1 Cum. Bull. 284, 289, permitted estates which were not liable on mortgages applicable to certain of decedent's property to return "only the value of the equity of redemption (or value of the property, less the indebtedness).

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"

26 Secs. 23 (n) and 114 (a), in defining the "basis upon which" depreciation is "to be allowed", do not distinguish between basis as the minuend from which the allowances are to be deducted, and as the dividend from which the amount of the allowance is to be computed. The Regulations indicate that the basis of property is the same for both purposes. Reg. 101, Art. 23 (1)-4, 5.

27 This is contrary to Treasury practice, and to Reg. 101, Art. 23 (1)-5, which provides in part:

"The capital sum to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production."

See Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101, 63 S.Ct. 902, 903, 87 L.Ed. 1286.

28 So long as the mortgagor remains in possession, the mortgagee can not take depreciation deductions, even if he is the one who actually sustains the capital loss, as § 23 (*l*) allows them only on property "used in the trade or business."

29 Sec. 113 (b) (1) (A) requires adjustment of basis "for expenditures

***

properly chargeable to capital account

***

."

30 Obviously we are not considering a situation in which a taxpayer has acquired and sold an equity of redemption only, i. e., a right to redeem the property without a right to present possession. In that situation, the right to redeem would itself be the aggregate of the taxpayer's rights and would undoubtedly constitute 'property' within the meaning of § 113 (a). No depreciation problems would arise. See note 28.

31 See note 22.

32 See Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 60 S.Ct. 209, 84 L.Ed. 226; Duffy v. Central R. Co., 268 U.S. 55, 64, 45 S.Ct. 429, 431, 69 L.Ed. 846.

33 See Maguire v. Commissioner, 313 U.S. 1, 8, 61 S.Ct. 789, 794, 85 L.Ed. 1149.

We are not troubled by petitioner's argument that her contract of sale expressly provided for the conveyance of the equity only. She actually conveyed title to the property, and the buyer took the same property that petitioner had acquired in 1932 and used in her trade or business until its sale.

34 United States v. Hendler, 303 U.S. 564, 58 S.Ct. 655, 82 L.Ed. 1018; Brons Hotels, Inc., 34 B.T.A. 376; Walter F. Haass, 37 B.T.A. 948. See Douglas v. Willcutts, 296 U.S. 1, 8, 56 S.Ct. 59, 62, 80 L.Ed. 3, 101 A.L.R. 391.

35 See Brons Hotels, Inc., supra, 34 B.T.A. at page 381.

36 See United States v. Hendler, supra, 303 U.S. at page 566, 58 S.Ct. at page 656, 82 L.Ed. 1018.

37 Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

38 For instance, this petitioner returned the gross rentals as her own income, and out of them paid interest on the mortgage, on which she claimed and was allowed deductions. See Reg. 77, Art. 141; Reg. 86, Art. 23 (b)-1; Reg. 94, Art. 23 (b)-1; Reg. 101, Art. 23 (b)-1.

39 See Commissioner v. Wilcox, 327 U.S. 404, 410, 66 S.Ct. 546, 550; Bingham's Trust v. Commissioner, 325 U.S. 365, 369-372, 65 S.Ct. 1232, 1234-1236, 89 L.Ed. 1670. Cf. John Kelley Co. v. Commissioner, 326 U.S. 521, 527, 698, 66 S.Ct. 299, 302; Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248.

40 Ibid; see also § 1141 (a) and (c), I.R.C., 26 U.S.C.A. Int.Rev.Code, § 1141 (a, c).

41 Douglas v. Willcutts, supra, 296 U.S. at page 9, 56 S.Ct. at page 62, 80 L.Ed. 3, 101 A.L.R. 391; Burnet v. Wells, 289 U.S. 670, 677, 53 S.Ct. 761, 763, 77 L.Ed. 1439.

42 In the course of the argument some reference was made, as by analogy, to a situation in which a taxpayer acquired by devise property subject to a mortgage in an amount greater than the then value of the property, and later transferred it to a third person, still subject to the mortgage, and for a cash boot. Whether or not the difference between the value of the property on acquisition and the amount of the mortgage would in that situation constitute either statutory or constitutional income is a question which is different from the one before us, and which we need not presently answer.

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American Federal Tax Reports

COMM. v. TUFTS, ET AL., Cite as 51 AFTR 2d 83-1132 (103 S.Ct. 1826), Code Sec(s) 752, (S Ct), 05/02/1983

COMMISSIONER of Internal Revenue, PETITIONER v. John F. TUFTS, ET AL., RESPONDENTS.

Case Information:

[pg. 83-1132]

Code Sec(s):	752
Court Name:	U.S. Supreme Court,
Docket No.:	No. 81-1536,
Date Decided:	05/02/1983
Prior History:	Court of Appeals for the Fifth Circuit, 48 AFTR 2d 81-5660, reversed.
Tax Year(s):	Year 1972.
Disposition:	Decision for Govt.
Cites:	51 AFTR 2d 83-1132, 461 US 300, 103 S Ct 1826, 75 L Ed 2d 863, 83-1 USTC P 9328.

HEADNOTE

1. GAIN OR LOSS—Amount realized—obligation assumed, cancelled, reduced, or taken subject to by buyer. Partner who sold interest in partnership that operated apartment complex realized amount equal to outstanding balance of nonrecourse mortgage even though balance exceeded FMV of complex. And Sec. 752(c) didn't limit amount realized to FMV. That section is directed at transactions between partner and partnership.

Reference(s): 1983 P-H Fed. ¶28,821(10); 31,026(15); 31,162(25). Code Sec. 752; Code Sec. 1001; Code Sec. 1012.

1. Lower court issue not decided on appeal: JUDICIAL PROCEEDINGS—Jurisdiction of courts and related matters—award [pg. 83-1133]of costs and attorney's fees.

Reference(s): 1983 P-H Fed. ¶38,850(1).

OPINION

Certiorari To The United States Court Of Appeals For The Fifth Circuit.

Syllabus

Section 752(d) of the Internal Revenue Code of 1954 (IRC) provides that liabilities incurred in the sale or exchange of a partnership interest are to be treated "in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." Under §1001(a) of the IRC, the gain or loss from a sale or other disposition of property is defined as the difference between "the amount realized" on the disposition and the property's adjusted basis. Section 1001(b) defines the "amount realized" as "the sum of any money received plus the fair market value of the property (other than money) received." A general partnership formed by respondents in 1970 to construct an apartment complex entered into a $1,851,500 nonrecourse mortgage loan with a savings association. The complex was completed in 1971. Due to the partners' capital contributions to the partnership and income tax deductions for their allocable shares of ordinary losses and depreciation, the partnership's claimed adjusted basis in the property in 1972 was $1,455,740. Because of an unanticipated reduction in rental income, the partnership was unable to make the payments due on the mortgage. Each partner thereupon sold his interest to a third party, who assumed the mortgage. The fair market value on the date of transfer did not exceed $1,400,000. Each partner reported the sale on his income tax return and indicated a partnership loss of $55,740. The Commissioner of Internal Revenue, however, determined that the sale resulted in a partnership gain of approximately $400,000 on the theory

that the partnership had realized the full amount of the nonrecourse obligation. The United States Tax Court upheld the deficiencies, but the Court of Appeals reversed.

Held: When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation exceeding the fair market value of the property sold, as in this case, the Commissioner may require him to include in the "amount realized" the outstanding amount of the obligation; the fair market value of the property is irrelevant to this calculation. Cf. Crane v. Commissioner, 331 U.S. 1 [35 AFTR 776]. Pp. 3-17.

(a) When the mortgagor's obligation to repay the mortgage loan is canceled, he is relieved of his responsibility to repay the sum he originally received and thus realizes value to that extent within the meaning of §1001(b). To permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss. A taxpayer must account for the proceeds of obligations he has received tax-free and has included in basis. Nothing in either §1001(b) or in this Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the property. Pp. 3-13.

(b) Section 752(c) of the IRC—which provides that for purposes of §752 "a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property"—does not authorize this type of asymmetrical treatment in the sale or disposition of partnership property. Rather, the legislative history indicates that the fair market value limitation of §752(c) was intended to apply only to transactions between a partner and his partnership under §§752(a) and (b), and was not intended to limit the amount realized in a sale or exchange of a partnership interest under §752(d). Pp. 13-16.

651 F.2d 1058 [48 AFTR 2d 81-5660], reversed.

BLACKMUN, J., delivered the opinion for a unanimous Court. O'CONNOR, J., filed a concurring opinion.

Judge: Justice BLACKMUN delivered the opinion of the Court.

Over 35 years ago, in Crane v. Commissioner, 331 U.S. 1 [35 AFTR 776] (1947), this Court ruled that a taxpayer, who sold property encumbered by a nonrecourse mortgage (the amount of the mortgage being less than the property's value), must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. The case now before us presents the question whether the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the fair market value of the property sold.

I

On August 1, 1970, respondent Clark Pelt, a builder, and his wholly owned corporation, respondent Clark, Inc., formed a [pg. 83-1134]general partnership. The purpose of the partnership was to construct a 120-unit apartment complex in Duncanville, Tex., a Dallas suburb. Neither Pelt nor Clark, Inc., made any capital contribution to the partnership. Six days later, the partnership entered into a mortgage loan agreement with the Farm & Home Savings Association (F&H). Under the agreement, F&H was committed for a $1,851,500 loan for the complex. In return, the partnership executed a note and a deed of trust in favor of F&H. The partnership obtained the loan on a nonrecourse basis: neither the partnership nor its partners assumed any personal liability for repayment of the loan. Pelt later admitted four friends and relatives, respondents Tufts, Steger, Stephens, and Austin, as general partners. None of them contributed capital upon entering the partnership.

The construction of the complex was completed in August 1971. During 1971, each partner made small capital contributions to the partnership; in 1972, however, only Pelt made a contribution. The total of the partners' capital contributions was $44,212. In each tax year, all partners claimed as income tax deductions their allocable shares of ordinary losses and depreciation. The deductions taken by the partners in 1971 and 1972 totalled $439,972. Due to these contributions and deductions, the partnership's adjusted basis in the property in August 1972 was $1,455,740.

In 1971 and 1972, major employers in the Duncanville area laid off significant numbers of workers. As a result, the partnership's rental income was less then expected, and it was unable to make the payments due on the mortgage. Each partner, on August 28, 1972, sold his partnership interest to an unrelated third party, Fred Bayles. As consideration, Bayles agreed to reimburse each partner's sale expenses up to $250; he also assumed the nonrecourse mortgage.

On the date of transfer, the fair market value of the property did not exceed $1,400,000. Each partner reported the sale on his federal income tax return and indicated that a partnership loss of $55,740 had been sustained.[1] The Commissioner of Internal Revenue, on audit, determined that the sale resulted in a partnership capital gain of approximately $400,000. His theory was that the partnership had realized the full amount of the nonrecourse obligation.[2]

Relying on Millar v. Commissioner, 577 F.2d 212, 215 [42 AFTR 2d 78-5246] (CA3), cert. denied, 439 U.S. 1046 (1978), the United States Tax Court, in an unreviewed decision, upheld the asserted deficiencies. 70 T.C. 756 (1978). The United States Court of Appeals for the Fifth Circuit reversed. 651 F.2d 1058 [48 AFTR 2d 81-5660] (1981). That court expressly disagreed with the Millar analysis, and, in limiting Crane v. Commissioner, supra, to its facts, questioned the theoretical underpinnings of the Crane decision. We granted certiorari to resolve the conflict. 456 U.S. 960 (1982).

II

Section 752(d) of the Internal Revenue Code of 1954, 26 U.S.C. §752(d), specifically provides that liabilities incurred in the sale or exchange of a partnership interest are to "be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." Section 1001 governs the determination of gains and losses on the disposition of property. Under §1001(a), the gain or loss from a sale or other disposition of property is defined as the difference between "the amount realized" on the disposition and the property's adjusted basis. Subsection (b) of §1001 defines "amount realized": "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." At issue is the application of the latter provision to the disposition of property encumbered by a nonrecourse mortgage of an amount in excess of the property's fair market value.

A

In Crane v. Commissioner, supra, this Court took the first and controlling step toward the resolution of this issue. Beulah B. Crane was the sole beneficiary under the will of her deceased husband. At his [pg. 83-1135] death in January 1932, he owned an apartment building that was then mortgaged for an amount which proved to be equal to its fair market value, as determined for federal estate tax purposes. The widow, of course, was not personally liable on the mortgage. She operated the building for nearly seven years, hoping to turn it into a profitable venture; during that period, she claimed income tax deductions for depreciation, property taxes, interest, and operating expenses, but did not make payments upon the mortgage principal. In computing her basis for the depreciation deductions, she included the full amount of the mortgage debt. In November 1938, with her hopes unfulfilled and the mortgagee threatening foreclosure, Mrs. Crane sold the building. The purchaser took the property subject to the mortgage and paid Crane $3,000; of that amount, $500 went for the expenses of the sale.

Crane reported a gain of $2,500 on the transaction. She reasoned that her basis in the property was zero (despite her earlier depreciation deductions based on including the amount of the mortgage) and that the amount she realized from the sale was simply the cash she received. The Commissioner disputed this claim. He asserted that Crane's basis in the property, under §113(a)(5) of the Revenue Act of 1938, 52 Stat. 490 (the current version is §1014 of the 1954 Code, as amended, 26 U.S.C. §1014 (1976 ed. and Supp. V)), was the property's fair market value at the time of her husband's death, adjusted for depreciation in the interim, and that the amount realized was the net cash received plus the amount of the outstanding mortgage assumed by the purchaser.

In upholding the Commissioner's interpretation of §113(a)(5) of the 1938 Act,[3] the Court observed that to regard merely the taxpayer's equity in the property as her basis would lead to depreciation deductions less than the actual physical deterioration of the property, and would require the basis to be recomputed with each payment on the mortgage. 331 U.S., at 9—10. The Court rejected Crane's claim that any loss due to depreciation belonged to the mortgagee. The effect of the Court's ruling was that the taxpayer's basis was the value of the property undiminished by the mortgage. Id., at 11.

The Court next proceeded to determine the amount realized under §111(b) of the 1938 Act, 52 Stat. 484 (the current version is §1001(b) of the 1954 Code, 26 USC §1001(b)). In order to avoid the "absurdity," see 331 U.S., at 13, of Crane's realizing only $2,500 on the sale of property worth over a quarter of a million dollars, the Court treated the amount realized as it had treated basis, that is, by including the outstanding value of the mortgage. To do otherwise would have permitted Crane to recognize a tax loss unconnected with any actual economic loss. The Court refused to construe one section of the Revenue Act so as "to frustrate the Act as a whole." Ibid.

Crane, however, insisted that the nonrecourse nature of the mortgage required different treatment. The Court, for two reasons, disagreed. First, excluding the nonrecourse debt from the amount realized would result in the same absurdity and frustration of the code. Id., at 13—14. Second, the Court concluded that Crane obtained an economic benefit from the purchaser's assumption of the mortgage identical to the benefit conferred by the cancellation of personal debt. Because the value of the property in that case exceeded the amount of the mortgage, it was in Crane's economic interest to treat the mortgage as a personal obligation; only by so doing could she realize upon sale the appreciation in her equity represented by the $2,500 boot. The purchaser's assumption of the liability thus resulted in a taxable economic benefit to her, just as if she had been given, in addition to the boot, a sum of cash sufficient to satisfy the mortgage.[4]

In a footnote, pertinent to the present case, the Court observed:

> "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally [pg. 83-1136] liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case." Id., at 14, n. 37.

B

[1] This case presents that unresolved issue. We are disinclined to overrule Crane, and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred. Crane ultimately does not rest on its limited theory of economic benefit; instead, we read Crane to have approved the Commissioner's decision to

treat a nonrecourse mortgage in this context as a true loan. This approval underlies Crane's holdings that the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant.

When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.

Another consequence to the taxpayer from this obligation occurs when the taxpayer applies the loan proceeds to the purchase price of property used to secure the loan. Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan, under §1012, is part of the taxpayer's cost of the property. Although a different approach might have been taken with respect to a nonrecourse mortgage loan,[5] the Commissioner has chosen to accord it the same treatment he gives to a recourse mortgage loan. The Court approved that choice in Crane, and the respondents do not challenge it here. The choice and its resultant benefits to the taxpayer are predicated on the assumption that the mortgage will be repaid in full.

When encumbered property is sold or otherwise disposed of and the purchaser assumes the mortgage, the associated extinguishment of the mortgagor's obligation to repay is accounted for in the computation of the amount realized.[6] See United States v. Hendler, 303 U.S. 564, 566—567 [20 AFTR 1041] (1938). Because no difference between recourse and nonrecourse obligations is recognized in calculating basis,[7] Crane teaches that the Commissioner [pg. 83-1137]may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property.[8] The Commissioner's interpretation of §1001(b) in this fashion cannot be said to be unreasonable.

C

The Commissioner in fact has applied this rule even when the fair market value of the property falls below the amount of the nonrecourse obligation. Treas. Reg. §1.1001-2(b), 26 CFR §1.1001-2(b) (1982);[9] Rev.Rul. 76-111, 1976-1 Cum. Bull. 214. Because the theory on which

the rule is based applies equally in this situation, see Millar v. Commissioner, 67 T.C. 656, 660 (1977), aff'd on this issue, 577 F.2d 212, 215-216 [42 AFTR 2d 78-5246] (CA3), cert. denied, 439 U.S. 1046 (1978);[10] Mendham Corp. v. Commissioner, 9 T.C. 320 323-324 (1947); Lutz & Schramm Co. v. Commissioner, 1 T.C. 682, 688-689 (1943), we have no reason, after Crane, to question this treatment.[11] [pg. 83-1138]

Respondents received a mortgage loan with the concomitant obligation to repay by the year 2012. The only difference between that mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property.[12] If the fair market value of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property to the mortgagee and be relieved of his obligation.

This, however, does not erase the fact that the mortgagor received the loan proceeds tax-free and included them in his basis on the understanding that he had an obligation to repay the full amount. See Woodsam Associates, Inc. v. Commissioner, 198 F.2d 357, 359 [42 AFTR 505] (CA2 1952); Bittker, 33 Tax. L. Rev., at 284. When the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he originally received and thus realizes value to that extent within the meaning of §1001(b). From the mortgagor's point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee on a nonrecourse basis, and then had used the cash to satisfy his obligation to the mortgagee.

Moreover, this approach avoids the absurdity the Court recognized in Crane. Because of the remedy accompanying the mortgage in the nonrecourse situation, the depreciation in the fair market value of the property is relevant economically only to the mortgagee, who by lending on a nonrecourse basis remains at risk. To permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss.[13] Such a result would be to construe "one section of the Act ... so as ... to defeat the intention of another or to frustrate the Act as a whole." 331 U.S., at 13.

In the specific circumstances of Crane, the economic benefit theory did support the Commissioner's treatment of the nonrecourse mortgage as a personal obligation. The footnote in Crane acknowledged the limitations of that theory when applied to a different set of facts. Crane also stands for the broader proposition, however, that a nonrecourse loan should be treated as a true loan. We therefore hold that a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis. Nothing in either §1001(b) or in the Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property

asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property. See Estate of Levine v. Commissioner, 634 F.2d 12, 15 [46 AFTR 2d 80-5349] (CA2 1980).

III

Relying on the Code's §752(c), 26 U.S.C. §752(c), however, respondents argue that Congress has provided for precisely this type of asymmetrical treatment in the sale or disposition of partnership property. Section 752 prescribes the tax treatment of certain partnership transactions,[14] and [pg. 83-1139]§752(c) provides that "[f]or purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property." Section 752(c) could be read to apply to a sale or disposition of partnership property, and thus to limit the amount realized to the fair market value of the property transferred. Inconsistent with this interpretation, however, is the language of §752(d), which specifically mandates that partnership liabilities be treated "in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." The apparent conflict of these subsections renders the facial meaning of the statute ambiguous, and therefore we must look to the statute's structure and legislative history.

Subsections (a) and (b) of §752 prescribe rules for the treatment of liabilities in transactions between a partner and his partnership, and thus for determining the partner's adjusted basis in his partnership interest. Under §704(d), a partner's distributive share of partnership losses is limited to the adjusted basis of his partnership interest. 26 U.S.C. §704(d) (1976 ed., Supp. V); see Perry, Limited Partnerships and Tax Shelters: The Crane Rule Goes Public, 27 Tax L. Rev. 525, 543 (1972). When partnership liabilities are increased or when a partner takes on the liabilities of the partnership, §752(a) treats the amount of the increase or the amount assumed as a contribution by the partner to the partnership. This treatment results in an increase in the adjusted basis of the partner's interest and a concomitant increase in the §704(d) limit on his distributive share of any partnership loss. Conversely, under §752(b), a decrease in partnership liabilities or the assumption of a partner's liabilities by the partnership has the effect of a distribution, thereby reducing the limit on the partner's distributive share of the partnership's losses. When property encumbered by liabilities is contributed to or distributed from the partnership, §752(c) prescribes that the liability shall be considered to be assumed by the transferee only to the extent of the property's fair market value. Treas. Reg. §1.752-1(c), 26 CFR §1.752-1(c) (1982).

The legislative history indicates that Congress contemplated this application of §752(c). Mention of the fair market value limitation occurs only in the context of transactions under subsections (a) and (b).[15] The sole reference to subsection (d) does not discuss the limitation.[16] While the legislative history is certainly not conclusive, it indicates that the fair market value limitation of §752(c) was directed to transactions between a partner and his partnership.[17] 1 A. Willis, J. Pennell, & P.

Postlewaite, [pg. 83-1140] Partnership Taxation §44.03, p. 44-3 (3d ed. 1981); Simmons, Tufts v. Commissioner: Amount Realized Limited to Fair Market Value, 15 U.C.D. L. Rev. 577, 611-613 (1982).

By placing a fair market value limitation on liabilities connected with property contributions to and distributions from partnerships under subsections (a) and (b), Congress apparently intended §752(c) to prevent a partner from inflating the basis of his partnership interest. Otherwise, a partner with no additional capital at risk in the partnership could raise the §704(d) limit on his distributive share of partnership losses or could reduce his taxable gain upon disposition of his partnership interest. See Newman, The Resurgence of Footnote 37: Tufts v. Commissioner, 18 Wake Forest L. Rev. 1, 16, n. 116 (1982). There is no potential for similar abuse in the context of §752(d) sales of partnership interests to unrelated third parties. In light of the above, we interpret subsection (c) to apply only to §752(a) and (b) transactions, and not to limit the amount realized in a sale or exchange of a partnership interest under §752(d).

IV

When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation. We find this interpretation to be consistent with Crane v. Commissioner, 331 U.S. 1 (1947), and to implement the statutory mandate in a reasonable manner. National Muffler Dealers Assn. v. United States, 440 U.S., 472, 476 [43 AFTR 2d 79-828] (1979).

The judgment of the Court of Appeals is therefore reversed.

It is so ordered.

Judge: Justice O'CONNOR, concurring.

I concur in the opinion of the Court, accepting the view of the Commissioner. I do not, however, endorse the Commissioner's view. Indeed, were we writing on a slate clean except for the Crane decision, I would take quite a different approach—that urged upon us by Professor Barnett as amicus.

Crane established that a taxpayer could treat property as entirely his own, in spite of the "coinvestment" provided by his mortgagee in the form of a nonrecourse loan. That is, the full basis of the property, with all its tax consequences, belongs to the mortgagor. That rule alone, though, does not in any weay tie nonrecourse debt to the cost of property or to the proceeds upon disposition. I see no reason to treat the purchase, ownership, and eventual disposition of property differently because the taxpayer also takes out a mortgage, an independent transaction. In this

case, the taxpayer purchased property, using nonrecourse financing, and sold it after it declined in value to a buyer who assumed the mortgage. There is no economic difference between the events in this case and a case in which the taxpayer buys property with cash; later obtains a nonrecourse loan by pledging the property as security; still later, using cash on hand, buys off the mortgage for the market value of the devalued property; and finally sells the property to a third party for its market value.

The logical way to treat both this case and the hypothesized case is to separate the two aspects of these events and to consider, first, the ownership and sale of the property, and, second, the arrangement and retirement of the loan. Under Crane, the fair market value of the property on the date of acquisition—the purchase price—represents the taxpayer's basis in the property, and the fair market value on the date of disposition represents the proceeds on sale. The benefit received by the taxpayer in return for the property is the cancellation of a mortgage that is worth no more than the fair market value of the property, for that is all the mortgagee can expect to collect on the mortgage. His gain or loss on the disposition of the property equals the difference between the proceeds and the cost of acquisition. Thus, the taxation of the transaction in property reflects the economic fate of the property. If the property has declined in value, as was the case here, the taxpayer recognizes a loss on the disposition of the property. The new purchaser then takes as his basis the fair market value as of the date of the sale. See, e.g., United States v. Davis, 370 U.S. 65, 72 [9 AFTR 2d 1625] (1962); Gibson Products Co. v. United States, 637 F. 2d 1041, 1045, n. 8 [47 AFTR 2d 81-863] (CA5 1981) (dictum); see generally Treas. Reg. §1.1001-2(a)(3), 26 CFR §1.1001-2(a)(3) (1982); B. Bittker, 2 Federal Income [pg. 83-1141] Taxation of Income, Estates and Gifts, ¶41.2.2, at 41-10-41-11 (1981).

In the separate borrowing transaction, the taxpayer acquires cash from the mortgagee. He need not recognize income at that time, of course, because he also incurs an obligation to repay the money. Later, though, when he is able to satisfy the debt by surrendering property that is worth less than the face amount of the debt, we have a classic situation of cancellation of indebtedness, requiring the taxpayer to recognize income in the amount of the difference between the proceeds of the loan and the amount for which he is able to satisfy his creditor. 26 U.S.C. §61(a)(12). The taxation of the financing transaction then reflects the economic fate of the loan.

The reason that separation of the two aspects of the events in this case is important is, of course, that the Code treats different sorts of income differently. A gain on the sale of the property may qualify for capital gains treatment, §§1202, 1221 (1976 ed. and Supp. V), while the cancellation of indebtedness is ordinary income, but income that the taxpayer may be able to defer. §§108, 1017 (1976 ed. Supp. V). Not only does Professor Barnett's theory permit us to accord appropriate treatment to each of the two types of income or loss present in these sorts of transactions, it also restores continuity to the system by making the taxpayer-seller's proceeds on the disposition of property equal to the purchaser's basis in the property. Further, and most important, it allows us to

tax the events in this case in the same way that we tax the economically identical hypothesized transaction.

Persuaded though I am by the logical coherence and internal consistency of this approach, I agree with the Court's decision not to adopt it judicially. We do not write on a slate marked only by Crane. The Commissioner's longstanding position, Rev. Rul. 76-111, 1976-1 C.B. 214, is now reflected in the regulations. Treas. Reg. §1.1001-2, 26 CFR §1.1001-2 (1982). In the light of the numerous cases in the lower courts including the amount of the unrepaid proceeds of the mortgage in the proceeds on sale or disposition, see, e.g., Estate of Levine v. Commissioner, 634 F. 2d 12, 15 [46 AFTR 2d 80-5349] (CA2 1980); Millar v. Commissioner, 577 F. 2d 212 [42 AFTR 2d 78-5246] (CA3), cert. denied, 439 U.S. 1046 (1978); Estate of Delman v. Commissioner, 73 T.C. 15, 28-30 (1979); Peninsula Properties Co., Ltd v. Commissioner, 47 B.T.A. 84, 92 (1942), it is difficult to conclude that the Commissioner's interpretation of the statute exceeds the bounds of his discretion. As the Court's opinion demonstrates, his interpretation is defensible. One can reasonably read §1001(b)'s reference to "the amount realized *from* the sale or other disposition of property" (emphasis added) to permit the Commissioner to collapse the two aspects of the transaction. As long as his view is a reasonable reading of §1001(b), we should defer to the regulations promulgated by the agency charged with interpretation of the statute. National Muffler Dealers Association v. United States, 440 U.S. 472, 488-489 [43 AFTR 2d 79-828] (1979); United States v. Correll, 389 U.S. 299, 307 [20 AFTR 2d 5845] (1967); see also Fulman v. United States, 434 U.S. 528, 534 [41 AFTR 2d 78-698] (1978). Accordingly, I concur.

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1 The loss was the difference between the adjusted basis, $1,455,740, and the fair market value of the property, $1,400,000. On their individual tax returns, the partners did not claim deductions for their respective shares of this loss. In their petitions to the Tax Court, however, the partners did claim the loss.

2 The Commissioner determined the partnership's gain on the sale by subtracting the adjusted basis, $1,455,740, from the liability assumed by Bayles, $1,851,500. Of the resulting figure, $395,760, the Commissioner treated $348,661 as capital gain, pursuant to §741 of the Internal Revenue Code of 1954, 26 U.S.C. §741, and $47,099 as ordinary gain under the recapture provisions of §1250 of the Code. The application of §1250 in determining the character of the gain is not at issue here.

3 Section 113 (a)(5) defined the basis of "property ... acquired by ... devise ... or by the decedent's estate from the decedent" as "the fair market value of such property at the time of such acquisition." The Court interpreted the term "property" to refer to the physical land and

buildings owned by Crane or the aggregate of her rights to control and dispose of them. 331 U.S., at 6.

4 Crane also argued that even if the statute required the inclusion of the amount of the nonrecourse debt, that amount was not Sixteenth Amendment income because the overall transaction had been "by all dictates of common sense ... a ruinous disaster." Brief for Petitioner in Crane v. Commissioner, O.T. 1946, No. 68, p. 51. The Court noted, however, that Crane had been entitled to and actually took depreciation deductions for nearly seven years. To allow her to exclude sums on which those deductions were based from the calculation of her taxable gain would permit her "a double deduction ... on the same loss of assets." The Sixteenth Amendment, it was said, did not require that result. 331 U.S., at 15—16.

5 The Commissioner might have adopted the theory, implicit in Crane's contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee. Note, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum. to. Rev. 1498, 1514 (1982); Lurie, Mortgagor's Gain on Mortgaging Property for More than Cost Without Personal Liability, 6 Tax. L. Rev. 319, 323 (1951); cf. Brief for Respondents 16 (nonrecourse debt resembles preferred stock). Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis. Note, 82 Colum. L. Rev., at 1515; cf. Gibson Products Co. v. United States, 637 F.2d 1041, 1047-1048 [47 AFTR 2d 81-863] (CA5 1981) (contingent nature of obligation prevents inclusion in basis of oil and gas leases of nonrecourse debt secured by leases, drilling equipment, and percentage of future production).

We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and Crane were not on the books, whether that approach would be preferred over Crane's analysis. We note only that the Crane Court's resolution of the basis issue presumed that when property is purchased with proceeds from a nonrecourse mortgage, the purchaser becomes the sole owner of the property. 331 U.S., at 6. Under the Crane approach, the mortgage is entitled to no portion of the basis. Id., at 10, n. 28. The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee. But see Note, 82 Colum. L. Rev., at 1513 (treating nonrecourse mortgage as coinvestment by mortgagee and critically concluding that Crane departed from traditional analysis that basis is taxpayer's investment in property).

6 In this case, respondents received the face value of their note as loan proceeds. If respondents initially had given their note at a discount, the amount realized on the sale of the

securing property might be limited to the funds actually received. See Commissioner v. Rail Joint Co., 61 F.2d 751, 752 [11 AFTR 989] (CA2 1932) (cancellation of indebtedness); Fashion Park, Inc. v. Commissioner, 21 T.C. 600, 606 (1954) (same). See generally J. Sneed, The Configurations of Gross Income 319 (1967) ("[I]t appears settled that the reacquisition of bonds at a discount by the obligor results in gain only to the extent the issue price, where this is less than par, exceeds the cost of reacquisition").

7 The Commissioner's choice in Crane "laid the foundation stone of most tax shelters," Bittker, Tax Shelters, Nonrecourse Debt, and the Crane Case, 33 Tax. L. Rev. 277, 283 (1978), by permitting taxpayers who bear no risk to take deductions on depreciable property. Congress recently has acted to curb this avoidance device by forbidding a taxpayer to take depreciation deductions in excess of amounts he has at risk in the investment. Pub. L. 94—455, §204(a), 90 Stat. 1531 (1976), 26 USC §465; Pub. L. 95—600, §§201—204, 92 Stat. 2814—2817 (1978), 26 USC §465(a)((1976 ed., Supp. V). Real estate investments, however, are exempt from this prohibition. §465(c)(3)(D) (1976 ed., Supp. V). Although this congressional action may foreshadow a day when nonrecourse and recourse debts will be treated differently, neither Congress nor the Commissioner has sought to alter Crane's rule of including nonrecourse liability in both basis and the amount realized.

8 Although the Crane rule has some affinity with the tax benefit rule, see Bittker, supra, at 282; Del Cotto, Sales and Other Dispositions of Property Under Section 1001: The Taxable Event, Amount Realized and Related Problems of Basis, 26 Buffalo L. Rev. 219, 323-324 (1977), the analysis we adopt is different. Our analysis applies even in the situation in which no deductions are taken. It focuses on the obligation to repay and its subsequent extinguishment, not on the taking and recovery of deductions. See generally Note, 82 Column L. Rev., at 1526-1529.

9 The regulation was promulgated while this case was pending before the Court of Appeals for the Fifth Circuit. T.D. 7741, 45 Fed. Reg. 81743, 1981-1 Cum. Bull. 430 (1980). It merely formalized the Commissioner's prior interpretation, however.

10 The Court of Appeals for the Third Circuit in Millar affirmed the Tax Court on the theory that inclusion of nonrecourse liability in the amount realized was necessary to prevent the taxpayer from enjoying a double deduction. 577 F.2d, at 215; cf. n. 4, supra. Because we resolve the question on another ground, we do not address the validity of the double deduction rationale.

11 Professor Wayne G. Barnett, as a amicus in the present case, argues that the liability and property portions of the transaction should be accounted for separately. Under his view, there was a transfer of the property for $1.4 million, and there was a cancellation of the $1.85 million obligation for a payment of $1.4 million. The former resulted in a capital loss of $50,000, and the latter in the realization of $450,000 of ordinary income. Taxation of the ordinary income

might be deferred under §108 by a reduction of respondents' bases in their partnership interests.

Although this indeed could be a justifiable mode of analysis, it has not been adopted by the Commissioner. Nor is there anything to indicate that the Code requires the Commissioner to adopt it. We note that Professor Barnett's approach does assume that recourse and nonrecourse debt may be treated identically.

The Commissioner also has chosen not to characterize the transaction as cancellation of indebtedness. We are not presented with and do not decide the contours of the cancellation-of-indebtedness doctrine. We note only that our approach does not fall within certain prior interpretations of that doctrine. In one view, the doctrine rests on the same initial premise as our analysis here—an obligation to repay—but the doctrine relies on a freeing-of-assets theory to attribute ordinary income to the debtor upon cancellation. See Commissioner v. Jacobson, 336 U.S. 28, 38-40 [37 AFTR 516] (1949); United States v. Kirby Lumber Co., 284 U.S. 1, 3 [10 AFTR 458] (1931). According to that view, when nonrecourse debt is forgiven, the debtor's basis in the securing property is reduced by the amount of debt canceled, and realization of income is deferred until the sale of the property. See Fulton Gold Corp. v. Commissioner, 31 B.T.A. 519, 520 (1934). Because that interpretation attributes income only when assets are freed, however, an insolvent debtor realizes income just to the extent his assets exceed his liabilities after the cancellation. Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 292 (1937). Similarly, if the nonrecourse indebtedness exceeds the value of the securing property, the taxpayer never realizes the full amount of the obligation canceled because the tax law has not recognized negative basis.

Although the economic benefit prong of Crane also relies on a freeing-of-assets theory, that theory is irrelevant to our broader approach. In the context of a sale or disposition of property under §1001, the extinguishment of the obligation to repay is not ordinary income; instead, the amount of the canceled debt is included in the amount realized, and enters into the computation of gain or loss on the disposition of property. According to Crane, this treatment is no different when the obligation is nonrecourse: the basis is not reduced as in the cancellation-of-indebtedness context, and the full value of the outstanding liability is included in the amount realized. Thus the problem of negative basis is avoided.

12 In his opinion for the Court of Appeals in Crane, Judge Learned Hand observed:

"[The mortgagor] has all the income from the property; he manages it; he may sell it; any increase in its value goes to him; any decrease falls on him, until the value goes below the amount of the lien ... When therefore upon a sale the mortgagor makes an allowance to the vendee of the amount of the lien, he secures a release from a charge upon his property quite

as though the vendee had paid him the full price on condition that before he took title the lien should be cleared ..." 153 F.2d 504, 506 [34 AFTR 894] (CA 2 1945).

13 In the present case, the Government bore the ultimate loss. The nonrecourse mortgage was extended to respondents only after the planned complex was endorsed for mortgage insurance under §§221(b) and (d)(4) of the National Housing Act, 12 U.S.C. §1715l(b) and (d)(4) (1976 ed. and Supp. V). After acquiring the complex from respondents, Bayles operated it for a few years, but was unable to make it profitable. In 1974, F&H foreclosed, and the Department of Housing and Urban Development paid off the lender to obtain title. In 1976, the Department sold the complex to another developer for $1,502,000. The sale was financed by the Department's taking back a note for $1,314,800 and a nonrecourse mortgage. To fail to recognize the value of the nonrecourse loan in the amount realized, therefore, would permit respondents to compound the Government's loss by claiming the tax benefits of that loss for themselves.

14 Section 752 provides:

("(a)) Increase in partner's liabilities

"Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

("(b)) Decrease in partner's liabilities

"Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

("(c)) Liability to which property is subject

"For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

("(d)) Sale or exchange of an interest

"In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships."

15 "The transfer of property subject to a liability by a partner to a partnership, or by the partnership to a partner, shall, to the extent of the fair market value of such property, be considered a transfer of the amount of the liability along with the property." H. R. Rep. No. 1337, 83d Cong., 2d Sess., A236 (1954); S. Rep. No. 1622, (3d Cong., 2d Sess., 405 (1954).

16 "When a partnership interest is sold or exchanged, the general rule for the treatment of the sale or exchange of property subject to liabilities will be applied." H. R. Rep. No. 1337, at A236-A237; S. Rep. No. 1622, at 405. These Reports then set out an example of subsection (d)'s application, which does not indicate whether the debt is recourse or nonrecourse.

17 The Treasury Regulations support this view. The regulations interpreting §752(c) state: "Where property subject to a liability is contributed by a partner to a partnership, or distributed by a partnership to a partner, the amount of the liability, to an extent not exceeding the fair market value of the property at the time of the contribution or distribution, shall be considered as a liability assumed by the transferee." §1.752-1(c), 26 CFR §1.752-1(c) (1982). The regulations also contain an example applying the fair market limitation to a contribution of encumbered property by a partner to a partnership. Ibid. The regulations interpreting §752(d) make no mention of the fair market limitation. §752-1(d). Both regulations were issued contemporaneously with the passage of the statute, T.D. 6175, 1956-1 Cum. Bull. 211, and are entitled to deference as an administrative interpretation of the statute. See Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501 [36 AFTR 604] (1948).

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Internal Revenue Code

§ 704 Partner's distributive share.

(a) Effect of partnership agreement.

A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) Determination of distributive share.

A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1)

the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2)

the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

(c) Contributed property.

(1) In general.

Under regulations prescribed by the Secretary—

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution,

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed—

(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

(ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and

(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph , and

(C) if any property so contributed has a built-in loss—

(i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and

(ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution.

For purposes of subparagraph (C) , the term "built-in loss" means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over

its fair market value at the time of contribution.

(2) Special rule for distributions where gain or loss would not be recognized outside partnerships.

Under regulations prescribed by the Secretary, if—

(A) property contributed by a partner (hereinafter referred to as the "contributing partner") is distributed by the partnership to another partner, and

(B) other property of a like kind (within the meaning of section 1031) is distributed by the partnership to the contributing partner not later than the earlier of—

(i) the 180th day after the date of the distribution described in subparagraph (A) , or

(ii) the due date (determined with regard to extensions) for the contributing partner's return of the tax imposed by this chapter for the taxable year in which the distribution described in subparagraph (A) occurs,

then to the extent of the value of the property described in subparagraph (B) , paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B) .

(3) Other rules.

Under regulations prescribed by the Secretary, rules similar to the rules of paragraph (1) shall apply to contributions by a partner (using the cash receipts and disbursements method of accounting) of accounts payable and other accrued but unpaid items. Any reference in paragraph (1) or (2) to the contributing partner shall be treated as including a reference to any successor of such partner.

(d)

(1) In general.

A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred.

(2) Carryover.

Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

(3) Special rules.

(A) In general. In determining the amount of any loss under paragraph (1) , there shall be taken into account the partner's distributive share of amounts described in paragraphs (4) and (6) of section 702(a) .

(B) Exception. In the case of a charitable contribution of property whose fair market value exceeds its adjusted basis, subparagraph (A) shall not apply to the extent of the partner's distributive share of such excess.

(e) Partnership interests created by gift.

(1) Distributive share of donee includible in gross income.

In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(2) Purchase of interest by member of family.

For purposes of this subsection , an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The “family” of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

(f) Cross reference.

For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see section 706(c)(2) .

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Federal Regulations

Reg § 1.704-1. Partner's distributive share.

Caution: The Treasury has not yet amended Reg § 1.704-1 to reflect changes made by P.L. 114-74, P.L. 101-239, P.L. 98-369

Effective: January 11, 2021. For dates of applicability, see §§1.245A(e)-1(h)(2) , 1.704-1(b)(1)(ii)(b)(1) , 1.861-8(h) , 1.861-9(k) , 1.861-12(k) , 1.861-14(k) , 1.861-17(h) , 1.861-20(i) , 1.881-3(f) , 1.904-4(q) , 1.904-6(g) , 1.904(b)-3(f) , 1.904(g)-3(l) , , 1.905-4(f) , 1.905-5(f) , 1.951A-7(d) , 1.954-1(h) , 1.954-2(i) , 1.960-7 , 1.965-9 , 1.1502-4(f) , and 301.6689-1(e) .

(a) Effect of partnership agreement. A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) Determination of partner's distributive share.

(0) Cross-references.

Heading	Section
Cross-references	1.704-1(b)(0)
In general	1.704-1(b)(1)
Basic principles	1.704-1(b)(1)(i)
Effective dates	1.704-1(b)(1)(ii)
Generally	1.704-1(b)(1)(ii)(a)
Foreign tax expenditures	1.704-1(b)(1)(ii)(b)

Heading	Section
In general	1.704-1(b)(1)(ii)(b)(1)
Special rules for certain interbranch payments	1.704-1(b)(1)(ii)(b)(3)
Effect of other sections	1.704-1(b)(1)(iii)
Other possible tax consequences	1.704-1(b)(1)(iv)
Purported allocations	1.704-1(b)(1)(v)
Section 704(c) determinations	1.704-1(b)(1)(vi)
Bottom line allocations	1.704-1(b)(1)(vii)
Substantial economic effect	1.704-1(b)(2)
Two-part analysis	1.704-1(b)(2)(i)
Economic effect	1.704-1(b)(2)(ii)
Fundamental principles	1.704-1(b)(2)(ii)(a)
Three requirements	1.704-1(b)(2)(ii)(b)
Obligation to restore deficit	1.704-1(b)(2)(ii)(c)
Alternate test for economic effect	1.704-1(b)(2)(ii)(d)
Partial economic effect	1.704-1(b)(2)(ii)(e)
Reduction of obligation to restore	1.704-1(b)(2)(ii)(f)
Liquidation defined	1.704-1(b)(2)(ii)(g)
Partnership agreement defined	1.704-1(b)(2)(ii)(h)
Economic effect equivalence	1.704-1(b)(2)(ii)(i)
Substantiality	1.704-1(b)(2)(iii)
General rules	1.704-1(b)(2)(iii)(a)
Shifting tax consequences	1.704-1(b)(2)(iii)(b)
Transitory allocations	1.704-1(b)(2)(iii)(c)
Maintenance of capital accounts	1.704-1(b)(2)(iv)
In general	1.704-1(b)(2)(iv)(a)
Basic rules	1.704-1(b)(2)(iv)(b)
Treatment of liabilities	1.704-1(b)(2)(iv)(c)
Contributed property	1.704-1(b)(2)(iv)(d)
In general	1.704-1(b)(2)(iv)(d)(1)
Contribution of promissory notes	1.704-1(b)(2)(iv)(d)(2)
Section 704(c) considerations	1.704-1(b)(2)(iv)(d)(3)
Exercise of noncompensatory options.	1.704-1(b)(2)(iv)(d)(4)
Distributed property	1.704-1(b)(2)(iv)(e)
In general	1.704-1(b)(2)(iv)(e)(1)

Heading	Section
Distribution of promissory notes	1.704-1(b)(2)(iv)(e)(2)
Revaluations of property	1.704-1(b)(2)(iv)(f)
Adjustments to reflect book value	1.704-1(b)(2)(iv)(g)
In general	1.704-1(b)(2)(iv)(g)(1)
Payables and receivables	1.704-1(b)(2)(iv)(g)(2)
Determining amount of book items	1.704-1(b)(2)(iv)(g)(3)
Determinations of fair market value	1.704-1(b)(2)(iv)(h)
In general	1.704-1(b)(2)(iv)(h)(1)
Adjustments for noncompensatory options.	1.704-1(b)(2)(iv)(h)(2)
Section 705(a)(2)(B) expenditures	1.704-1(b)(2)(iv)(i)
In general	1.704-1(b)(2)(iv)(i)(1)
Expenses described in section 709	1.704-1(b)(2)(iv)(i)(2)
Disallowed losses	1.704-1(b)(2)(iv)(i)(3)
Basic adjustments to section 38 property	1.704-1(b)(2)(iv)(j)(1)
Depletion of oil and gas properties	1.704-1(b)(2)(iv)(k)
In general	1.704-1(b)(2)(iv)(k)(1)
Simulated depletion	1.704-1(b)(2)(iv)(k)(2)
Actual depletion	1.704-1(b)(2)(iv)(k)(3)
Effect of book values	1.704-1(b)(2)(iv)(k)(4)
Transfers of partnership interests	1.704-1(b)(2)(iv)(l)
Section 754 elections	1.704-1(b)(2)(iv)(m)
In general	1.704-1(b)(2)(iv)(m)(1)
Section 743 adjustments	1.704-1(b)(2)(iv)(m)(2)
Section 732 adjustments	1.704-1(b)(2)(iv)(m)(3)
Section 734 adjustments	1.704-1(b)(2)(iv)(m)(4)
Limitations on adjustments	1.704-1(b)(2)(iv)(m)(5)
Partnership level characterization	1.704-1(b)(2)(iv)(n)
Guaranteed payments	1.704-1(b)(2)(iv)(o)
Minor discrepancies	1.704-1(b)(2)(iv)(p)
Adjustments where guidance is lacking	1.704-1(b)(2)(iv)(q)
Restatement of capital accounts	1.704-1(b)(2)(iv)(r)

Heading	Section
Adjustments on the exercise of a noncompensatory option	1.704-1(b)(2)(iv)(s)
Partner's interest in the partnership	1.704-1(b)(3)
In general	1.704-1(b)(3)(i)
Factors considered	1.704-1(b)(3)(ii)
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Special rules	1.704-1(b)(4)
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Excess percentage depletion	1.704-1(b)(4)(iii)
Allocations Attributable to nonrecourse liabilities	1.704-1(b)(4)(iv)
Allocations under section 613A(c)(7)(D)	1.704-1(b)(4)(v)
Amendments to partnership agreement	1.704-1(b)(4)(vi)
Recapture	1.704-1(b)(4)(vii)
Allocation of creditable foreign taxes	1.704-1(b)(4)(viii)
In general	1.704-1(b)(4)(viii)(a)
Creditable foreign tax expenditures (CFTEs)	1.704-1(b)(4)(viii)(b)
Income to which CFTEs relate	1.704-1(b)(4)(viii)(c)
In general	1.704-1(b)(4)(viii)(c)(1)
CFTE category	1.704-1(b)(4)(viii)(c)(2)
Net income in a CFTE category	1.704-1(b)(4)(viii)(c)(3)
CFTE category share of income	1.704-1(b)(4)(viii)(c)(4)
No net income in a CFTE category	1.704-1(b)(4)(viii)(c)(5)
Allocation and apportionment of CFTEs to CFTE categories	1.704-1(b)(4)(viii)(d)
In general	1.704-1(b)(4)(viii)(d)(1)
Timing and base differences	1.704-1(b)(4)(viii)(d)(2)
Special rules for certain interbranch payments	1.704-1(b)(4)(viii)(d)(3)
Allocations with respect to noncompensatory options	1.704-1(b)(4)(ix)
Corrective allocations	1.704-1(b)(4)(x)
Examples	1.704-1(b)(5)
Examples	1.704-1(b)(6)

(1) In general.

(i) Basic principles. Under section 704(b) if a partnership agreement does not provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, or if the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner but such allocation does not have substantial economic effect, then the partner's distributive share of such income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances). If the partnership agreement provides for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner, there are three ways in which such allocation will be respected under section 704(b) and this paragraph. First, the allocation can have substantial economic effect in accordance with paragraph (b)(2) of this section. Second, taking into account all facts and circumstances, the allocation can be in accordance with the partner's interest in the partnership. See paragraph (b)(3) of this section. Third, the allocation can be deemed to be in accordance with the partner's interest in the partnership pursuant to one of the special rules contained in paragraph (b)(4) of this section and §1.704-2. To the extent an allocation under the partnership agreement of income, gain, loss, deduction, or credit (or item thereof) to a partner does not have substantial economic effect, is not in accordance with the partner's interest in the partnership, and is not deemed to be in accordance with the partner's interest in the partnership, such income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner's interest in the partnership (determined under paragraph (b)(3) of this section).

(ii) Effective/applicability date.

(a) Generally. Except as otherwise provided in this section, the provisions of this paragraph are effective for partnership taxable years beginning after December 31, 1975. However, for partnership taxable years beginning after December 31, 1975, but before May 1, 1986, (January 1, 1987, in the case of allocations of nonrecourse deductions as defined in paragraph (b)(4)(iv)(a) of this section) an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that is not respected under this paragraph nevertheless will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of this paragraph in effect for partnership taxable years beginning before May 1, 1986. Paragraphs (b)(2)(iii)(a) (last sentence), (b)(2)(iii)(d), (b)(2)(iii)(e), and (b)(5) Example 28, Example 29, and Example 30 of this section. The last sentence of paragraph (b)

(2)(iv)(g)(3) of this section is applicable for partnership taxable years ending on or after September 24, 2019. However, a partnership may choose to apply the last sentence in paragraph (b)(2)(iv)(g)(3) of this section for the partnership's taxable years ending on or after September 28, 2017. A partnership may rely on the last sentence in paragraph (b)(2)(iv)(g)(3) of this section in regulation project REG-104397-18 (2018-41 I.R.B. 558) (see §601.601(d)(2)(ii)(b) of this chapter) for the partnership's taxable years ending on or after September 28, 2017, and ending before the partnership's taxable year that includes September 24, 2019. Furthermore, the last sentence of paragraph (b)(2)(ii)(b)(3) of this section and paragraphs (b)(2)(ii)(b)(4) through (7) and (b)(2)(ii)(c) of this section apply to partnership taxable years ending on or after October 9, 2019. However, taxpayers may apply the last sentence of paragraph (b)(2)(ii)(b)(3) of this section and paragraphs (b)(2)(ii)(b)(4) through (7) and (b)(2)(ii)(c) of this section for partnership taxable years ending on or after October 5, 2016. For partnership taxable years ending before October 9, 2019, see §1.704-1 as contained in 26 CFR part 1 revised as of April 1, 2019.

(b) Rules relating to foreign tax expenditures.

(1) In general. Except as otherwise provided in this paragraph (b)(1)(ii)(b)(1), the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section (regarding the allocation of creditable foreign taxes) apply for partnership taxable years beginning on or after October 19, 2006. The rules that apply to allocations of creditable foreign taxes made in partnership taxable years beginning before October 19, 2006 are contained in §1.704-1T(b)(1)(ii)(b)(1) and (b)(4)(xi) as in effect before October 19, 2006 (see 26 CFR part 1 revised as of April 1, 2005). However, taxpayers may rely on the provisions of paragraphs (b)(3)(iv) and (b)(4)(viii) of this section for partnership taxable years beginning on or after April 21, 2004. Except as provided in the next sentence, the provisions of paragraphs (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and (iii), (b)(4)(viii)(c)(3) and (4), and (b)(4)(viii)(d)(1) (as in effect on July 24, 2019) and in paragraphs (b)(6)(i), (ii), and (iii) of this section (Examples 1, 2, and 3) apply for partnership taxable years that both begin on or after January 1, 2016, and end after February 4, 2016. For partnership taxable years beginning after December 31, 2019, paragraph (b)(4)(viii)(d)(1) of this section applies. For the rules that apply to partnership taxable years beginning on or after October 19, 2006, and before January 1, 2016, and to taxable years that both begin on or after January 1, 2016, and end on or before February 4, 2016, see § 1.704-1(b)(1)(ii)(b), (b)(4)(viii)(a)(1), (b)(4)(viii)(c)(1), (b)(4)(viii)(c)(2)(ii) and (iii), (b)(4)

(viii)(c)(3) and (4), (b)(4)(viii)(d)(1), and (b)(5), Example 25 (as contained in 26 CFR part 1 revised as of April 1, 2015).

(2) Transition rule. Transition relief is provided herein to partnerships whose agreements were entered into prior to April 21, 2004. In such case, if there has been no material modification to the partnership agreement on or after April 21, 2004, then the partnership may apply the provisions of paragraph (b) of this section as if the amendments made by paragraphs (b)(3)(iv) and (b)(4)(viii) of this section had not occurred. If the partnership agreement was materially modified on or after April 21, 2004, then the rules provided in paragraphs (b)(3)(iv) and (b)(4)(viii) of this section shall apply to the later of the taxable year beginning on or after October 19, 2006 or the taxable year within which the material modification occurred, and to all subsequent taxable years. If the partnership agreement was materially modified on or after April 21, 2004, and before a tax year beginning on or after October 19, 2006, see §§1.704-1T(b)(1)(ii)(b)(1) and 1.704-1T(b)(4)(xi) as in effect prior to October 19, 2006 (26 CFR part 1 revised as of April 1, 2005). For purposes of this paragraph (b)(1)(ii)(b)(2), any change in ownership constitutes a material modification to the partnership agreement. This transition rule does not apply to any taxable year (and all subsequent taxable years) in which persons that are related to each other (within the meaning of section 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party.

(3) Special rules for certain inter-branch payments.

(i) In general. The provisions of §1.704-1(b)(4)(viii)(d)(3) apply for partnership taxable years ending after February 9, 2015. See 26 CFR 1.704-1T(b)(4)(viii)(d)(3) (revised as of April 1, 2014) for rules applicable to taxable years beginning on or after January 1, 2012, and ending on or before February 9, 2015.

(ii) Transition rule. Transition relief is provided by this paragraph (b)(1)(ii)(b)(3)(ii) to partnerships whose agreements were entered into before February 14, 2012. In such cases, if there has been no material modification to the partnership agreement on or after February 14, 2012, then, for taxable years beginning on or after January 1, 2012, and before January 1, 2016, and for taxable years that both begin on or after January 1, 2012, and end on or before February 4, 2016, these partnerships may apply the provisions of §1.704-1(b)(4)(viii)(c)(3)(ii) and (b)(4)(viii)(d)(3) (see 26 CFR part 1

revised as of April 1, 2011). For taxable years that both begin on or after January 1, 2016, and end after February 4, 2016, these partnerships may apply the provisions of §1.704-1(b)(4)(viii)(d)(3) (see 26 CFR part 1 revised as of April 1, 2011). For purposes of this paragraph (b)(1)(ii)(b)(3), any change in ownership constitutes a material modification to the partnership agreement. The transition rule in this paragraph (b)(1)(ii)(b)(3)(ii) does not apply to any taxable year in which persons bearing a relationship to each other that is specified in section 267(b) or section 707(b) collectively have the power to amend the partnership agreement without the consent of any unrelated party (and all subsequent taxable years).

(4) Special rules for covered asset acquisitions. Paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section apply to covered asset acquisitions (CAAs) (as defined in §1.901(m)-1(a)(13)) occurring on or after March 23, 2020. Taxpayers may, however, choose to apply paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section before the date paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section are applicable provided that they (along with any persons that are related (within the meaning of section 267(b) or 707(b)) to the taxpayer)--

(i) Consistently apply paragraphs (b)(4)(viii)(c)(4)(v) through (vii) of this section, §1.901(m)-1, and §§1.901(m)-3 through 1.901(m)-8 (excluding §1.901(m)-4(e)) to all CAAs occurring on or after January 1, 2011, and consistently apply § 1.901(m)-2 (excluding §1.901(m)-2(d)) to all CAAs occurring on or after December 7, 2016, on any original or amended tax return for each taxable year for which the application of the provisions listed in this paragraph (b)(1)(ii)(b)(4)(i) affects the tax liability and for which the statute of limitations does not preclude assessment or the filing of a claim for refund, as applicable;

(ii) File all tax returns described in paragraph (b)(1)(ii)(b)(4)(i) of this section for any taxable year ending on or before March 23, 2020, no later than March 23, 2021; and

(iii) Make appropriate adjustments to take into account deficiencies that would have resulted from the consistent application under paragraph (b)(1)(ii)(b)(4)(i) of this section for taxable years that are not open for assessment.

In addition, paragraph (b)(2)(iv)(d)(4), paragraph (b)(2)(iv)(f)(1), paragraph (b)(2)(iv)(f)(5)(iv), paragraph (b)(2)(iv)(h)(2), paragraph (b)(2)(iv)(s), paragraph (b)(4)(ix), paragraph (b)(4)(x), and Examples 31 through 35 in paragraph (b)(5) of this section apply to noncompensatory options (as defined in §1.721-2(f)) that are issued on or after February 5, 2013.

(iii) Effect of other sections. The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, *e.g.,* Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of §1.751-1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in §1.743-1 (see paragraph (b)(2)(iv)(m)(2) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

(iv) Other possible tax consequences. Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of §1.46-3, §1.47-6, paragraph (b)(1) of §1.721-1 (and related principles), and paragraph (e) of §1.752-1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

(v) Purported allocations. Section 704(b) and this paragraph do not apply to a purported allocation if it is made to a person who is not a partner of the partnership (see section 7701(a)(2) and paragraph (d) of §301.7701-3) or to a person who is not receiving the purported allocation in his capacity as a partner (see section 707(a) and paragraph (a) of §1.707-1).

(vi) Section 704(c) determinations. Section 704(c) and §1.704-3 generally require that if property is contributed by a partner to a partnership, the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to the property are determined so as to take account of the variation between the adjusted tax basis and fair market value of the property. Although section 704(b) does not directly determine the partners' distributive shares of tax items governed by section 704(c), the partners' distributive shares of tax items may be determined under section 704(c) and §1.704-3 (depending on the allocation method chosen by the partnership under §1.704-3) with reference to the partners' distributive shares of the corresponding book items, as determined under section 704(b) and this paragraph. (See paragraphs (b)(2)(iv)(d) and (b)(4)(i) of this section.) See §1.704-3 for methods of making allocations under section 704(c), and §1.704-3(d)(2) for a special rule in determining the amount of book items if the remedial allocation method is chosen by the partnership. See also paragraph (b)(5) Example (13)(i) of this section.

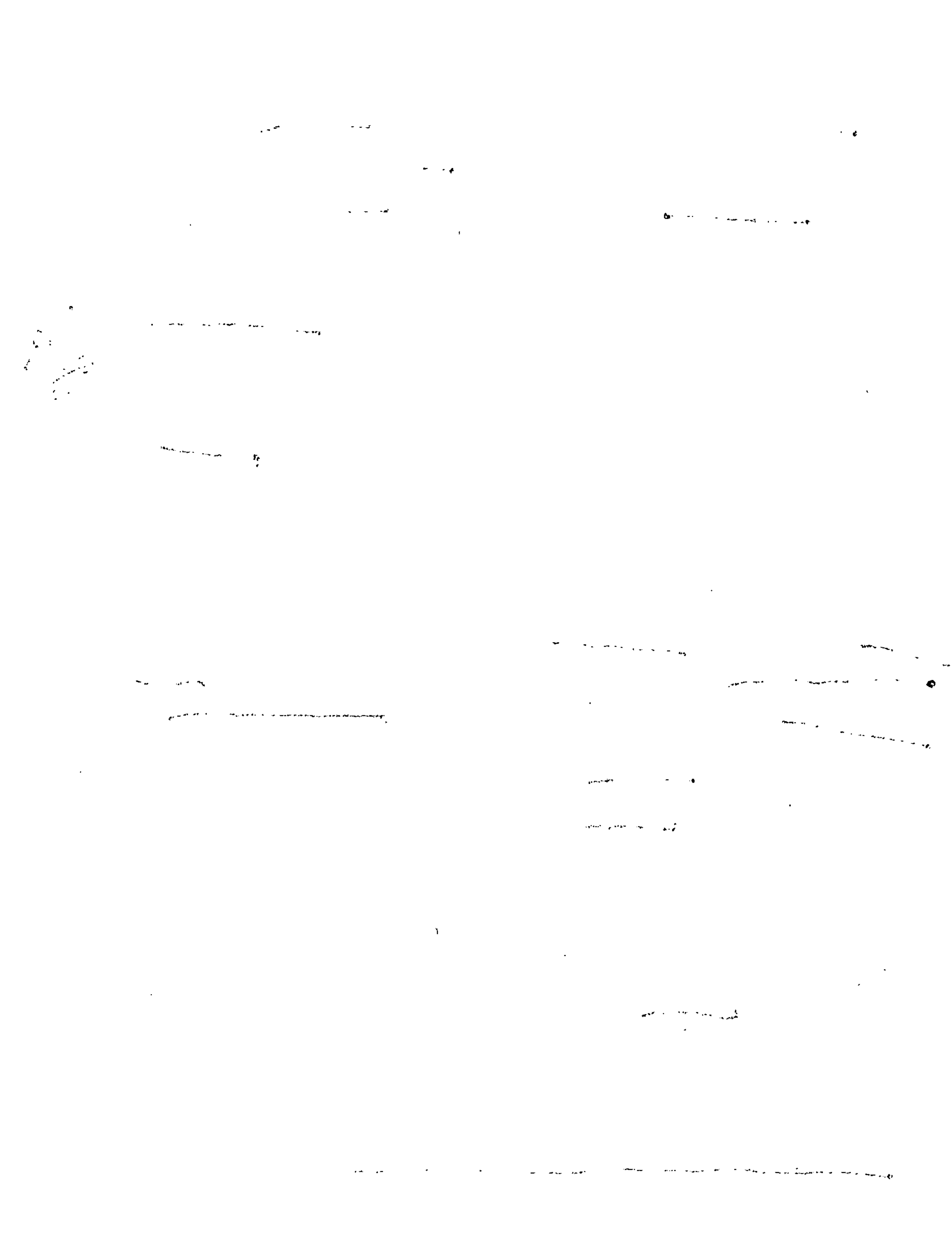
(vii) Bottom line allocations. Section 704(b) and this paragraph are applicable to allocations of income, gain, loss, deduction, and credit, allocations of specific items of income, gain, loss, deduction, and credit, and allocations of partnership net or "bottom line" taxable income and loss. An allocation to a partner of a share of partnership net or "bottom line" taxable income or loss shall be treated as an allocation to such partner of the same share of each item of income, gain, loss, and deduction that is taken into account in computing such net or "bottom line" taxable income or loss. See example (15)(i) of paragraph (b)(5) of this section.

(2) Substantial economic effect.

(i) Two-part analysis. The determination of whether an allocation of income, gain, loss, or deduction (or item thereof) to a partner has substantial economic effect involves a two-part analysis that is made as of the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect (within the meaning of paragraph (b)(2)(ii) of this section). Second, the economic effect of the allocation must be substantial (within the meaning of paragraph (b)(2)(iii) of this section).

(ii) Economic effect.

(a) Fundamental principles. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.



(b) Three requirements. Based on the principles contained in paragraph (b)(2)(ii)(a) of this section, and except as otherwise provided in this paragraph, an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides—

(1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)). Notwithstanding the partnership agreement, an obligation to restore a deficit balance in a partner's capital account, including an obligation described in paragraph (b)(2)(ii)(c)(1) of this section, will not be respected for purposes of this section to the extent the obligation is disregarded under paragraph (b)(2)(ii)(c)(4) of this section.

(4) For purposes of paragraphs (b)(2)(ii)(b)(1) through (3) of this section, a partnership taxable year shall be determined without regard to section 706(c)(2)(A).

(5) The requirements in paragraphs (b)(2)(ii)(b)(2) and (3) of this section are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the

partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section.

(6) The requirement in paragraph (b)(2)(ii)(b)(2) of this section is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in the requirement in paragraph (b)(2)(ii)(b)(2) of this section in the ratios of the partners' positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners' positive capital account balances.

(7) See Examples 1. (i) and (ii), 4. (i), 8. (i), and 16. (i) of paragraph (b)(5) of this section for issues concerning paragraph (b)(2)(ii)(b) of this section.

(c) Obligation to restore deficit.

(1) Other arrangements treated as obligations to restore deficits. If a partner is not expressly obligated to restore the deficit balance in such partner's capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section and subject to paragraph (b)(2)(ii)(c)(2) of this section) to the extent of—

(A) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(B) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker).

(2) Satisfaction requirement. For purposes of paragraph (b)(2)(ii)(c)(1) of this section, a promissory note or unconditional obligation is taken into account only if it is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation). If a promissory note referred to in paragraph (b)(2)(ii)(c)(1) of this section is negotiable, a partner will be considered required to satisfy such note within the time period specified in this paragraph (b)(2)(ii)(c)(2) if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. See paragraph (b)(2)(iv)(d)(2) of this section. See Examples 1. (ix) and (x) of paragraph (b)(5) of this section.

(3) Related party notes. For purposes of paragraph (b)(2) of this section, if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988, and the maker of such note is a person related to such partner (within the meaning of §1.752-4(b)(1)), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(4) Obligations disregarded.

(A) General rule. A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section) to the extent such partner's obligation is a bottom dollar payment obligation that is not recognized under §1.752-2(b)(3) or is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. See paragraphs (b)(2)(ii)(f), (b)(2)(ii)(h), and (b)(4)(vi) of this section for other rules regarding such obligation. To the extent a partner is not considered obligated to restore the deficit balance in the partner's capital account to the partnership (in accordance with the requirement in paragraph (b)(2)(ii)(b)(3) of this section), the obligation is disregarded and paragraph (b)(2) of this section and §1.752-2 are applied as if the obligation did not exist.

(B) Factors indicating plan to circumvent or avoid obligation. In the case of an obligation to restore a deficit balance in a partner's capital account upon liquidation of a partnership, paragraphs (b)(2)(ii)(c)(4)

(B)(i) through (iv) of this section provide a non-exclusive list of factors that may indicate a plan to circumvent or avoid the obligation. For purposes of making determinations under this paragraph (b)(2)(ii)(c)(4), the weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The following factors are taken into consideration for purposes of this paragraph (b)(2):

(i) The partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation.

(ii) The partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership.

(iii) The obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in §1.704-1(b)(2)(iv) is negative other than when a transferee partner assumes the obligation.

(iv) The terms of the obligation are not provided to all the partners in the partnership in a timely manner.

(d) Alternate test for economic effect. If—

(1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(3) The partnership agreement contains a "qualified income offset,"

such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which

such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for—

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of §1.751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under § 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain.

For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners' interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. See examples (1)(iii), (iv), (v), (vi), (vii), (ix), and (x), (15), and (16)(ii) of paragraph (b)(5) of this section.

(e) Partial economic effect. If only a portion of an allocation made to a partner with respect to a partnership taxable year has economic effect, both the portion that has economic effect and the portion that is reallocated shall consist of a proportionate share of all items that made up the allocation to such partner for such year. See examples (15)(ii) and (iii) of paragraph (b)(5) of this section.

(f) Reduction of obligation to restore. If requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, a partner's obligation to restore the deficit balance in his capital account (or any limited dollar amount thereof) to the partnership may be eliminated or reduced as of the end of a partnership taxable year without affecting the validity of prior allocations (see paragraph (b)(4)(vi) of this section) to the extent the deficit balance (if any) in such partner's capital account, after reduction for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section, will not exceed the partner's remaining obligation (if any) to restore the deficit balance in his capital account. See example (1)(viii) of paragraph (b)(5) of this section.

(g) Liquidation defined. For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of §1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner's obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section.

(h) Partnership agreement defined. For purposes of this paragraph, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases

to be made in accordance with the partners' positive capital account balances (requirement (2) of paragraph (b)(2)(ii)(b) of this section), and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account (requirement (3) of paragraph (b)(2)(ii)(b) of this section), all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options, and other buy-sell agreements, and any other "stop-loss" arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending upon the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.) In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement (see the last sentence of paragraph (c) of §1.761-1). For purposes of this paragraph (b)(2)(ii)(h), an agreement with a partner or a partnership shall include an agreement with a person related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to such partner or partnership. For purposes of the preceding sentence, sections 267(b) and 707(b)(1) shall be applied for partnership taxable years beginning after December 29, 1988 by (1) substituting "80 percent or more" for "more than 50 percent" each place it appears in such sections, (2) excluding brothers and sisters from the members of a person's family, and (3) disregarding section 267(f)(1)(A).

(i) Economic effect equivalence. Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership. See examples (4)(ii) and (iii) of paragraph (b)(5) of this section.

(iii) Substantiality.

(a) General rules. Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time

the allocation becomes part of the partnership agreement; (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. See examples (5) and (9) of paragraph (b)(5) of this section. The economic effect of an allocation is not substantial in the two situations described in paragraphs (b)(2)(iii)(b) and (c) of this section. However, even if an allocation is not described therein, its economic effect may be insubstantial under the general rules stated in this paragraph (b)(2)(iii)(a). References in this paragraph (b)(2)(iii) to allocations includes capital account adjustments made pursuant to paragraph (b)(2)(iv)(k) of this section. References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners' interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).

(b) Shifting tax consequences. The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if, at the time the allocation (or allocations) becomes part of the partnership agreement, there is a strong likelihood that—

(1) The net increases and decreases that will be recorded in the partners' respective capital accounts for such taxable year will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such year if the allocations were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership). If, at the end of a partnership taxable year to which an allocation (or allocations) relates, the net increases and decreases that are recorded in the partners' respective capital accounts do not differ

substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the allocation (or allocations) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had the allocation (or allocations) not been contained in the partnership agreement, it will be presumed that, at the time the allocation (or allocations) became part of such partnership agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (6), (7)(ii) and (iii), and (10)(ii) of paragraph (b)(5) of this section.

(c) Transitory allocations. If a partnership agreement provides for the possibility that one or more allocations (the "original allocation(s)") will be largely offset by one or more other allocations (the "offsetting allocation(s)"), and, at the time the allocations become part of the partnership agreement, there is a strong likelihood that—

(1) The net increases and decreases that will be recorded in the partners' respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded in such partners' respective capital accounts for such years if the original allocation(s) and offsetting allocation(s) were not contained in the partnership agreement, and

(2) The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership)

the economic effect of the original allocation(s) and offsetting allocation(s) will not be substantial. If, at the end of a partnership taxable year to which an offsetting allocation(s) relates, the net increases and decreases recorded in the partners' respective capital accounts do not differ substantially from the net increases and decreases that would have been recorded in such partners' respective capital accounts had the original allocation(s) and the offsetting allocation(s) not been contained in the partnership agreement, and the total tax liability of the partners is (as described in (2) above) less than it would have been had such allocations not been contained in the partnership agreement, it will be presumed that, at the time the allocations became part of the partnership

agreement, there was a strong likelihood that these results would occur. This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (1)(xi), (2), (3), (7), (8)(ii), and (17) of paragraph (b)(5) of this section. Notwithstanding the foregoing, the original allocation(s) and the offsetting allocation(s) will not be insubstantial (under this paragraph (b)(2)(iii)(c)) and, for purposes of paragraph (b)(2)(iii)(a), it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis). See example (2) of paragraph (b)(5) of this section. For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. See examples (1)(vi) and (xi) of paragraph (b)(5) of this section.

(d) Partners that are look-through entities or members of a consolidated group.

(1) In general. For purposes of applying paragraphs (b)(2)(iii)(a), (b), and (c) of this section to a partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account. For purposes of applying paragraphs (b)(2)(iii)(a), (b), and (c) of this section to a partner that is a member of a consolidated group (within the meaning of § 1.1502-1(h)), the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. See paragraph (b)(5) Example 29 of this section.

(2) Look-through entity. For purposes of this paragraph (b)(2)(iii)(d), a look-through entity means—

(i) A partnership;

(ii) A subchapter S corporation;

(iii) A trust or an estate;

(iv) An entity that is disregarded for Federal tax purposes, such as a qualified subchapter S subsidiary under section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under §§301.7701-1 through 301.7701-3 of this chapter, or a qualified REIT subsidiary within the meaning of section 856(i)(2); or

(v) A controlled foreign corporation if United States shareholders of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership's taxable year. In such case, the controlled foreign corporation shall be treated as a look-through entity, but only with respect to allocations of income, gain, loss, or deduction (or items thereof) that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. See paragraph (b)(2)(iii)(d)(6) for the definition of indirect ownership.

(3) Controlled foreign corporations. For purposes of this section, the term controlled foreign corporation means a controlled foreign corporation as defined in section 957(a) or section 953(c). In the case of a controlled foreign corporation that is a look-through entity, the tax attributes to be taken into account are those of any person that is a United States shareholder (as defined in paragraph (b)(2)(iii)(d)(5) of this section) of the controlled foreign corporation, or, if the United States shareholder is a look-through entity, a United States person that owns an interest in such shareholder directly or indirectly through one or more look-through entities.

(4) United States person. For purposes of this section, a United States person is a person described in section 7701(a)(30).

(5) United States shareholder. For purposes of this section, a United States shareholder is a person described in section 951(b) or section 953(c).

(6) Indirect ownership. For purposes of this section, indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 318, substituting the phrase "10 percent" for the phrase "50 percent" each time it appears.

(e) De minimis rule.

(1) Partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012. Except as provided in paragraph (b)(2)(iii)(e)(2) of this section, for purposes of applying this paragraph (b)(2)(iii), for partnership taxable years beginning after May 19, 2008 and beginning before December 28, 2012, the tax attributes of de minimis partners need not be taken into account. For purposes of this paragraph (b)(2)(iii)(e)(1), a de minimis partner is any partner, including a look-through entity that owns, directly or indirectly, less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit. See paragraph (b)(2)(iii)(d)(6) of this section for the definition of indirect ownership.

(2) Nonapplicability of de minimis rule.

(i) Allocations that become part of the partnership agreement on or after December 28, 2012. Paragraph (b)(2)(iii)(e)(1) of this section does not apply to allocations that become part of the partnership agreement on or after December 28, 2012.

(ii) Retest for allocations that become part of the partnership agreement prior to December 28, 2012. If the de minimis partner rule of paragraph (b)(2)(iii)(e)(1) of this section was relied upon in testing the substantiality of allocations that became part of the partnership agreement before December 28, 2012, such allocations must be retested on the first day of the first partnership taxable year beginning on or after December 28, 2012, without regard to paragraph (b)(2)(iii)(e)(1) of this section.

(iv) Maintenance of capital accounts.

(a) In general. The economic effect test described in paragraph (b)(2)(ii) of this section requires an examination of the capital accounts of the partners of a partnership, as maintained under the partnership agreement. Except as otherwise provided in paragraph (b)(2)(ii)(i) of this section, an allocation of

income, gain, loss, or deduction will not have economic effect under paragraph (b)(2)(ii) of this section, and will not be deemed to be in accordance with a partner's interest in the partnership under paragraph (b)(4) of this section, unless the capital accounts of the partners are determined and maintained throughout the full term of the partnership in accordance with the capital accounting rules of this paragraph (b)(2)(iv).

(b) Basic rules. Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by (1) the amount of money contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities that the partnership is considered to assume or take subject to), and (3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and is decreased by (4) the amount of money distributed to him by the partnership, (5) the fair market value of property distributed to him by the partnership (net of liabilities that such partner is considered to assume or take subject to), (6) allocations to him of expenditures of the partnership described in section 705(a)(2)(B), and (7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g) of this section, but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv). For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired. For liabilities assumed before June 24, 2003, references to liabilities in this paragraph (b)(2)(iv)(b) shall include only liabilities secured by the contributed or distributed property that are taken into account under section 752(a) and (b).

(c) Treatment of liabilities. For purposes of this paragraph (b)(2)(iv), (1) money contributed by a partner to a partnership includes the amount of any partnership liabilities that are assumed by such partner (other than liabilities described in paragraph (b)(2)(iv)(b)(5) of this section that are assumed by a distributee partner) but does not include increases in such partner's share of partnership liabilities (see section 752(a)), and (2) money distributed to a partner by a partnership includes the amount of such partner's individual liabilities that are

assumed by the partnership (other than liabilities described in paragraph (b)(2)(iv)(b)(2) of this section that are assumed by the partnership) but does not include decreases in such partner's share of partnership liabilities (see section 752(b)). For purposes of this paragraph (b)(2)(iv)(c), liabilities are considered assumed only to the extent the assuming party is thereby subjected to personal liability with respect to such obligation, the obligee is aware of the assumption and can directly enforce the assuming party's obligation, and, as between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable.

(d) Contributed property.

(1) In general. The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be increased by the fair market value of property contributed to the partnership by such partner on the date of contribution. See example (13)(i) of paragraph (b)(5) of this section. Consistent with section 752(c), section 7701(g) does not apply in determining such fair market value.

(2) Contribution of promissory notes. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(2) of this section, except as provided in this paragraph (b)(2)(iv)(d)(2), if a promissory note is contributed to a partnership by a partner who is the maker of such note, such partner's capital account will be increased with respect to such note only when there is a taxable disposition of such note by the partnership or when the partner makes principal payments on such note. See example (1)(ix) of paragraph (b)(5) of this section. The first sentence of this paragraph (b)(2)(iv)(d)(2) shall not apply if the note referred to therein is readily tradable on an established securities market. See also paragraph (b)(2)(ii)(c) of this section. Furthermore, a partner whose interest is liquidated will be considered as satisfying his obligation to restore the deficit balance in his capital account to the extent of (i) the fair market value, at the time of contribution, of any negotiable promissory note (of which such partner is the maker) that such partner contributes to the partnership on or after the date his interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(3) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partner is the maker) that such partner previously contributed to the partnership. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at the time of valuation.

(3) Section 704(c) considerations. Section 704(c) and §1.704-3 govern the determination of the partners' distributive shares of income, gain, loss, and deduction, as computed for tax purposes, with respect to property contributed to a partnership (see paragraph (b)(1)(vi) of this section). In cases where section 704(c) and §1.704-3 apply to partnership property, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of this section for allocations to them of income, gain, loss, and deduction (including depreciation, depletion, amortization, or other cost recovery) as computed for book purposes, with respect to the property. See, however, §1.704-3(d)(2) for a special rule in determining the amount of book items if the partnership chooses the remedial allocation method. See also Example (13)(i) of paragraph (b)(5) of this section. Capital accounts are not adjusted to reflect allocations under section 704(c) and §1.704-3 (e.g., tax allocations of precontribution gain or loss).

(4) Exercise of noncompensatory options. Solely for purposes of paragraph (b)(2)(iv)(b)(2) of this section, the fair market value of the property contributed on the exercise of a noncompensatory option (as defined in §1.721-2(f)) does not include the fair market value of the option privilege, but does include the consideration paid to the partnership to acquire the option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the option. With respect to convertible debt, the fair market value of the property contributed on the exercise of the option is the adjusted issue price of the debt and the accrued but unpaid qualified stated interest (as defined in §1.1273-1(c)) on the debt immediately before the conversion, plus the fair market value of any property (other than the convertible debt) contributed to the partnership on the exercise of the option. See Examples 31 through 35 of paragraph (b)(5) of this section.

(e) Distributed property.

(1) In general. The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be decreased by the fair market value of property distributed by the partnership (without regard to section 7701(g)) to such partner (whether in connection with a liquidation or otherwise). To satisfy this requirement, the capital accounts of the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such

property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property (taking section 7701(g) into account) on the date of distribution. See example (14)(v) of paragraph (b)(5) of this section.

(2) Distribution of promissory notes. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(5), except as provided in this paragraph (b)(2)(iv)(e)(2), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (i) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of this section, and (ii) the fair market value, at the time of liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at time of valuation.

(f) Revaluations of property. A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(1) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(h) of this section. See Example 33 of paragraph (b)(5) of this section.

(2) The adjustments reflect the manner is which the unrealized income, gain, loss, or deduction inherent in such property (that has not been

reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date, and

(3) The partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of this section for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property, and

(4) The partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and

(5) The adjustments are made principally for a substantial non-tax business purpose—

(i) In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or

(ii) In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or

(iii) In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, or

(iv) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or

(v) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures,

or similar instruments that are readily tradable on an established securities market.

See example (14) and (18) of paragraph (b)(5) of this section. If the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquished to the partnership, paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied to determine the partners' distributive shares of depreciation, depletion, amortization, and gain or loss as computed for tax purposes, with respect to such property.

(6) Notwithstanding paragraph (b)(2)(iv)(f)(5) of this section, the revaluation is required under §1.721(c)-3(d)(1) as a condition of the application of the gain deferral method (as described in § 1.721(c)-3(b)) and is pursuant to an event described in this paragraph (b)(2)(iv)(f)(6). If an interest in a partnership is contributed to a section 721(c) partnership (as defined in §1.721(c)-1(b)(14)), the partnership whose interest is contributed may revalue its property in accordance with this section. In this case, the revaluation by the partnership whose interest was contributed must occur immediately before the contribution. If a partnership that revalues its property pursuant to this paragraph owns an interest in another partnership, the partnership in which it owns an interest may also revalue its property in accordance with this section. When multiple partnerships revalue under this paragraph (b)(2)(iv)(f)(6), the revaluations occur in order from the lowest-tier partnership to the highest-tier partnership.

(g) Adjustments to reflect book value.

(1) In general. Under paragraphs (b)(2)(iv)(d) and (b)(2)(iv)(f) of this section, property may be properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property. In these circumstances, paragraphs (b)(2)(iv)(d)(3) and (b)(2)(iv)(f)(3) of this section provide that the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires the partners' capital accounts to be adjusted in accordance with this paragraph (b)(2)(iv)(g) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such

property. In determining whether the economic effect of an allocation of book items is substantial, consideration will be given to the effect of such allocation on the determination of the partners' distributive shares of corresponding tax items under section 704(c) and paragraph (b)(4)(i) of this section. See example (17) of paragraph (b)(5) of this section. If an allocation of book items under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise respected under this paragraph, such items will be reallocated in accordance with the partners' interests in the partnership, and such reallocation will be the basis upon which the partners' distributive shares of the corresponding tax items are determined under section 704(c) and paragraph (b)(4)(i) of this section. See examples (13), (14), and (18) of paragraph (b)(5) of this section.

(2) Payables and receivables. References in this paragraph (b)(2)(iv) and paragraph (b)(4)(i) of this section to book and tax depreciation, depletion, amortization, and gain or loss with respect to property that has an adjusted tax basis that differs from book value include, under analogous rules and principles, the unrealized income or deduction with respect to accounts receivable, accounts payable, and other accrued but unpaid items.

(3) Determining amount of book items. The partners' capital accounts will not be considered adjusted in accordance with this paragraph (b)(2)(iv)(g) unless the amount of book depreciation, depletion, or amortization for a period with respect to an item of partnership property is the amount that bears the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to such property for such period bears to the adjusted tax basis of such property. If such property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership. For purposes of the preceding sentence, additional first year depreciation deduction under section 168(k) is not a reasonable method.

(h) Determinations of fair market value.

(1) In general. For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. If, however, these

conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.

(2) Adjustments for noncompensatory options. The value of partnership property as reflected on the books of the partnership must be adjusted to account for any outstanding noncompensatory options (as defined in §1.721-2(f)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)(f) or (s) of this section. If the fair market value of outstanding noncompensatory options (as defined in §1.721-2(f)) as of the date of the adjustment exceeds the consideration paid to the partnership to acquire the options, then the value of partnership property as reflected on the books of the partnership must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the consideration paid to the partnership to acquire the outstanding noncompensatory options (as defined in §1.721-2(f)) exceeds the fair market value of such options as of the date of the adjustment, then the value of partnership property as reflected on the books of the partnership must be increased by that excess to the extent of the unrealized loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized loss in proportion to their respective amounts of unrealized loss. However, any reduction or increase shall take into account the economic arrangement of the partners with respect to the property.

(i) Section 705(a)(2)(B) expenditures.

(1) In general. The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be decreased by allocations made to such partner of expenditures described in section 705(a)(2)(B). See example (11) of paragraph (b)(5) of this section. If an allocation of these expenditures under the partnership agreement does not have substantial economic effect (as determined under paragraphs (b)(2)(ii) and (b)(2)(iii) of this section), or is not otherwise

respected under this paragraph, such expenditures will be reallocated in accordance with the partners' interest in the partnership.

(2) Expenses described in section 709. Except for amounts with respect to which an election is properly made under section 709(b), amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such a partnership shall, solely for purposes of this paragraph, be treated as section 705(a)(2)(B) expenditures, and upon liquidation of the partnership no further capital account adjustments will be made in respect thereof.

(3) Disallowed losses. If a deduction for a loss incurred in connection with the sale or exchange of partnership property is disallowed to the partnership under section 267(a)(1) or section 707(b), that deduction shall, solely for purposes of this paragraph, be treated as a section 705(a)(2)(B) expenditure.

(j) Basis adjustments to section 38 property. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted by the partners' shares of any upward or downward basis adjustments allocated to them under this paragraph (b)(2)(iv)(j). When there is a reduction in the adjusted tax basis of partnership section 38 property under section 48(q)(1) or section 48(q)(3), section 48(q)(6) provides for an equivalent downward adjustment to the aggregate basis of partnership interests (and no additional adjustment is made under section 705(a)(2)(B)). These downward basis adjustments shall be shared among the partners in the same proportion as the adjusted tax basis or cost of (or the qualified investment in) such section 38 property is allocated among the partners under paragraph (f) of § 1.46-3 (or paragraph (a)(4)(iv) of §1.48-8). Conversely, when there is an increase in the adjusted tax basis of partnership section 38 property under section 48(q)(2), section 48(q)(6) provides for an equivalent upward adjustment to the aggregate basis of partnership interests. These upward adjustments shall be allocated among the partners in the same proportion as the investment tax credit from such property is recaptured by the partners under § 1.47-6.

(k) Depletion of oil and gas properties.

(1) In general. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless such capital accounts are adjusted for

depletion and gain or loss with respect to the oil or gas properties of the partnership in accordance with this paragraph (b)(2)(iv)(k).

(2) Simulated depletion. Except as provided in paragraph (b)(2)(iv)(k)(3) of this section, a partnership shall, solely for purposes of maintaining capital accounts under this paragraph, compute simulated depletion allowances with respect to its oil and gas properties at the partnership level. These allowances shall be computed on each depletable oil or gas property of the partnership by using either the cost depletion method or the percentage depletion method (computed in accordance with section 613 at the rates specified in section 613A(c)(5) without regard to the limitations of section 613A, which theoretically could apply to any partner) for each partnership taxable year that the property is owned by the partnership and subject to depletion. The choice between the simulated cost depletion method and the simulated percentage depletion method shall be made on a property-by-property basis in the first partnership taxable year beginning after April 30, 1986, for which it is relevant for the property, and shall be binding for all partnership taxable years during which the oil or gas property is held by the partnership. The partnership shall make downward adjustments to the capital accounts of the partners for the simulated depletion allowance with respect to each oil or gas property of the partnership, in the same proportion as such partners (or their predecessors in interest) were properly allocated the adjusted tax basis of each such property. The aggregate capital account adjustments for simulated percentage depletion allowances with respect to an oil or gas property of the partnership shall not exceed the aggregate adjusted tax basis allocated to the partners with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, such partnership's simulated gain or loss shall be determined by subtracting its simulated adjusted basis in such property from the amount realized upon such disposition. (The partnership's simulated adjusted basis in an oil or gas property is determined in the same manner as adjusted tax basis except that simulated depletion allowances are taken into account instead of actual depletion allowances.) The capital accounts of the partners shall be adjusted upward by the amount of any simulated gain in proportion to such partners' allocable shares of the portion of the total amount realized from the disposition of such property that exceeds the partnership's simulated adjusted basis in such property. The capital accounts of such partners shall be adjusted downward by the amount of any simulated loss in proportion to such partners' allocable shares of the total amount realized from the disposition of such property that represents recovery of the partnership's simulated

adjusted basis in such property. See section 613A(c)(7)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section. See example (19)(iv) of paragraph (b)(5) of this section.

(3) Actual depletion. Pursuant to section 613A(c)(7)(D) and the regulations thereunder, the depletion allowance under section 611 with respect to the oil and gas properties of a partnership is computed separately by the partners. Accordingly, in lieu of adjusting the partner's capital accounts as provided in paragraph (b)(2)(iv)(k)(2) of this section, the partnership may make downward adjustments to the capital account of each partner equal to such partner's depletion allowance with respect to each oil or gas property of the partnership (for the partner's taxable year that ends with or within the partnership's taxable year). The aggregate adjustments to the capital account of a partner for depletion allowances with respect to an oil or gas property of the partnership shall not exceed the adjusted tax basis allocated to such partner with respect to such property. Upon the taxable disposition of an oil or gas property by a partnership, the capital account of each partner shall be adjusted upward by the amount of any excess of such partner's allocable share of the total amount realized from the disposition of such property over such partner's remaining adjusted tax basis in such property. If there is no such excess, the capital account of such partner shall be adjusted downward by the amount of any excess of such partner's remaining adjusted tax basis in such property over such partner's allocable share of the total amount realized from the disposition thereof. See section 613A(c)(7)(4)(D) and the regulations thereunder and paragraph (b)(4)(v) of this section.

(4) Effect of book values. If an oil or gas property of the partnership is, under paragraphs (b)(2)(iv)(d) or (b)(2)(iv)(f) of this section, properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property, the rules contained in this paragraph (b)(2)(iv)(k) and paragraph (b)(4)(v) of this section shall be applied with reference to such book value. A revaluation of a partnership oil or gas property under paragraph (b)(2)(iv)(f) of this section may give rise to a reallocation of the adjusted tax basis of such property, or a change in the partners' relative shares of simulated depletion from such property, only to the extent permitted by section 613A(c)(7)(D) and the regulations thereunder.

(l) Transfers of partnership interests. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon the transfer of all or a part of an interest in

the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner. (See paragraph (b)(2)(iv)(m) of this section for rules concerning the effect of a section 754 election on the capital accounts of the partners.) If the transfer of an interest in a partnership causes a termination of the partnership under section 708(b)(1)(B), the capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership under §1.708-1(b)(1)(iv). Moreover, the deemed contribution of assets and liabilities by the terminated partnership to a new partnership and the deemed liquidation of the terminated partnership that occur under §1.708-1(b)(1)(iv) are disregarded for purposes of paragraph (b)(2)(iv) of this section. See Example 13 of paragraph (b)(5) of this section and the example in §1.708-1(b)(1)(iv). The previous three sentences apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997; however, the sentences may be applied to terminations occurring on or after May 9, 1996, provided that the partnership and its partners apply the sentences to the termination in a consistent manner.

(m) Section 754 elections.

(1) In general. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless, upon adjustment to the adjusted tax basis of partnership property under section 732, 734, or 743, the capital accounts of the partners are adjusted as provided in this paragraph (b)(2)(iv)(m).

(2) Section 743 adjustments. In the case of a transfer of all or a part of an interest in a partnership that has a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions (see paragraph (b)(2)(iv)(e)(1) of this section) and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment. The preceding sentence shall not apply to the extent such basis adjustment is allocated to the common basis of partnership property under paragraph (b)(1) of §1.734-2; in these cases, such basis adjustment shall, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, give rise to adjustments to the capital accounts of the partners in accordance with their interests in the partnership under paragraph (b)(3) of this section. See examples (13)(iii) and (iv) of paragraph (b)(5) of this section.

(3) Section 732 adjustments. In the case of a transfer of all or a part of an interest in a partnership that does not have a section 754 election in effect for the partnership taxable year in which such transfer occurs, adjustments to the adjusted tax basis of partnership property under section 732(d) will be treated in the capital accounts of the partners in the same manner as section 743 basis adjustments are treated under paragraph (b)(2)(iv)(m)(2) of this section.

(4) Section 734 adjustments. Except as provided in paragraph (b)(2)(iv)(m)(5) of this section, in the case of a distribution of property in liquidation of a partner's interest in the partnership by a partnership that has a section 754 election in effect for the partnership taxable year in which the distribution occurs, the partner who receives the distribution that gives rise to the adjustment to the adjusted tax basis of partnership property under section 734 shall have a corresponding adjustment made to his capital account. If such distribution is made other than in liquidation of a partner's interest in the partnership, however, except as provided in paragraph (b)(2)(iv)(m)(5) of this section, the capital accounts of the partners shall be adjusted by the amount of the adjustment to the adjusted tax basis of partnership property under section 734, and such capital account adjustment shall be shared among the partners in the manner in which the unrealized income and gain that is displaced by such adjustment would have been shared if the property whose basis is adjusted were sold immediately prior to such adjustment for its recomputed adjusted tax basis.

(5) Limitations on adjustments. Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

(n) Partnership level characterization. Except as otherwise provided in paragraph (b)(2)(iv)(k) of this section, the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules

of this paragraph (b)(2)(iv) unless adjustments to such capital accounts in respect of partnership income, gain, loss, deduction, and section 705(a)(2)(B) expenditures (or item thereof) are made with reference to the Federal tax treatment of such items (and in the case of book items, with reference to the Federal tax treatment of the corresponding tax items) at the partnership level, without regard to any requisite or elective tax treatment of such items at the partner level (for example, under section 58(i)). However, a partnership that incurs mining exploration expenditures will determine the Federal tax treatment of income, gain, loss, and deduction with respect to the property to which such expenditures relate at the partnership level only after first taking into account the elections made by its partners under section 617 and section 703(b)(4).

(o) Guaranteed payments. Guaranteed payments to a partner under section 707(c) cause the capital account of the recipient partner to be adjusted only to the extent of such partner's distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.

(p) Minor discrepancies. Discrepancies between the balances in the respective capital accounts of the partners and the balances that would be in such respective capital accounts if they had been determined and maintained in accordance with this paragraph (b)(2)(iv) will not adversely affect the validity of an allocation, provided that such discrepancies are minor and are attributable to good faith error by the partnership.

(q) Adjustments where guidance is lacking. If the rules of this paragraph (b)(2)(iv) fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership, such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that (1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (2) is consistent with the underlying economic arrangement of the partners, and (3) is based, wherever practicable, on Federal tax accounting principles.

(r) Restatement of capital accounts. With respect to partnerships that began operating in a taxable year beginning before May 1, 1986, the capital accounts of the partners of which have not been determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) since inception, such capital accounts shall not be considered to be determined and maintained in

accordance with the rules of this paragraph (b)(2)(iv) for taxable years beginning after April 30, 1986, unless either—

(1) such capital accounts are adjusted, effective for the first partnership taxable year beginning after April 30, 1986, to reflect the fair market value of partnership property as of the first day of such taxable year, and in connection with such adjustment, the rules contained in paragraph (b)(2)(iv)(f)(2), (3), and (4) of this section are satisfied, or

(2) the differences between the balance in each partner's capital account and the balance that would be in such partner's capital account if capital accounts had been determined and maintained in accordance with this paragraph (b)(2)(iv) throughout the full term of the partnership are not significant (for example, such differences are solely attributable to a failure to provide for treatment of section 709 expenses in accordance with the rules of paragraph (b)(2)(iv)(i)(2) of this section or to a failure to follow the rules in paragraph (b)(2)(iv)(m) of this section), and capital accounts are adjusted to bring them into conformity with the rules of this paragraph (b)(2)(iv) no later than the end of the first partnership taxable year beginning after April 30, 1986.

(3) With respect to a partnership that began operating in a taxable year beginning before May 1, 1986, modifications to the partnership agreement adopted on or before November 1, 1988, to make the capital account adjustments required to comply with this paragraph, and otherwise to satisfy the requirements of this paragraph, will be treated as if such modifications were included in the partnership agreement before the end of the first partnership taxable year beginning after April 30, 1986. However, compliance with the previous sentences will have no bearing on the validity of allocations that relate to partnership taxable years beginning before May 1, 1986.

(s) Adjustments on the exercise of a noncompensatory option. A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in §1.721-2(f)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid to the partnership to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the following requirements are met:

(1) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(f) of this section immediately before the exercise of the option, the partnership

revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(f)(1) through (f)(4) of this section immediately after the exercise of the option.

(2) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(s)(1) of this section, the partnership first allocates any unrealized income, gain, or loss in partnership property (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income, gain, or loss (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, or loss in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date. For purposes of the preceding sentence, if the exercising partner's initial capital account as determined under §1.704-1(b)(2)(iv)(b) and (d)(4) of this section would be less than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only income or gain may be allocated to the exercising partner from partnership properties with unrealized appreciation, in proportion to their respective amounts of unrealized appreciation. If the exercising partner's initial capital account, as determined under §1.704-1(b)(2)(iv)(b) and (d)(4) of this section, would be greater than the amount that reflects the exercising partner's right to share in partnership capital under the partnership agreement, then only loss may be allocated to the exercising partner from partnership properties with unrealized loss, in proportion to their respective amounts of unrealized loss. However, any allocation must take into account the economic arrangement of the partners with respect to the property.

(3) If, after making the allocations described in paragraph (b)(2)(iv)(s)(2) of this section, the exercising partner's capital account does not reflect that partner's right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account reflects the exercising partner's right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or decrease in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(s)(3) must be allocated among the existing partners in

accordance with the principles of this section. See Example 32 of paragraph (b)(5) of this section.

(4) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(s)(3) of this section (see paragraph (b)(4)(x) of this section). See Example 32 of paragraph (b)(5) of this section.

(3) Partner's interest in the partnership.

(i) In general. References in section 704(b) and this paragraph to a partner's interest in the partnership, or to the partners' interests in the partnership, signify the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is allocated. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner's capital account back up to zero.) The determination of a partner's interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners.

(ii) Factors considered. In determining a partner's interest in the partnership, the following factors are among those that will be considered:

(a) The partners' relative contributions to the partnership,

(b) The interests of the partners in economic profits and losses (if different than that in taxable income or loss),

(c) The interests of the partners in cash flow and other non-liquidating distributions, and

(d) The rights of the partners to distributions of capital upon liquidation.

The provisions of this subparagraph (b)(3) are illustrated by examples (1)(i) and (ii), (4)(i), (5)(i) and (ii), (6), (7), (8), (10)(ii), 16(i), and (19)(iii) of paragraph (b)(5) of this section. See paragraph (b)(4)(i) of this section concerning rules for

determining the partners' interests in the partnership with respect to certain tax items.

(iii) Certain determinations. If—

(a) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(b) All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership taxable year does not have economic effect under paragraph (b)(2)(ii) of this section. The partners' interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of this section. See examples (1)(iv), (v), and (vi), and (15)(ii) and (iii) of paragraph (b)(5) of this section.

(iv) Special rule for creditable foreign tax expenditures. In determining whether an allocation of a partnership item is in accordance with the partners' interests in the partnership, the allocation of the creditable foreign tax expenditure (CFTE) (as defined in paragraph (b)(4)(viii)(b) of this section) must be disregarded. This paragraph (b)(3)(iv) shall not apply to the extent the partners to whom such taxes are allocated reasonably expect to claim a deduction for such taxes in determining their U.S. tax liabilities.

(4) Special rules.

(i) Allocations to reflect revaluations. If partnership property is, under paragraphs (b)(2)(iv)(d) or (b)(2)(iv)(f) of this section, properly reflected in the capital accounts of the partners and on the books of the partnership at a book value that differs from the adjusted tax basis of such property, then depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property will be greater or less than the depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property. In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book

items to such partners (see paragraph (b)(2)(iv)(g) of this section), and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts. Thus, separate allocations of these tax items cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the partners' distributive shares of such tax items must (unless governed by section 704(c)) be determined in accordance with the partners' interests in the partnership. These tax items must be shared among the partners in a manner that takes account of the variation between the adjusted tax basis of such property and its book value in the same manner as variations between the adjusted tax basis and fair market value of property contributed to the partnership are taken into account in determining the partners' shares of tax items under section 704(c). See examples (14) and (18) of paragraph (b)(5) of this section.

(ii) Credits. Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts (except to the extent that adjustments to the adjusted tax basis of partnership section 38 property in respect of tax credits and tax credit recapture give rise to capital account adjustments under paragraph (b)(2)(iv)(l) of this section). Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. With respect to the investment tax credit provided by section 38, allocations of cost or qualified investment made in accordance with paragraph (f) of §1.46-3 and paragraph (a)(4)(iv) of §1.48-8 shall be deemed to be made in accordance with the partners' interests in the partnership. With respect to other tax credits, if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments). See example (11) of paragraph (b)(5) of this section. Identical principles shall apply in determining the partners' interests in the partnership with respect to tax credits that arise from receipts of the partnership (whether or not taxable).

(iii) Excess percentage depletion. To the extent the percentage depletion in respect of an item of depletable property of the partnership exceeds the adjusted tax basis of such property, allocations of such excess percentage depletion are not reflected by adjustments to the partners' capital accounts. Thus, such allocations cannot have economic effect under paragraph (b)(2)(ii)(b)(1) of this section, and such excess percentage depletion must be allocated in accordance with the partners' interests in the partnership. The partners' interests in the partnership for a partnership taxable

year with respect to such excess percentage depletion shall be in the same proportion as such partners' respective distributive shares of gross income from the depletable property (as determined under section 613(c)) for such year. See example (12) of paragraph (b)(5) of this section. See paragraphs (b)(2)(iv)(k) and (b)(4)(v) of this section for special rules concerning oil and gas properties of the partnership.

(iv) Allocations attributable to nonrecourse liabilities. The rules for allocations attributable to nonrecourse liabilities are contained in §1.704-2.

(v) Allocations under section 613A(c)(7)(D). Allocations of the adjusted tax basis of a partnership oil or gas property are controlled by section 613A(c)(7)(D) and the regulations thereunder. However, if the partnership agreement provides for an allocation of the adjusted tax basis of an oil or gas property among the partners, and such allocation is not otherwise governed under section 704(c) (or related principles under paragraph (b)(4)(i) of this section), that allocation will be recognized as being in accordance with the partners' interests in partnership capital under section 613A(c)(7)(D), provided (a) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(k) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(iii) of this section), and (b) all other material allocations and capital account adjustments under the partnership agreement are recognized under this paragraph (b). Otherwise, such adjusted tax basis must be allocated among the partners pursuant to section 613A(c)(7)(D) in accordance with the partners' actual interests in partnership capital or income. For purposes of section 613A(c)(7)(D) the partners' allocable shares of the amount realized upon the partnership's taxable disposition of an oil or gas property will, except to the extent governed by section 704(c) (or related principles under paragraph (b)(4)(i) of this section), be determined under this paragraph (b)(4)(v). If, pursuant to paragraph (b)(2)(iv)(k)(2) of this section, the partners' capital accounts are adjusted to reflect the simulated depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that represents recovery of its simulated adjusted tax basis therein will be allocated to the partners in the same proportion as the aggregate adjusted tax basis of such property was allocated to such partners (or their predecessors in interest). If, pursuant to paragraph (b)(2)(iv)(k)(3) of this section, the partners' capital accounts are adjusted to reflect the actual depletion of an oil or gas property of the partnership, the portion of the total amount realized by the partnership upon the taxable disposition of such property that equals the partners' aggregate remaining adjusted basis therein will be allocated to the partners in proportion to their respective remaining adjusted tax bases in such property. An allocation provided by the partnership agreement of the portion of the total amount realized by the partnership on its taxable disposition of an oil or gas property that exceeds the portion of the total amount realized allocated

under either of the previous two sentences (whichever is applicable) shall be deemed to be made in accordance with the partners' allocable shares of such amount realized, provided (c) such allocation does not give rise to capital account adjustments under paragraph (b)(2)(iv)(k) of this section the economic effect of which is insubstantial (as determined under paragraph (b)(2)(ii) of this section), and (d) all other allocations and capital account adjustments under the partnership agreement are recognized under this paragraph. Otherwise, the partners' allocable shares of the total amount realized by the partnership on its taxable disposition of an oil or gas property shall be determined in accordance with the partners' interests in the partnership under paragraph (b)(3) of this section. See example (19) of paragraph (b)(5) of this section. (See paragraph (b)(2)(iv)(k) of this section for the determination of appropriate adjustments to the partners' capital accounts relating to section 613A(c)(7)(D).)

(vi) Amendments to partnership agreement. If an allocation has substantial economic effect under paragraph (b)(2) of this section or is deemed to be made in accordance with the partners' interests in the partnership under paragraph (b)(4) of this section under the partnership agreement that is effective for the taxable year to which such allocation relates, and such partnership agreement thereafter is modified, both the tax consequences of the modification and the facts and circumstances surrounding the modification will be closely scrutinized to determine whether the purported modification was part of the original agreement. If it is determined that the purported modification was part of the original agreement, prior allocations may be reallocated in a manner consistent with the modified terms of the agreement, and subsequent allocations may be reallocated to take account of such modified terms. For example, if a partner is obligated by the partnership agreement to restore the deficit balance in his capital account (or any limited dollar amount thereof) in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section and, thereafter, such obligation is eliminated or reduced (other than as provided in paragraph (b)(2)(ii)(f) of this section), or is not complied with in a timely manner, such elimination, reduction, or noncompliance may be treated as if it always were part of the partnership agreement for purposes of making any reallocations and determining the appropriate limitations period.

(vii) Recapture. For special rules applicable to the allocation of recapture income or credit, see paragraph (e) of § 1.1245-1, paragraph (f) of §1.1250-1, paragraph (c) of §1.1254-1, and paragraph (a) of §1.47-6.

(viii) Allocation of creditable foreign taxes.

(a) In general. Allocations of creditable foreign taxes do not have substantial economic effect within the meaning of paragraph (b)(2) of this section and, accordingly, such expenditures must be allocated in accordance with the

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1701 The Section 704(e) Income Allocation Rules

1701.1 IRC Sec. 704(e), sometimes referred to as the *family partnership rule*, is intended to prevent the use of partnerships to shift taxable income from one taxpayer to another, thereby "circumventing the progressive rate structure of the federal income tax" [*Krause*]. The 704(e) income allocation rules apply to any partnership interest created by gift, but for these rules, selling an interest to a family member is treated as a gift (see paragraph 1701.9 for details). Even if an income allocation has substantial economic effect (see the discussion starting at section 900, it will not be respected under the IRC Sec. 704(e) rules unless—

a. the allocation reflects an allowance for reasonable compensation to the donor for services he performs for the partnership (see Example 1701-1), and

b. the donee's share of partnership income is proportionate to that of the donor when compared to their respective capital interests. (See Example 1701-2.)

1701.2 Practice Aid PA-62 is a questionnaire that can be used to determine whether the Section 704(e) income allocation rules apply to a partnership.

Reasonable Compensation Paid to the Donor

1701.3 An income allocation among partners that has substantial economic effect and would be respected in other settings is disregarded (so that income allocated to a donee is reallocated to the donor) to the extent that reasonable compensation is not paid to the donor for services rendered to the partnership [IRC Sec. 704(e)(1); Reg. 1.704-1(e)(3)(i)(a)]. To put it another way, income allocated to the donee is taxed to the donor, to the extent necessary to reflect reasonable compensation for the donor's services. (Special rules apply when the donee has performed

services for the partnership but ceases to do so because of military service) [IRC Sec. 704(e)(1); Reg. 1.704-1(e)(3)(i)(d); *Gorrill*].

1701.4 This rule works to reallocate income only between a donor and a donee. Because the donor is not always the nominal transferor, it is important to identify the donor. See the discussion beginning at paragraph 1701.10.

1701.5 When partnership agreement allocations do not comply with this reasonable compensation requirement, the donor's and donee's distributive shares of income must be adjusted by making reasonable allowances for the donor's and donee's respective services. The balance of the partnership's income is allocated to the donor and the donee in proportion to their capital [Reg. 1.704-1(e)(3)(i)(b); *Gorrill*; *Woodbury*]. It is unclear whether IRC Sec. 704(e) would be applied to a loss, but some commentators have suggested that the provision should be applied to prohibit a disproportionate allocation of net losses to donors as well.

1701.6 The amount that constitutes a reasonable allowance for services is determined in light of all relevant facts and circumstances. These include the level of managerial responsibility borne by the partner and the amount that would be paid if a nonpartner performed the same services [Reg. 1.704-1(e)(3)(i)(c)].

Example 1701-1: Accounting for the value of a donor's services when allocating partnership income.

Colin gave his son, Boris, a 50% interest in Colin's sole proprietorship. Colin and Boris then contributed their interests in the business to Shelley Hardware (Shelley), a general partnership. Boris and Colin were credited with equal capital accounts. Under the partnership agreement, all items are allocable 50% to each partner. Colin worked full-time in Shelley's business, but was not compensated other than through his share of partnership income. Boris was not actively involved in the business. During the year, Shelley had net income of $70,000, which was allocated $35,000 to each partner.

In this case Shelley made no allowance for Colin's services. Consequently, the allocation of income between Colin and Boris will not be fully respected for federal income tax purposes due to the family partnership rule. If Colin's services were found to have a reasonable value of $20,000, Shelley's $70,000 of income would be reallocated as follows:

	Colin	Boris
Income allocated to reflect services	$20,000	$—
Allocation of remainder in proportion to capital	25,000	25,000

	Colin	Boris
Total income allocation	$45,000	$25,000

Because this tax reallocation would not legally affect the allocations under the partnership agreement, this reallocation could have gift and income tax consequences in future years. (See Example 1701-2.)

In such situations, it may be advisable to pay reasonable compensation to the donor for his services. A guaranteed payment reflecting the reasonable value of the donor's services can accomplish this. If the partners explicitly provide for such a payment and can, in good faith, argue that the amount is reasonable, even if it is at the low end of the range of compensation that might be expected for such services, they can significantly enhance their ability to avoid or withstand an IRS attempt to reallocate income. However, they must keep in mind that payment of compensation to a donor partner may be cited by the IRS if it later contends that the donor retained a right to economic enjoyment of the gifted partnership interest for transfer tax purposes.

Sharing Income Proportionately Between Donor's and Donee's Capital Interests

1701.7 An otherwise valid income allocation among partners will be disregarded to the extent that the donee's income allocation is disproportionately high compared to the donor's and donee's relative capital interests. This rule does not affect allocations to partners other than the donor and the donee.

1701.8 Arguably, the IRC Sec. 704(e) income allocation rules appear to prohibit only allocations of income that are disproportionate to capital [IRC Sec. 704(e)(1); Regs. 1.704-1(e)(3)(i)(a) and (b)]. Some commentators, nevertheless, have suggested that the provision should be applied to prohibit a disproportionate allocation of net losses to donors as well. It appears clear that special allocations of specific items of loss or deductions (such as depreciation) to a donor that have the effect of increasing the net income allocated to a donee would not be respected.

Example 1701-2: Reallocating income in proportion to the donor's and donee's capital interests.

Fred gave his daughter, Wilma, a 40% interest in the business which he previously operated as a sole proprietorship. Fred and Wilma then contributed their interests to Flint Stores Partnership. The net value of the contributed assets was $150,000. Flint Stores' written partnership agreement was drafted by Fred's family lawyer and provides that Fred's initial capital account balance was $90,000, and Wilma's was $60,000. The agreement provides

that net losses, if any, will be allocated 65% to Fred and 35% to Wilma, but net income will be allocated 40% to Fred and 60% to Wilma. Fred is reasonably compensated for his services to the business through a guaranteed payment.

During the year, Flint Stores has net income of $50,000 after deducting Fred's guaranteed payment. Under the partnership agreement, $20,000 was allocated to Fred and $30,000 to Wilma.

Wilma is treated as the donee of a partnership interest because she received the property she contributed to the partnership as a gift from Fred [Reg. 1.704-1(e)(3)(ii)(a), Example 1]. Assume she is treated as the real owner of her partnership interest.

The allocation of 60% of Flint Stores' income to Wilma and 40% to Fred is not proportionate to their capital interests. Under IRC Sec. 704(e), the disproportionate allocation of income between donor and donee will not be respected for income tax purposes. Income will be reallocated for income tax purposes in accordance with the partners' interests in partnership capital; i.e., 60% ($30,000) to Fred and 40% ($20,000) to Wilma.

However, this income tax reallocation should not affect the legal validity of the partnership agreement. Under that agreement, unless it is modified by the parties, income would be allocated $30,000 to Wilma and $20,000 to Fred. Their capital accounts and legal rights to distributions would be determined accordingly. For income tax purposes, the transactions apparently would be treated as a gift from Fred to Wilma of the $10,000 that would be taxed to Fred but allocated to Wilma's capital account.

It is not clear, however, whether this is also the gift tax result. While it seems certain that one or more gifts occur at some point in this transaction, it would appear that the gift occurred only when the initial capital or partnership interest and attendant legal rights were transferred to the donee, as additional gifts would not occur for transfer tax purposes when the income was taxed to Fred but allocated to Wilma's capital account. However, the IRS could contend that each year's reallocated income is a separate gift (in much the same manner as the foregone interest from an interest-free demand loan), especially if the donor possesses the power to alter the partnership agreement or liquidate the partnership. (See IRC Sec. 7872.)

The transaction also can affect later years as the partners' interests in partnership capital change. If Flint Stores makes no distributions to the partners during the year, at the beginning of the next year, Fred's and Wilma's capital accounts will be $110,000 and $90,000, respectively, computed as follows:

	Fred	Wilma	Total
Initial capital balance	$90,000	$60,000	$150,000
Allocation of income for book purposes (according to partnership agreement)	20,000	30,000	50,000
Adjusted capital balance	$110,000	$90,000	$200,000
Percentage of total	55%	45%	100%

If Flint Stores again had $50,000 of net income the following year, the book allocations would be $20,000 to Fred and $30,000 to Wilma, as required by the partnership agreement. However, to reflect their new capital percentages, the proper income tax allocation should be $27,500 (55%) to Fred and $22,500 (45%) to Wilma.

The practitioner must recognize these consequences and determine whether they are consistent with the goals of the parties. If the only purpose for the special allocation is to have income shifted to Wilma's lower tax bracket, the allocation will not accomplish its purpose, at least in the short term. The proposed transfer should either be abandoned or accompanied by an additional gift of capital from Fred to Wilma. Fred could still retain certain management rights, so long as these rights were consistent with Wilma being the true owner of her interest. (See paragraph 1702.2.)

Alternatively, if income will not be distributed, the build-up of capital inside the partnership and the resulting increase in Wilma's capital percentage may eventually accomplish Fred's goals. Consequently, so long as the potential income tax and gift tax issues are fully considered and understood by both Fred and Wilma, the practitioner may choose to leave this structure in place.

Identifying Partnership Interests Subject to the Section 704(e) Income Allocation Rules

1701.9 Normally, the Section 704(e) income allocation rules apply to partnership interests transferred by gift. In a family setting, however, transfers other than gifts can create donor/donee relationships that trigger a Section 704(e) income reallocation. This can occur, for example, when a donee receives a gift of property that is later contributed to a partnership or stock in a corporation that is subsequently liquidated into a partnership. If the original donor is a partner in the resulting partnership and there is a close enough connection between the two transfers, the donee's partnership interest may be treated as having been created by a gift from the donor, thus creating

exposure to the family partnership income allocation rules [Reg. 1.704-1(e)(3)(ii)(a), Examples 1 and 3].

1701.10 Moreover, in the case of an indirect transfer, the donor may be a person other than the nominal transferor [IRC Sec. 704(e)(2); Reg. 1.704-1(e)(3)(ii)(a)]. Regulations provide the example of a person who transfers a sole proprietorship into a partnership with his spouse, after which the spouse gives an interest in the partnership to their child. In this case, both spouses may be treated as donors [Reg. 1.704-1(e)(3)(ii)(a), Example 2].

1701.11 A partnership interest also is treated as having been created by gift when it is purchased by one family member from another. The seller is treated as the donor, and the FMV of the purchased interest is treated as donated capital. For this rule, an individual's family members include only their spouse, ancestors, lineal descendants, and any trusts for the primary benefit of such persons [IRC Sec. 704(e)(2)].

Example 1701-3: Partnership interests that are deemed to have been acquired by gift.

Four years ago, Franklin gave a 10% interest in his farm (including land and equipment) to Samuel, his son. Franklin and Samuel later contributed their interests in these assets to a new partnership, Benjamin Farm. In the current year, Franklin gave 5% interests in Benjamin Farm to his daughter Donna and her husband, Sly. Franklin also sold an additional 20% interest to Samuel and 10% interests each to Donna and Sly, all at FMV. Following these transactions, the parties' capital and profits interests were as follows:

Franklin	40 %
Samuel	30 %
Donna	15 %
Sly	15 %
	100 %

The 5% partnership interests given directly by Franklin to Donna and Sly clearly were created by gift. Samuel's original 10% interest, obtained through his contribution of property received as a gift from Franklin, is also deemed to have been created by gift. In addition, because Samuel and Donna are members of Franklin's family, the 20% and 10% interests respectively purchased from Franklin are treated as having been created by gift. On the other hand, the 10% interest Sly purchased is not treated as a gift because Sly is not considered a member of Franklin's family for this purpose (i.e., he is not Franklin's spouse, his ancestor, or his lineal descendant). As a result, the family partnership income allocations rules apply with

respect to all interests owned by Samuel, Donna, and Sly, except for the 10% interest purchased by Sly.

1701.12 The family partnership income allocation rules under IRC Sec. 704(e) are income tax rules that govern who will be taxed on partnership income. The rules are designed to place income tax burdens on the persons who earn the income.

1701.13 These income tax rules do not govern the transfer tax (estate, gift, and generation skipping tax) consequences. For example, although the concept of retained controls over partnership income and property is relevant under both the income tax rules of IRC Sec. 704(e) and the gift and estate tax provisions, an intrafamily transfer of a partnership interest may fail to shift income tax burdens but, nevertheless, effectively shift ownership for estate and gift tax purposes [see IRC Secs. 2036 and 2038]. Issues relating to transfer taxes are addressed in more detail in section 1002 of the Tax Planning and Advisory *Estate and Gift Planning for Business Owners* topic.

General Anti-abuse Rule

1701.14 Practitioners also must consider the effects of the partnership anti-abuse regulation (Reg. 1.701-2). Under this regulation the IRS may recast a transaction or series of transactions involving a partnership if a principal purpose of the transaction(s) is the substantial reduction of the present value of the partners' aggregate federal tax liability in a manner inconsistent with Subchapter K [Reg. 1.701-2(b)].

1701.15 According to the regulation, the intent of Subchapter K is to permit taxpayers "to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax" [Reg. 1.701-2(a)]. This type of arrangement has the following components: (a) the existence of a bona fide partnership with a substantial business purpose for each transaction or series of transactions, (b) each transaction (or series of transactions) is respected under substance-over-form principles, and (c) the tax consequences to each partner reflect the partners' economic agreement and their income. The IRS has claimed broad powers to disregard a partnership in whole or in part, treat partners as nonpartners, revise a partnership's method of accounting, reallocate tax items among partners, or otherwise adjust or modify claimed tax treatments. Therefore, the client should carefully document the nontax reasons for the partnership's existence, preferably in the partnership agreement.

1701.16 See section 111 for more on the partnership anti-abuse rules.

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Key Issue 28B: Allocations When a Partner's Interest Changes; The Varying Interest Rules.

Regulations under IRC Sec. 706 provide allocation rules for when a partner's interest in a partnership varies during the year as a result of a disposition of the entire interest as described in Reg. 1.706-1(c)(2) (such as in the case of a partner's death or the sale or exchange or liquidation of a partner's interest) or as a result of the disposition of less than the entire interest, including the admission of a new member. In these situations, called *variations*, the partnership's distributive share items are allocated to the partners whose interest changed in one of two ways [Reg. 1.706-4(a)(3)(iii)]:

- The interim closing method.

- The proration method.

The proration method can only be used if agreed to by the partners. In the absence of such an agreement (which is described later in this key issue), the interim closing method must be used. However, partnerships may use different methods for variations that occur in the same tax year. Also, special rules apply to *extraordinary items* and *cash basis items*, as explained later in this key issue.

Note: A deemed disposition of the partner's interest pursuant to Reg. 1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group), Reg. 1.1362-3(c)(1) (relating to the termination of the S election of an S corporation partner), or Reg. 1.1377-1(b)(3)(iv) (regarding an election to terminate the tax year of an S corporation partner), is treated as a disposition of the partner's entire interest in the partnership solely for the rules of IRC Sec. 706 [Reg. 1.706-1(c)(2)(iii)].

Exceptions for Service Partnerships

Partnerships in which capital is not a material income-producing factor can use any reasonable method to allocate partnership items to account for the varying interests of the partners in the partnership during the tax year [provided that the allocations satisfy the provisions of IRC Sec. 704(b)] [Reg. 1.706-4(b)(2)].

Segmenting the Tax Year

To account for the partners' varying interests, a partnership must maintain segments for each partner whose interest changes during the year. A segment is a specific portion of a partnership's tax year. If the partnership does not perform regular interim closings, the first segment of a tax year begins on the first day of the partnership's tax year and ends at the time of the first interim closing of the books (determined using the applicable convention). Any additional segment begins immediately after the closing of the prior segment and ends at the next interim closing (or the end of the partnership's tax year, if sooner). If there are no interim closings, the partnership has one segment that corresponds to its entire tax year [Reg. 1.706-4(a)(3)(vi)].

The partners can agree to perform regular monthly or semi-monthly interim closings (regardless of whether a variation occurs). In that case, the partnership performs an interim closing of the books at the end of each month (or at the end and middle of each month). If the partners do not agree to perform regular interim closings, the only interim closings during the year are when variations for which the partnership uses the interim closing method are deemed (under the applicable convention) to occur [Reg. 1.706-4(d)].

After the segments are identified, the next step is to apportion the partnership's items for the year to its segments. Generally, each segment is treated as if it were a separate distributive share period. For example, a partnership could compute a capital loss for a segment of a tax year even though it has a net capital gain for the entire tax year. For allocating items to segments, any special limit or requirement relating to the time or amount of income, gain, loss, deduction, or credit applicable to the entire tax year is applied based on whether the partnership satisfies the limit or requirement as of the end of its tax year. For example, the expenses related to claiming a Section 179 expense deduction must first be calculated (and limited, if applicable) based on the partnership's full tax year, and then the effect of any limit is apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method. Special rules apply to extraordinary items and are discussed later in this key issue.

If a partnership uses the proration method, it prorates its distributive share items (other than extraordinary items) in each segment based on the number of days in the proration period relative to the number of days in the segment. Proration periods are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method. The first proration period in each segment begins at the beginning of the segment and ends at the time of the first variation within the segment for which the partnership selects the proration method. The next proration period begins immediately after the close of the prior proration period and ends at the time of the next variation for which the partnership selects the proration method. However, each proration period ends no later than the close of the segment [Reg. 1.706-4(a)(3)(viii)].

The partner's distributive shares of partnership items are then computed by taking into account their interest in such items during each segment and proration period.

Conventions

Conventions are rules of administrative convenience that determine when each variation is deemed to occur for these allocation rules. Because the timing of each variation determines the partnership's segments and proration periods, which in turn are used to determine the partners' distributive shares, the convention used by the partnership with respect to a variation will generally affect the allocation of partnership items. However, extraordinary items generally must be allocated without regard to the partnership's convention. Partnerships can use either of the following conventions [Reg. 1.706-4(c)]:

• *Calendar Day Convention.* Each variation is deemed to occur at the end of the day on which it occurs.

• *Semi-monthly Convention.* Each variation is deemed to occur either: (1) at the end of the last day of the immediately preceding calendar month (for variations occurring on the first through the 15th day of a calendar month) or (2) at the end of the 15th calendar day of that month (for variations occurring on the 16th through the last day of a calendar month).

• *Monthly Convention.* Each variation is deemed to occur either: (1) at the end of the last day of the immediately preceding calendar month (for variations occurring on the first through the 15th day of a month) or (2) at the end of the last day of that calendar month (for variations occurring on the 16th through the last day of a calendar month).

A partnership must use the same convention for all variations for which it used the interim closing method. Special rules apply if a convention would result in a variation being deemed to occur outside the partnership's tax year or if a partner becomes a partner because of one variation and ceases to be a partner as a result of another variation, and under the applicable convention both variations would be deemed to occur at the same time.

For variations for which the proration method is used, the calendar day convention must be used [Reg. 1.706-4(c)(3)(i)].

Example 28B-1: Allocating income when partners' interests vary.

At the beginning of the year, Prytania Partners (PP), a calendar year partnership, has three equal partners: Adam, Beth, and Charles. On April 16, Adam sells 50% of his interest in PP to Daphne. On August 6, Beth sells 50% of her interest in PP to Edward. During the year, PP's only distributive share items were ordinary income, ordinary deductions, and capital gains and losses incurred in the ordinary course of business. PP uses the following steps to allocate its distributive share items to its partners under Reg. 1.706-4.

1. Determine the available allocation methods. Assume capital is a material income-producing factor for PP. So, it must use either the closing of the books or the proration method to allocate its distributive share items to its partners.

2. Determine whether there are any extraordinary items that must be allocated according to special rules. In this case, there are none.

3. Determine which allocation method to apply to each variation. Assume the partners agree to apply the proration method to the April 16 variation, and PP accepts the default (interim closing) method for the August 6 variation.

4. Determine the deemed date of the variations based on PP's selected convention. Because it uses the proration method for the April 16 variation, PP must use the calendar day convention for that variation. Therefore, the variation that resulted from Adam's sale to Daphne on April 16 is deemed to occur at the end of the day on April 16. Assume the partners agree to apply the semi-monthly convention to the August 6 variation. Then, the August 6 variation is deemed to occur at the end of the day on July 31.

5. Determine whether the partnership will perform regular semi-monthly or monthly closings. In this case, it will not.

6. Determine the segments for the year. PP will have only one interim closing for the year, occurring at the end of the day on July 31, resulting in two segments for the year. The first segment begins January 1 and ends at the close of the day on July 31. The second segment begins at the beginning of the day on August 1, and ends at the close of the day on December 31.

7. Determine the income during the first segment (January 1-July 31). PP performs the interim closing of the books as of July 31 and determines the following:

	Period to Which Items Pertain		
Distributive Share Items	**1/1-7/31**	**8/1-12/31**	**1/1-12/31**
Ordinary income	60,000	15,000	75,000
Ordinary deductions	(24,000)	(9,000)	(33,000)
Capital gain in the ordinary course of business	12,000		12,000
Capital loss in the ordinary course of business	(6,000)	(3,000)	(9,000)

8. Determine the proration periods (if any). PP has two proration periods. The first begins January 1 and ends at the close of the day on April 16; the second begins April 17 and ends at the close of the day on July 31.

9. Prorate income from the first segment of the tax year among the two proration periods. Because each proration period has 106 days, PP allocates 50% of its items from the first segment to each proration period. Thus, each proration period contains $30,000 ordinary income, $12,000 ordinary deductions, $6,000 capital gain, and $3,000 capital loss.

10. Determine each partner's distributive share. First, PP determines each of the partners' ownership interests for the proration periods and segments as follows:

Segments and Proration Periods	Partners' Ownership Percentages Adam	Beth	Charles	Daphne	Edward
First segment, first proration period (1/1-4/16)	1/3	1/3	1/3	—	—
First segment, second proration period (4/17-7/31)	1/6	1/3	1/3	1/6	—
Second segment (8/1-12/31)	1/6	1/6	1/3	1/6	$ 1/6

Then, using that information, PP allocates its distributive share items as follows:

	Adam	Beth	Charles	Daphne	Edward	Total
First segment, first proration period (1/1-4/16)						
Ordinary income	$ 10,000	$ 10,000	$ 10,000			$ 30,000
Ordinary deductions	(4,000)	(4,000)	(4,000)			(12,000)
Capital gain	2,000	2,000	2,000			6,000
Capital loss	(1,000)	(1,000)	(1,000)			(3,000)
First segment, second proration period (4/17-7/31)						
Ordinary income	5,000	10,000	10,000	$ 5,000		30,000
Ordinary deductions	(2,000)	(4,000)	(4,000)	(2,000)		(12,000)
Capital gain	1,000	2,000	2,000	1,000		6,000
Capital loss	(500)	(1,000)	(1,000)	(500)		(3,000)
Second segment (8/1-12/31)						
Ordinary income	2,500	2,500	5,000	2,500	$ 2,500	15,000
Ordinary deductions	(1,500)	(1,500)	(3,000)	(1,500)	(1,500)	(9,000)
Capital gain	—	—	—	—	—	—
Capital loss	(500)	(500)	(1,000)	(500)	(500)	(3,000)

Preparation Pointer: Preparers should check if their tax preparation software is able to calculate the changes in interest and allocations under the proration method. Often, tax preparation software can calculate the allocations and provide a statement of how they were determined.

Extraordinary Items

Regardless of whether it is using the interim closing or the proration method, a partnership must allocate *extraordinary items* among partners in proportion to their interests at the time of day the item arose. Extraordinary items are the following [Reg. 1.706-4(e)]:

1. Items from the disposition or abandonment (other than in the ordinary course of business) of a capital asset.

2. Items from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or business.

3. Items from the disposition or abandonment of an asset excluded from capital asset treatment [as described in IRC Secs. 1221(a)(1), (a)(3), (a)(4) or (a)(5)], if substantially all the assets in the same category from the same business are disposed of or abandoned.

4. Items from assets disposed of in an applicable asset acquisition under IRC Sec. 1060(c).

5. Section 481(a) adjustments initiated by the filing of the appropriate form after a variation occurs.

6. Items from the discharge or retirement of indebtedness except items subject to IRC Sec. 108(e)(8).

7. Items from the settlement of a tort or similar third-party liability.

8. Credits, to the extent they arise from activities or items that are not ratably allocated (such as the rehabilitation credit, which is based on placement in service).

9. Any additional item that the partners agree to consistently treat as an extraordinary item for that year unless doing so would result in a substantial distortion of income in any partner's tax return.

10. Items that, in the opinion of the Commissioner, would, if ratably allocated, result in a substantial distortion of income in any consolidated or separate return in which the item is included.

11. Any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin.

Note: Prop. Regs. 1.706-4(e)(2)(ix) and (x), which would be effective if and when finalized, would add two extraordinary items: (1) for publicly traded partnerships (PTPs), certain items subject to withholding as defined in Reg. 1.1441-2(a) or withholdable payments under Reg. 1.1473-1(a) and (2) any deductions for the transfer of a partnership interest in connection with the performance of services. Prop. Reg. 1.706-4(e)(2)(viii) adds a third extraordinary item: any item arising from a final determination under the centralized partnership audit regime with respect to a partnership adjustment resulting in an imputed underpayment (that the partnership

does not elect, under Reg. 301.6226-1, to *push-out* to the reviewed-year partners). See Key Issue 6A for discussion of the centralized partnership audit regime.

There is a small-item exception to the extraordinary item rule. Items are not treated as extraordinary if, for the partnership's tax year [Reg. 1.706-4(e)(3)]—

1. the total of all items in the particular class of extraordinary items (for example, all tort or similar liabilities) is less than 5% of the partnership's gross income (in the case of income or gain items) or gross expenses and losses (in the case of losses and expense items), and

2. the amount of extraordinary items from all classes of extraordinary items described in item 1. is $10 million or less (determined by treating all such extraordinary items as positive amounts).

Agreement by the Partners

An agreement by the partners is required if the partnership selects any of the following:

• The proration method to allocate its income.

• The monthly or semi-monthly convention for determining when a variation occurs.

• To perform regular interim closings.

• Additional extraordinary items.

In these cases, an agreement by the partners means either (1) an agreement in a dated, written statement maintained with the partnership's books and records (including, for example, a selection included in the partnership agreement); or (2) a selection made by a person authorized to do so, including under a grant of general authority provided for by either state law or in the partnership agreement, if that person's selection is in a dated written statement maintained with the partnership's books and records. In either case, the dated written agreement must be maintained with the partnership's books and records by the due date, including extension of the partnership tax return [Reg. 1.706-4(f)].

Special Rules for Cash Basis Items

Generally, a partnership's items of income and loss are recognized and allocated based on the partnership's accounting method. A cash-basis partnership must assign certain *cash-basis items* to days of the year and allocate these items among the partners according to their partnership interests on each day [IRC Sec. 706(d)(2)]. The cash-basis items treated in this manner include [IRC Sec. 706(d)(2)(B)]—

1. interest,

2. taxes,

3. payments for service,

4. rents and other payments for the use of property, and

5. any other item designated by regulations (yet to be issued).

Note: Prop. Reg. 1.706-2, which will be effective when finalized, would provide that deductions for the transfer of a partnership interest are not cash basis items under IRC Sec. 706(d)(2). Instead, these deductions will be treated as extraordinary items when allocating income to the partners. In addition, any deduction that had been previously deferred due to the related party rules under IRC Sec. 267(a)(2) would be added to the list of cash basis items. Finally, under a *de minimis* rule, cash basis items below certain thresholds will not be subject to the special allocation rules under IRC Sec. 706(d)(2) [Prop. Reg. 1.706-2(c)].

If one of these cash-basis items is accrued in a tax year prior to when it is paid, the item is assigned to the first day of the year it is paid. However, if the partners' interests varied during the accrual period in the prior year, the varying interests during that period control the allocation of the cash-basis items. The partners' interests on the first day of the payment year do not control. To the extent a cash-basis item is allocable to a person who is no longer a partner, the item must be capitalized and added to the basis of the partnership's assets [IRC Sec. 706(d)(2)].

Example 28B-2: Allocating cash basis items.

James and Michael are equal partners in JEM Associates, a cash-basis calendar-year partnership. The partnership acquired commercial real estate in 20X1 for cash and a note dated October 15, 20X1, in the amount of $1 million bearing an 8.5% interest rate. [The partnership elected to use the cash method to report the note's interest expense. Without this election, the original issue discount (OID) rules would apply.] The first note payment, including accrued interest, was made on October 15, 20X2. The partnership admitted a third partner, Jennifer, on July 1, 20X2. She acquired an equal (one-third) interest in JEM for a $550,000 cash contribution. Certain cash-basis items, including interest expense, must be apportioned to the period in which they accrued. In this case, the $85,000 of interest accrues at the rate of $232.88 per day [($1,000,000 × 8.5%) ÷ 365], and it must be allocated to the partners on a daily basis. There was $17,932 of interest accrued during 20X1 (77 days × $232.88 per day) that was not paid in that year, so it was assigned to January 1, 20X2 and allocated among those who were partners during the time the accrual took place and who were still partners on the first of the year (in this case, James and Michael). Interest that accrued in the first six months of 20X2 ($232.88 × 181 = $42,150) is also allocated equally to James and Michael. The balance is allocated equally among the three members. The total allocation is as follows:

	20X1 Interest	1/1/X2 through 6/30/X2	7/1/X2 through 10/15/X2	Total Interest
James	$ 8,966	$ 21,075	$ 8,306	$ 38,347

	20X1 Interest	1/1/X2 through 6/30/X2	7/1/X2 through 10/15/X2	Total Interest
Michael	8,966	21,075	8,306	38,347
Jennifer	—	—	8,306	8,306
Total	$ 17,932	$ 42,150	$ 24,918	$ 85,000

Varying Interest Rules May Be at Odds with Economic Deal

The varying interest rules prohibiting retroactive allocations apply only for tax purposes. These rules do not prevent or limit the partners' ability to make retroactive allocations applicable for economic (not tax) purposes. For example, a late entering partner can be allocated the full economic loss (or income) accrued prior to becoming a partner—even though the pre-existing partners must be allocated the corresponding tax loss (or income).

Under the general Section 704(b) principles for partnership tax allocations, the tax results are required to be consistent with the economic arrangement. However, the varying interests rules under IRC Sec. 706(d) are intended to prevent retroactive allocations of tax items. The rules apply regardless of the underlying economic arrangement [Reg. 1.704-1(b)(1)(iii)]. At times, the varying interests rules of IRC Sec. 706(d) are incompatible with the allocation rules of IRC Sec. 704, but the Section 706(d) rules must be followed anyway.

Congress recognized and accepted this incompatibility as the cost of preventing retroactive allocations. Allocating the economic gains and losses differently from the corresponding tax allocations creates a permanent *book/tax* difference (i.e., a difference between the partner's tax-basis and book capital account used to determine the liquidating distribution to which a partner would be entitled).

Example 28B-3: Some retroactive economic allocations must be ignored for tax purposes.

Warren and Alice are equal partners in WHS II, a cash-basis partnership reporting on the calendar year. The partnership acquired commercial real estate for a $100,000 down payment and a $900,000 nonrecourse mortgage note with an 8% interest rate payable annually on December 31. WHS II does not have the cash necessary to pay the $72,000 of interest expense due and payable for the current year. Janet agrees to join the partnership as of the last day of the current year. As part of the arrangement, the partners agree Janet will be allocated all the accrued interest for the current year, and it will be charged to her capital account. The special allocation agreement complies with the substantial economic effect requirements under the safe harbor rules for special allocations.

The varying interests rules prevent WHS II from allocating a tax deduction for *any* of the current year interest to Janet—even though she bears 100% of the economic cost of the expense. Nevertheless, for purposes of maintaining WHS's economic books (which determine the partners' liquidation rights), the interest expense will be charged against Janet's capital account. The allocation of the economic loss to Janet and the tax loss to Warren and Alice creates a $90,000 book/tax difference in the partners' capital accounts.

Observation: The fact pattern in Example 28B-3 will occur infrequently since partners would generally be unwilling to pay a partnership expense without receiving the corresponding tax deduction.

In certain situations, it may be possible to make special allocations having the same economic impact as a prohibited retroactive allocation [IRC Sec. 704(b); *Mary K.S. Ogden*]. This prevents an unwanted book/tax difference like the one described in Example 28B-3. Example 28B-4 illustrates the use of special allocations to overcome a problem caused by the retroactive varying interests rules.

Example 28B-4: Retroactive allocation accomplished with special allocation.

Assume the same facts as in Example 28B-3. If Janet had agreed to join WHS II earlier in the year, it may have been possible to specially allocate items, accruing after her admission, giving Janet the same current tax benefit as an immediate deduction of all the accrued interest. For example, perhaps a disproportionate amount of the depreciation could have been allocated to Janet to provide the same total deduction.

To accomplish this, the special allocation must meet the substantial economic effect or partner's interest in the partnership (PIP) rules, and the specially allocated expense item must have occurred or accrued after the new partner was admitted. For example, if Janet were admitted on July 1, up to 100% of the depreciation expense for the last half of the year could be allocated to her, but none of the depreciation expense accruing prior to the time she became a partner could be allocated to her—even if the special allocation of preadmission depreciation met the substantial economic effect or partner's interest in the partnership rules under IRC Sec. 704.

Retroactive Allocations of Service Partnership Income

Another form of retroactive allocation is often used by professional service partnerships to change income allocations either late in the tax year or after year-end. These adjustments are typically made to divide the annual profits once the results for the year can be accurately determined. Apparently, the varying interests rules that are intended to prevent inappropriate retroactive allocations of tax items are not intended to apply to retroactive allocations of income among partners of a service partnership. Such retroactive allocations among service partners are generally respected where reallocations are among existing partners and are not the result of a contribution of capital during the year. (See *Kenneth E. Lipke.*)

Example 28B-5: Retroactive allocations in a service partnership.

Edwin Wayne & Co. is a calendar-year general partnership with 25 partners. The partners of this accounting firm change their partnership agreement in February of this year to provide that 95% of the current year earnings will be allocated to the partners based upon their respective partnership interests, and the remaining 5% will be allocated by the managing partner as discretionary bonuses based on individual partner performance. The current year discretionary bonus allocation is determined on or before March 15 of the following year. New partners are admitted only on the first day of the year, and no additional capital contributions are made after that date. This retroactive change in the allocation scheme is permissible.

Transfers at Death

The tax year of a partnership closes for a partner who dies. In such cases, the partnership's income and expenses should be allocated as provided in the permissible allocation methods provided by Reg.1.706-4(a)(3)(iii). See Chapter 37 for coverage of the tax implications when a partner dies.

Liquidation Payments to Retiring Partners

Generally, a partnership can make payments to a retiring partner that are treated as made in exchange for the retiring partner's interest. A partnership does not terminate and the partnership's tax year does not close with respect to the retiring partner until he or she receives the final payment in liquidation of the interest. See Chapter 37 for coverage of retirement payments to partners.

Transfers by Gift

The gift of a partnership interest does not close the partnership tax year. However, under Reg. 1.706-1(c)(5), the income up to the gift date is allocated to the donor under the rules for partnership interests created by gifts [IRC Sec. 704(e)]. Thus, the impact on allocations is the same as if the gift closed the partnership year with respect to the donor.

Example 28B-6: Gift of a partnership interest.

In October, Charles gifts his interest in Bigoil 86A, Ltd. to his daughter Winnie. The partnership will not terminate and the tax year does not end with respect to Charles [Reg. 1.706-1(c)(5)]. However, the results will be similar to a closing of the partnership's year with respect to Charles. Income for the year will be allocated between Charles and Winnie pursuant to the Section 704(e)(2) provisions [Reg. 1.706-1(c)(5)]. Under those rules, Charles is allocated income up to the gift date, and Winnie is allocated the income attributable to the period after the gift. Charles's Schedule K-1 should be marked final.

See Illustration 28-1 for a side-by-side comparison of Schedules K-1 for Charles and Winnie.

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Real-World Reform of Partnership Allocations

WALTER SCHWIDETZKY*

Abstract

Section 704(b) and its Regulations allows partnerships a great deal of flexibility on how items of income and deduction are allocated to partners. This flexibility has been heavily criticized over the years. The article reviews section 704(b) and its Regulations, including the partner's-interest-in-the-partnership test, the substantial-economic-effect safe harbor, and "target allocations." (Target allocations are widely used notwithstanding the lack of clear legal underpinnings). The article discusses the shortcomings of the existing scholarship, argues for a flexible section 704(b) allocation regime, but acknowledges that reform is necessary. The article proposes a new definition of substantiality, limiting section 704(b) to "bottom-line" items, and adding a safe harbor for target allocations.

Keywords: Section 704(b), allocations, partner's interest in the partnership, substantial economic effect, target allocations, Wynn, related partners.

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I. Introduction

There have been many articles written on the allocation rules of section 704(b)[1] over the years.[2] Many of these articles suffer from a disconnect with the real world. It is common, for example, for articles to recommend that allocations essentially be made the same way they are for S corporations, rigidly based on the partners' capital contributions.[3] Some have even

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[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated, and references to the "Service" are to the Internal Revenue Service.

[2] *See, e.g.*, Andrea Monroe, *Making Tax Law Work, Improvisation and Forgotten Taxpayers in Partnership Tax*, 55 U. MICH. J.L. REFORM 549 (2022) [hereinafter Monroe]; Stuart L. Rosow & Rachel A. Hughes, *Reforming Subchapter K: The Partnership Tax Simplification Act of 20__*, 94 TAXES 361 (2016) [hereinafter Rosow & Hughes]; Gregg D. Polsky, *Deterring Tax Driven Partnership Allocations*, 64 TAX LAW. 97 (2010) [hereinafter Polsky]; Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105 (1991) [hereinafter Berger]; Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990) [hereinafter Gergen].

[3] *See* I.R.C. § 1377(a); Monroe, *supra* note 2; Monte A. Jackel, *Is It (Finally) Time? Reforming Subchapter K*, 170 TAX NOTES 2031 (Mar. 29, 2021) [hereinafter Jackel]; George K. Yin & David

recommended that we should (directly or indirectly) eliminate Subchapter K.[4] As I will discuss, these views often are not only politically unrealistic but fail to meet the real-world needs of many businesses.

In September 2021, Senate Finance Committee Chair Ron Wyden (D. OR) released a draft proposing what would be the most substantial changes to Subchapter K since 1954 ("Wyden Proposals").[5] While taking a hard look at Subchapter K is commendable, I will discuss where its proposals to reform section 704(b) allocations fall short.

I agree, however, that reform is necessary. But any reform must align with how the real world operates. My proposal, discussed in detail below, would redefine substantiality, limit allocations to "bottom line" items, and add "target allocations" as a safe harbor. This approach should limit abusive use of allocations, while still permitting legitimate deals to take place, and would align the Regulations with current legitimate practices.

It is worth recalling that partnerships play a pivotal role in our economy. The most recent year for which tax filing data are available is 2020. In that year there were 4.3 million partnerships with over 28.2 million partners, almost $43.2 trillion in assets, and more than $760.2 billion in net income. [6]

J. Shakow, *Federal Income Tax Project: Taxation of Private Business Enterprises: Reporters' Study*, AM. L. INST. (1999) [hereinafter ALI Study]; Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451 (2001), (criticizing the ALI Study); Gergen, *supra* note 2.

[4] *See* Martin J. McMahon, Jr., *Rethinking Taxation of Privately Held Businesses*, 69 TAX LAW. 345 (2016) [hereinafter McMahon]; ALI Study, *supra* note 3, at 5; Rosow & Hughes, *supra* note 2; Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249 (1999); Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1997); Berger, *supra* note 2.

[5] *Wyden Unveils Proposal to Close Loopholes Allowing Wealth Taxpayers, Mega-Corporations to use Partnerships to Avoid Paying Tax*, CHAIRMAN'S NEWS, NEWSROOM, SENATE FINANCE COMMITTEE (Sept. 10, 2021) https://www.finance.senate.gov/chairmans-news/wyden-unveils-proposal-to-close-loopholes-allowing-wealthy-investors-mega-corporations-to-use-partnerships-to-avoid-paying-tax (an over-the-top title, albeit par for the course these days) [https://perma.cc/NHS7-ASAC] [hereinafter Wyden Proposals].

[6] Ron DeCarlo, Tuba Ozer-Gurbuz & Nina Shumofsky, *Partnership Returns, Tax Year 2020*, INTERNAL REVENUE SERV. STAT. OF INCOME BULL., last accessed Aug. 30, 2023, https://www.irs.gov/pub/irs-soi/soi-a-copa-id2204.pdf [https://perma.cc/A3LH-ER9N]. Partnerships and other non-corporate entities have earned about 37% of annual reported business net income from 2004-2015. *See SOI Tax Stats - Integrated Business Data*, tbl. 1, INTERNAL REVENUE SERV., last accessed Aug. 30, 2023, https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data [https://perma.cc/9FLS-MZF2]. Although the Tax Cuts and Jobs Act of 2017 reduced the C corporation rate from a maximum of 35% to a flat 21%, when all tax consequences were considered, it did not make sense for most businesses to switch to the C corporation form. *See, e.g.*, James R. Repetti, *The Impact of the 2017 Act's Tax Rate Changes on Choice of Entity*, 21 FLA. TAX REV. 686 (2018), Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate*, 162 TAX NOTES FEDERAL (TA) 977 (Mar. 4, 2019), and Michael S. Knoll, *The TCJA and the Questionable Incentive to Incorporate, Part 2*, 162 TAX NOTES FEDERAL (TA)

In 2020, about 1% of partnerships held about 79% of partnership assets, and about 10% of partnerships held about 95% of partnership assets. Therefore, the bottom 90% of partnerships only held about 5% of partnership assets.[7] It is tempting to focus on the largest partnerships after seeing these figures.[8] Indeed, the Wyden Proposals seem to do just that.[9] One should tread carefully, however; 5% of $43.2 trillion of partnership assets is still a big number in absolute terms and can have a substantial economic impact. Any changes to Subchapter K should take small and mid-sized partnerships into account. They should also be made carefully with appreciation for their economic impact given the economic size of the partnership universe. Ill-advised reform has the potential to wreak real economic havoc.

In the main, I will assume that the partners are fully taxable and acting at arm's length. Allocations between related partners raise very different concerns and are not a focus of this article. Nonetheless, in light of the mostly sensible Wyden Proposal in this regard, I will discuss them briefly. Tax exempt partners and items the allocation of which cannot have substantial economic effect, such as nonrecourse deductions and tax credits, are mostly beyond the scope of this article, though some discussion is unavoidable. I will assume that the at-risk rules of section 465, the passive loss rules of section 469, and the excess business loss rules of section 461(l) do not limit the deduction of losses. More often than not, this is a bad assumption, but it creates excessive complications to have to fold these loss limitation rules into my discussion. Further, given how common it is to use partnerships, the loss limitation rules do not seem to provide much of a barrier in ways that are relevant to this article. Finally, by partnerships, tax partnerships are meant, which typically includes, under the default rule, LLCs with two or more members.[10]

Part I provides a basic review and analysis of the relevant law, Part II discusses target allocations and why they should be included in any safe harbor, Part III addresses related party allocations, Part IV discusses

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1447 (Mar. 25, 2019). The data does not show any significant exodus from the partnership form. *See also*, Karen C. Burke, *The Spurious Allure of Pass-Through Parity*, 52 LOY. U. CHI. L.J. 351 (2020); Karen C. Burke, *Section 199A and Choice of Passthrough Entity*, 72 TAX LAW. 551 (2019).

[7] *SOI Tax Stats - Partnership Data by Size of Total Assets*, tbl. 15, INTERNAL REVENUE SERV., last accessed Aug. 31, 2023, https://www.irs.gov/statistics/soi-tax-stats-partnership-data-by-size-of-total-assets [https://perma.cc/5BGJ-XWLY] (under "All Partnerships," select "2020" to download an Excel file of tbl.15). A total of 4.3 million partnerships filed federal income tax returns, and these partnerships held $43.2 trillion in assets. *Id.* There were 43,995 partnerships with assets of $100 million or more, and they held total assets of $34,028,592,438,000. *Id.* By contrast, 3,093,303 partnerships held assets of $1 million or less, and these partnerships held total assets of $396,613,715,000 (net). *Id.* Monroe, *supra* note 2 at fn. 8 contains similar data for 2019.

[8] *See* Monroe, *supra* note 2, at n. 8.

[9] *See* Part V of Wyden Proposals, *supra* note 5; Walter Schwidetzky, *The Wyden Proposals on Partnership Debt: Step Forward or Back?*, 76 TAX LAW. 389 (2023) [hereinafter *Partnership Debt*].

[10] *See* Reg. § 301.7701-2.

misguided criticisms of section 704(b) allocations, Part V critiques the Wyden Proposals on section 704(b) allocations, Part VI provides my proposals for reforming section 704(b) allocations, and Part VII contains the conclusion.

II. A Basic Review and Analysis of Allocations under Section 704(b)[11]

A. *Introduction*

A partnership is a flow-through entity. Income and deductions are passed through to the partners. A mechanism needs to exist, therefore, for determining each partner's allocable share of partnership income and deductions. Section 704(b) and its Regulations generally allow partners a great deal of flexibility in this regard. The allocations do not necessarily need to be in proportion to the underlying ownership of the partnership interests or capital contributions. Someone who contributed 10% of the partnership's capital could be allocated 90% of depreciation deductions, for example. Or, in the classic "Brains-Money" deal, all losses could initially be allocated to the "money partners," with subsequent income allocated to them to the same extent as losses were previously, with income then allocated 50% to the "money partners" and 50% to the "brains partners." This is sometimes called a "flip." Disproportionate allocations are sometimes called "special allocations."

Section § 704(b) provides that a partner's "distributive share of income, gain, loss, and deduction, or credit . . . shall be determined in accordance with the partner's interest in the partnership . . . if" the partnership agreement does not provide for how a distributive [*i.e.*, allocable[12]] share will be allocated *or* if the allocations do not have "substantial economic effect." Thus, if an allocation *does* have substantial economic effect, it need not be in accordance with a partner's interest in the partnership. As I will discuss, a partner's interest in the partnership is determined under a facts-and-circumstances test. The Regulations provide specific—and at times quite complex—rules as to when allocations have substantial economic effect. The substantial economic effect rules provide a safe harbor. If the partnership agreement complies with the rules, the partnership knows the transaction will be safe. It used to be that practitioners viewed compliance with the substantial economic effect rules as virtually mandatory, but for some time now practitioners have been increasingly drafting agreements to come under the partners'-interest in-the-partnership facts-and-circumstances test. Indeed, in large, complex deals, the latter approach is likely the norm.

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[11] In this review I rely heavily on RICHARD LIPTON ET AL., PARTNERSHIP TAXATION, Chapter 5 (5th ed. 2021) [hereinafter PARTNERSHIP TAXATION]. I am the primary author of the portions of Chapter 5 discussed in this Article.

[12] The poorly chosen word "distributive" has nothing to do with distributions and, as noted, is generally synonymous with "allocable." *See* I.R.C. § 704(b).

The partnership allocations rules have been called "a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject."[13] In complex deals, I fully subscribe to this view. But in simpler deals, like the Brains-Money example above, it is an exaggeration. Simpler deals do not require the same kind of command of these rules, and fewer of the rules are relevant. Thus, the burden of the complexity is not the same for all partnerships.

B. *Capital Accounts*

For an allocation to comply with the substantial economic effect rules, the capital accounts must be maintained in accordance with the rules in the Regulations.[14] As the name substantial economic effect suggests, to meet the safe harbor an allocation must have a genuine post-tax, economic effect on the partner to whom the allocation is made. The rules for maintaining the capital accounts help to fulfill this task. Generally, these rules are based on sound economic concepts and are consistent with the applicable financial accounting rules.[15]

As the focus is on the economic rather than tax impact, the rules for keeping partners' capital accounts are quite different from the rules for computing the bases of partners' partnership interests.

Under the Regulations, a partner's capital account is increased by:

(1) The amount of money contributed to the partnership.

(2) The fair market value of property contributed to the partnership (net of liabilities secured by the property that the partnership is considered to assume or take subject to under section 752).[16]

(3) Allocations of partnership income and gain, including tax-exempt income.

A partner's capital account is decreased by:

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[13] Lawrence Lokken, Partnership Allocations, 41 TAX L. REV. 547, 621 (1986).

[14] Reg. § 1.704-1(b)(2)(iv)(a); *see* Raymond & Co. PLLC v. Commissioner, 124 T.C.M. (CCH) 246, 2022 T.C.M. (RIA) ¶ 2022-105 (hereinafter Clark Raymond), which dubiously held that an allocation lacked economic effect not because the partnership did not keep capital accounts but failed to keep them correctly; *see also*, Richard M. Lipton & Leah Gruen, *Did the Tax Court Correctly Apply Subchapter K in Clark Raymond?*, J. TAX'N (Mar. 2023) [hereinafter Lipton & Gruen].

[15] *See* WILLIAM MCKEE ET. AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02[2][c][i] [hereinafter MCKEE].

[16] The fair market value assigned to property will be regarded as correct provided that: (1) such value is reasonably agreed to among the partners in arm's-length negotiations and (2) the partners have sufficiently adverse interests. *See* Reg. § 1.704-1(b)(2)(iv)(h).

(1) The amount of money distributed to the partner.

(2) The fair market value of property distributed to the partner (net of liabilities secured by the property that the partner is considered to assume or take subject to under section 752).

(3) Allocations of expenditures of the partnership that can neither be capitalized nor deducted in computing taxable income.

(4) Allocations of partnership loss and deduction.

Section 752 effectively permits a partner to include her share of partnership liabilities in her basis in her partnership interest. A partner's capital account, on the other hand, does not include that partner's share of liabilities. If the partnership has liabilities, a partner's basis in her partnership interest often will exceed her capital account balance.[17] The amount of basis in the partnership interest is highly important because a partner may receive loss allocations up to her basis in the partnership interest under section 704(d). As the basis in the partnership interest goes down, the capital account can go negative, which the Regulations permit in certain circumstances. For example, if a partner's basis in the partnership interest is $25,000 and capital account is $15,000, the partner may be allowed to have up to a negative $10,000 capital account balance.

A partnership normally also maintains "book" accounts for the properties it holds. For example, if a partner contributes property with a tax basis of $7,000 and a fair market value of $10,000, the partnership's tax basis in that property under section 723 is $7,000. However, the partnership's "book value" (which some tax professors like to call book basis) is the full fair market value of $10,000. Book value, like capital accounts, focuses on the economic value of contributed property. If a partnership makes a distribution of property for which the fair market value differs from its book value, for capital account purposes the partnership recognizes the inherent gain or loss and allocates that gain or loss to the partners' capital accounts. There may not be any corresponding *taxable* gain or loss.[18]

C. *Substantial Economic Effect Rules*

1. *Introduction*

As noted above, the Regulations' substantial economic effect rules ("SEE") are a safe harbor. An allocation that complies with SEE will be allowed under section 704(b). There are two parts to the SEE test. First, the allocation must

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[17] This is not inevitably the case, however. For example, if the partner contributes property to a partnership with a fair market value that greatly exceeds its basis or the partnership adjusts capital at a time when the fair market value of property greatly exceeds basis, the capital account may exceed the tax basis of the partnership interest even after factoring in liabilities.

[18] *See* I.R.C. § 733 and Reg. § 1.704-1(b)(2)(iv)(e).

have "economic effect."[19] The Regulations in most instances provide a mechanical test for determining whether or not an allocation has economic effect. Second, because it is often possible to manipulate the economic effect test, the Regulations also provide that the economic effect of an allocation must be "substantial."[20]

2. *Economic Effect Test*

Partnerships have three options under the Regulations to satisfy the economic effect test, the "regular" economic effect test, the "alternative" economic effect test, and the "economic effect equivalence" test, each of which is discussed below.

a. *Regular Economic Effect Test.* The regular test has three parts:

(1) The partnership must keep capital accounts in accordance with the rules described above.

(2) When an interest of a partner is liquidated, the partner must be paid any positive balance in his capital account.

(3) If a partner has a deficit balance in his capital account, he must pay the deficit to the partnership by the end of the tax year in which his partnership interest is liquidated (or, if later, 90 days after liquidation). This last rule is sometimes called a "deficit restoration obligation" or "DRO."[21]

Example: A and B each contribute $10,000 to the AB partnership and are equal partners. The partnership borrows $40,000 on a recourse basis with only interest due for the first five years of the note. Assume that under section 752, $20,000 of the liability is allocated to each partner. AB purchases equipment for $60,000. The equipment generates depreciation deductions of $10,000 per year. A has a beginning tax basis in the partnership interest of $30,000 and a beginning capital account of $10,000. Now assume that in

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[19] Reg. § 1.704-1(b)(2)(i).

[20] Reg. § 1.704-1(b)(2)(i).

[21] Reg. § 1.704-1(b)(2)(ii)(a)–(c). A DRO will not be respected if it is not legally enforceable, or the facts and circumstances otherwise indicate a plan to circumvent or avoid such obligation. The Regulations provide the following non-exclusive list of factors that may indicate a plan to circumvent or avoid the obligation: (i) the partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation (ii) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership (iii) the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account is negative other than when a transferee partner assumes the obligation (iv) the terms of the obligation are not provided to all the partners in the partnership in a timely manner. Reg. § 1.704-1(b)(2)(ii)(c)(4)(B). These rules are similar to the anti-abuse rules that can apply for section 752 purposes, *i.e.*, the rules for including partnership liabilities in the partners' bases in their partnership interests.

Year 1 the partnership breaks even except for depreciation deductions on the equipment and allocates the entire $10,000 of that depreciation to A. A's basis is reduced to $20,000 and her capital account is reduced to zero. In Year 2, the partnership again breaks even on partnership operations except for depreciation, and again allocates $10,000 of depreciation to A. A's basis is reduced to $10,000, and A's capital is reduced to a negative ($10,000). If A's partnership interest is liquidated on January 1 of Year 3 with the partnership relieving A of any obligation on the partnership liabilities, A is required to contribute $10,000 to the partnership to bring her capital account to zero under the DRO rule.[22] Without this requirement, A would be getting more out of the partnership than she put into it, *i.e.*, her tax losses would exceed her economic losses. The contribution of $10,000 ensures that the entire allocation of depreciation indeed has an "economic effect" on her. The contribution increases her partnership interest basis to $20,000. As A's share of the liability is also $20,000. Under section § 752(d), A's amount realized on the liquidation of her interest is also $20,000, yielding no gain or loss.[23]

b. *Alternative Economic Effect Rules.* The difficulty with the regular economic effect rules is that partners are required to have unlimited DROs. This is rarely wise, especially for passive investors. The example I use when teaching this material: Assume the partners form a limited partnership and

[22] This requirement may exist for a general partnership under state law. For limited liability entities such as LLCs, the obligation to re-contribute a negative capital account would need to be contractually created. Contractually creating unlimited liability may be good tax planning in some circumstances, but it may not be consistent with business objectives.

[23] This assumes no application of section 751; see Reg. § 1.704-1(b)(3)(iii)(b) for how to address what would happen in the example if the allocation would not have economic effect. If a partner is not expressly obligated to restore the deficit balance in his capital account, the partner nonetheless will still be treated as having a DRO to the extent of (i) the outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by the partner (other than a promissory note that is readily tradable on an established securities market), and (ii) the amount of any unconditional obligation of the partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership. Reg. § 1.704-1(b)(2)(ii)(c)(1). A promissory note or unconditional obligation is taken into account only if it is required to be satisfied at a time no later than the end of the partnership taxable year in which the partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation). Reg. § 1.704-1(b)(2)(ii)(c)(2). If a promissory note is negotiable, a partner will be considered required to satisfy the note within the required period if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and the partner will contribute to the partnership the excess, if any, of the outstanding principal balance of the note over its fair market value at the time of liquidation. *Id.* If a partner contributes a promissory note to the partnership during a partnership taxable year, and the maker of the note is a person related to such partner, then such promissory note is treated as a promissory note of which the partner is the maker. Reg. § 1.704-1(b)(2)(ii)(c)(3). A partner will not be considered obligated to restore the deficit balance in his capital account to the partnership to the extent the partner's obligation is a bottom dollar payment obligation. *See* PARTNERSHIP TAXATION, *supra* note 11, at ¶ 3.04. Reg. § 1.704-1(b)(2)(ii)(c)(4)(A).

that all partners have unlimited deficit restoration obligations. An employee of the partnership, while conducting partnership business, runs over and kills a neurosurgeon with eight handicapped children. A large tort liability, in excess of insurance limits, results. The general partner is the only one liable under state partnership law, and he contributes sufficient funds to the partnership to enable it to pay the liability, increasing the general partner's capital account. The payment results in a large tax loss to the partnership that (if the limited partners had unlimited deficit restoration obligations) may be primarily allocated to the limited partners. The allocation causes the limited partners to have substantial negative capital accounts. Should they have to restore those deficit capital accounts (as might happen if the general partner decided to take this opportune moment to cause the partnership to liquidate), they would in effect be paying the tort liability, something that likely was not contemplated when they entered into the partnership agreement. The bottomless risk that an unlimited deficit obligation poses causes most advisors to recommend that their clients not agree to such a provision.

The Regulations, recognizing this business reality, contain an alternative economic effect test.[24] Under this alternative, an allocation must meet the first two economic effect tests (keep capital accounts according to the rules and upon liquidation, pay to a partner any positive balance in his capital account), but instead of having an unlimited deficit restoration obligation, the third requirement is that the partnership agreement contain a qualified-income-offset provision (discussed below). If this alternative test is met, an allocation will be treated as having economic effect if the allocation does not cause the partner to have a deficit capital account balance or increase an already-existing deficit capital account balance.[25] If allocations cannot drive a capital account negative, how would a deficit capital account arise? Primarily, it would go negative due to distributions, which the Service cannot prevent a partnership from making. Thus, the Service needed a mechanism for eliminating the deficit capital account of a partner who has no obligation to restore it. That mechanism is to require the partnership to allocate income as quickly as possible to the partner to offset any such deficit, *i.e.*, a "qualified income offset."[26]

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[24] Reg. § 1.704-1(b)(2)(ii)(d).

[25] In calculating the balance in the capital account, an adjustment must be made for certain reasonably expected future events, but such adjustments are out of the ordinary. *See* Reg. § 1.704-1(b)(2)(ii)(d).

[26] *See* Reg. § 1.704-1(b)(2)(ii)(d); poor planning can create problems under this rule. In Rev. Rul. 92-97, 1992-46 I.R.B. 6, two partners shared the "economic risk of loss" on debt of 90/10 but purported to allocate cancellation-of-indebtedness income that arose in the partnership's sixth year 50-50. That allocation would have predictably created a negative capital account for a partner who had no obligation to restore it. The Ruling properly reallocated the cancellation-of-indebtedness income 90/10.

Sometimes partners have limited deficit restoration obligations. They will agree to restore a deficit in their capital account up to a certain amount, but not beyond that. Limited deficit restoration obligations are much more common than unlimited DROs. A partner might agree to a limited deficit restoration obligation in order to be allocated more losses. In this circumstance, the partnership will need to comply with the qualified-income-offset rules, and allocations may be made to a partner that create a negative capital account up to the fixed amount that partner is obligated to restore. Thus, if a partner has a $10,000 deficit restoration obligation, he could be given allocations that caused him to have up to a $10,000 negative capital account as long as the partnership otherwise complies with the qualified-income-offset rules.[27]

c. *Economic Effect Equivalence*. The third alternative provided in the Regulations to meet the economic effect test is the "economic effect equivalence test." Allocations made to a partner that do not otherwise have economic effect under the rules discussed above can nevertheless be deemed to have economic effect under this test. The economic effect equivalence test is met provided that a liquidation of the partnership at the end of a given year (or at the end of any future year) would produce the same economic results to the partners as would occur if the regular economic effect test were met, regardless of the economic performance of the partnership.[28] In some ways, this test is designed for partnerships which failed to include appropriate economic effect provisions in their agreements, but whose structure is inoffensive. For example, assume A and B contribute $75,000 and $25,000, respectively, to the AB partnership. Assume further that the partnership maintains no capital accounts and the partnership agreement provides that

[27] Reg. § 1.704-1(b)(2)(ii)(c) provides that a (typically limited) DRO can be considered to exist in some circumstances where the partner has not formally agreed to a DRO. That Regulation provides that if a partner is not expressly obligated to restore the deficit balance in the partner's capital account, the partner nevertheless will be treated as obligated to restore the deficit balance in his capital account to the extent of: (A) the outstanding principal balance of his promissory note, which is contributed to the partnership (other than a promissory note that is readily tradable on an established securities market), and (B) the amount of any unconditional obligation of the partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership (not covered by "A"). *Id.* For these purposes, a promissory note or unconditional obligation is taken into account only if it is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner's interest is liquidated (or, if later, within 90 days after the date of such liquidation), a rule that also applies to DROs generally. *Id.* If a promissory note is negotiable, a partner will be considered required to satisfy the note within the relevant period if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain the note and the partner will contribute to the partnership the excess, if any, of the outstanding principal balance of the note over its fair market value at the time of liquidation. *Id.* Promissory notes made by a party related to the partner are generally treated the same as promissory notes made by the partner. *Id.*

[28] Reg. § 1.704-1(b)(2)(ii)(i).

all income, gain, loss, deduction, and credit will be allocated 75% to A and 25% to B and distributions will also be 75-25. A and B are ultimately liable (under a state law right of contribution) for 75% and 25%, respectively, of any recourse debts of the partnership.[29] Although the allocations do not satisfy the requirements of the regular or alternative economic effect rules, the allocations have economic effect under the economic-effect-equivalence test.[30] In principle, this test only applies to the simplest partnerships. In more complex situations, such as when the partners have varying interests over time or varying interests in different items, it will be much more difficult (or impossible) to prove that a liquidation of the partnership at the end of a given year (or at the end of any future year) would produce the same economic results to the partners as would occur if the formal economic effect test were met, regardless of the economic performance of the partnership. Those partnerships usually need to comply with the regular or alternative tests to be safe. That said, partnerships have sometimes used this test to defend target allocations, as I discuss below.

3. *Substantiality Test*

a. *General Rules.* For all of their complexity, the economic effect rules are not enough to get the job done. They are in the main mechanical rules, and like all mechanical rules can be manipulated inappropriately. Accordingly, the Regulations provide that not only must the allocation have economic effect, but also that economic effect must be substantial. The Regulations provide three independent tests for determining whether the economic effect of an allocation is substantial: (1) "the present value post tax rule," (2) the shifting tax consequences test, and (3) the transitory allocations test.[31] Because these tests are independent of one another, one must effectively pass all three for the economic effect of an allocation to be substantial, though not all may be relevant. There is essentially no case law on substantiality.[32]

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[29] In the case of a partnership operating through an LLP or LLC, where the owners are not normally liable for the debts of the entity, presumably A and B would have to agree to be personally liable for any recourse debts of the entity in the 75-25 ratio.

[30] This example is based on Reg. § 1.704-1(b)(5), example 4(ii).

[31] Reg. § 1.704-1(b)(2)(iii).

[32] I say essentially, because one case does discuss substantiality: TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006) (*Castle Harbour II*), rev'g Castle Harbour I, 342 F. Supp. 2d 94; TIFD III-E, Inc. v. United States, 666 F.3d 836 (2d Cir. 2012) (*Castle Harbour IV*), rev'g TIFD III-E, Inc. v. United States, 660 F. Supp. 2d 367 (D. Conn. 2009) (*Castle Harbour III*) [hereinafter together, *Castle Harbour*]. The details of the case are highly complex, and the trial court's opinion was decidedly troubled, resulting in multiple reversals. Ultimately, the appellate court concluded that that the recipients of the relevant allocations were not valid partners (essentially invalidating the partnership), making the trial discussion of substantiality of little value. *See also*, two truly excellent articles, Karen C. Burke & Grayson M.P. McCouch, *Snookered Again: Castle Harbour Revisited*, 128 TAX NOTES FEDERAL (TA) 1143 (Sept. 13, 2010) and Karen C.

(i) *Present Value, Post Tax Test.* For the present value post tax test, the Regulations provide that an allocation is *not* substantial if:

(1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and

(2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.[33]

Or, as I like to tell my students, the allocation is not substantial if, on a present-value, post-tax basis, someone is better off, and no one is worse off than would be the case if the allocation had not been made. If no one is worse off, it necessarily means that the allocation only had a tax effect and not a bottom-line economic effect (on a present value post tax basis). For there to be SEE, on a present value post tax basis, if any partner is made better off, then another partner must be worse off and vice versa. The devil is in the details.

In judging whether the economic effect of a given allocation is substantial, one must ask: Compared to what? The comparison would be with how items would be allocated if the allocation in question did not exist. In most of the examples that I will discuss in this Article and that are contained in the Regulations, it is fairly obvious what the comparative allocation would be. But in the real world, determining the comparative allocation can present a major challenge.[34] Generally, the comparison is made to the allocations that would be made in accordance with the partners' interests in the partnership; but as I will discuss, determining the partners' interest in the partnership is sometimes no small feat.[35]

For a special allocation, it is likely a given that someone is better off, or the allocation never would have been made. Accordingly, the focus typically is on the second part of the test: is someone worse off? What does it take to have a "strong likelihood" or be "substantially diminished?" The Regulations do not contain definitions of these terms. The Regulations give one example in which the after-tax economic consequences of an allocation was *not*

Burke & Grayson M.P. McCouch, *Sham Partnerships and Equivocal Transactions*, 69 TAX LAW. 625 (2016) [hereinafter together, Burke & McCouch].

[33] Reg. § 1.704-1(b)(2)(iii)(a).

[34] *See* MCKEE, *supra* note 15, at ¶ 11.02[2][b][v].

[35] Reg. § 1.704-1(b)(2)(iii)(a). In addition, if the partner to whom an allocation is made is a pass-through entity or a member of a consolidated group, the partnership testing an allocation must look through the pass-through partner or member of the consolidated group to the owners of the pass-through partner and the consolidated group to test the after-tax consequences.

substantially diminished; it states that $360 is not substantially less than $362.50 (about a .7% difference). But the terminology of the Regulations seems to suggest that to be substantially diminished, it must be very likely that some partner's present value post-tax outcome will be worse than it would be without the allocation *and* by a significant amount. How likely does it have to be: 100%, 75%, over 50%? And how much of a detriment does it have to be? Compared to the circumstance when the allocation is not present, does a partner have to be worse off by some absolute dollar amount or by a percentage? I would assume the latter, but then how big of percentage? Apparently, it has to exceed .7%, but by how much? Does it have to be 5%, 10% more? These are all unanswered questions.

In determining whether a partner is better off or worse off, tax consequences that result from the interaction of the allocation with the partner's tax attributes that are unrelated to the partnership are taken into account. Example: A partner has a substantial net operating loss unrelated to the partnership that would otherwise expire unused. Allocating extra income to the partner would not increase her tax liability to the extent offset by the net operating loss; as a consequence, under the Regulations, the economic effect of the allocation is not substantial.[36]

Another substantiality example: Assume taxpayers A and B are equal partners in the AB partnership. A expects to be in the 50% tax bracket over the next several years.[37] B, on the other hand, expects to be in the 15% tax bracket. Over the next several years the partnership expects to earn approximately equal amounts of tax-exempt interest and taxable dividends. Rather than divide each type of income equally, A and B agree that 80% of the tax-exempt income will be allocated to A and the balance of the tax-exempt income and all of the taxable dividends will be allocated to B. The partners can make this allocation without violating any of the economic effect rules. The economic effect of the allocation is not substantial because on a present-value, post-tax basis, A's position is enhanced (compared to the situation in which she would if she had been allocated half of each type of income) and B's position is not diminished (indeed his position is also enhanced, on an after-tax basis, B receives more than he would if he had been allocated half of each type of income).[38]

Unlike the transitory allocation rule discussed below which generally looks ahead no more than five years, the present value post tax rule does not have a time limit. However, the longer an allocation structure takes to come to closure, the greater the risk to the partners, and the more likely that the

[36] *See* Reg. § 1.704-1(b)(5), Ex. 8.

[37] This example is based on Reg. § 1.704-1(b)(5), Ex. (5), which uses this now fictitious 50% tax bracket. Even today it is possible for a taxpayer to approach this tax bracket if state and federal income taxes are combined and the taxpayer lives in a state with high income taxes.

[38] For the math, *see* PARTNERSHIP TAXATION, *supra* note 11, at ¶ 5.03C.

economic impact of the allocation is genuine. The lack of a formal time limit, therefore, typically is not of great significance.

(ii) *Shifting Allocations.* The Regulations provide independent substantiality tests for what the Regulations call "shifting" and "transitory" allocations. For these tests, the focus is on capital account balances. Generally, shifting allocations occur within a single tax year, and transitory allocations occur over a period of up to five years. In either case, the economic effect of an allocation will not be substantial if there is a strong likelihood that the capital accounts of the partners would be about the same as they would have been had the allocation not been made, and the allocation results in a net reduction of the partners' tax liability.

Beginning with shifting allocations, assume our equal AB partnership now owns section 1231 property and capital assets. It expects to sell each type of property in the current tax year and incur a $50,000 section1231 loss and a $50,000 capital loss. The partnership agreement complies with the economic effect rules. Partner A has ordinary income of $300,000 and no section 1231 gains. She can therefore fully use the section 1231 loss but make only limited use of the capital loss.[39] Partner B has $200,000 of ordinary income and $100,000 of section 1231 gains, meaning that he can fully use either type of loss and receive the same tax benefit. The partnership amends the partnership agreement and provides that for the current tax year only, all section 1231 losses will be allocated to A and all capital losses will be allocated to B. While the allocation will have economic effect, the economic effect will not be substantial. There is a strong likelihood (actually, an absolute certainty) that A and B will have the same capital account balances they would have had if the allocation were not contained in the partnership agreement (still a $50,000 loss each, consisting of equal parts of each type of loss). Further, the total taxes of A and B are reduced as a result of the allocation (A's taxes go down, B's taxes are unaffected).[40]

(iii) *Transitory Allocations.* Transitory allocations operate in essentially the same way as shifting allocations, except they occur over a period of years. Under the Regulations, if there is a strong likelihood that: (1) an "original allocation" and a later "offsetting allocation" will leave the capital accounts approximately where they would have been had the allocations not occurred and (2) the tax liability of the partners will be reduced as a result of the allocations, then the economic effect of the allocations will not be substantial. The Regulations provide that if the offset happens and taxes are reduced, it will be presumed that there was a strong likelihood that this would

[39] Under I.R.C. § 1231, if a taxpayer has losses in excess of gains from the sale of I.R.C. § 1231 property, the losses and gains are generally treated as ordinary losses. If I.R.C. § 1231 gains exceed I.R.C. § 1231 losses, the gains and losses are generally treated as long-term capital gains and losses. Under I.R.C. § 1211(b), capital losses are fully deductible from capital gains. Individuals may only deduct $3,000 of capital losses in excess of capital gains from ordinary income.

[40] This example is based on Reg. § 1.704-1(b)(5), Ex. (6).

happen unless the taxpayers can present facts and circumstances demonstrating otherwise. However, if there is a strong likelihood that the offsetting allocation will not be made "in large part" (another undefined term) within five years of the original allocation, then the economic effect of the allocation will be substantial.[41]

Expanding on a prior example, assume that our equal AB partnership has predictable, approximately equal amounts of income each year and A has an expiring net operating loss carryforward. To allow A to take greater advantage of the net operating loss carryforward, the partnership allocates all of its income in Year 1 to A. It allocates all of its income in Year 2 to B. Thereafter, it returns to allocating income equally between the partners. The partnership agreement complies with the economic effect rules. The economic effect of the allocation is not substantial because there is a strong likelihood of the offset occurring and the partners' tax liability is less than it would have been without the allocation (the allocation lowers A's taxes and, except for modest time-value-of-money considerations, which the Regulations ignore, is neutral as to B). Note that if the offset would occur more than five years after the original allocation (not that B would ever agree to that), the allocation would be allowed.[42]

b. *Depreciation–Recapture Gain Chargebacks.* The regulatory rules on depreciation and the associated gain chargeback might be the most controversial portion of the substantiality regulations. It is quite common for partnership agreements to allocate depreciation to a subset of partners, typically the money partners, and upon a subsequent sale of the property, to allocate any gain recognized to the same subset of partners up to the amount of depreciation allocated to them. Such a provision is sometimes called a "gain chargeback."[43] Recognized gain in excess of the amount needed for the gain chargeback might be allocated to all of the partners. If everything goes according to plan, this approach can offer substantial tax savings to the relevant subset of partners. The preferential allocation of depreciation reduces the partners' ordinary income, and, particularly with real estate, any gain allocated would be favorably taxed as section 1231 gain or long-term capital gain.[44]

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[41] Reg. § 1.704-1(b)(2)(iii)(c).

[42] This example is based on Reg. § 1.704-1(b)(5), Ex. (8)(ii).

[43] *See* MCKEE, *supra* note 15, at ¶ 11.02[2][b][iii]; depreciation gain chargeback should not be confused with the "minimum gain chargeback" that can be required by the Nonrecourse Deduction Regulations. *See* Reg. § 1.704-2(b)(2).

[44] Note, however, that unrecaptured section 1250 gain (*i.e.*, gain on real estate equal to the depreciation deductions taken) typically is taxed at a higher capital gain rate (25%) than adjusted net capital gain (15% or 20%). *See* I.R.C. § 1(h). Straight-line depreciation is typically the only type of depreciation allowed for real estate. I.R.C. § 168(b)(3). *See also* I.R.C. § 1250; Reg. § 1.1250-1(f). Personal property typically drops in value over time, but in principle the same issue could arise with depreciation of personal property, except that gain equal to any depreciation taken is recaptured as ordinary income under I.R.C. § 1245.

One might ask whether there could be a transitory allocation issue, assuming the gain is recognized within five years of the depreciation deductions. The deduction for depreciation allocated in the early years is offset by an income allocation in a later year, leaving the relevant partners' capital accounts in the same place they would have been had the depreciation allocation never been made. It should at least be possible for this arrangement to violate the transitory allocation rules, but under the Regulations it will not. There cannot be a strong likelihood of the offset occurring because the Regulations assume, for purposes of the substantiality rules, that a property has a fair market value equal to its book value.[45] Book value, in turn, is reduced by depreciation deductions. For example, if book value has been reduced to zero, the Regulations assume for substantiality purposes that the fair market value of the property is zero. Any gain, given the presumption, is a "surprise." There is no coherent reason for this assumption ("FMV-Book rule"). And in the case of real estate, it is likely to be untrue. Even those critical of Subchapter K reform proposals acknowledge that the regulatory assumption is dubious.[46]

Interestingly, apparently even the drafters of the Regulations could not fully accept this assumption. While the FMV-Book rule is unequivocal, as such, an exception of sorts is carved out for zero book value property that continues to generate net income. To state the obvious, property that continues to generate net income does not have a fair market value equal to zero even if the book value is zero. Yielding to that reality, Example 2 of the Regulations states that property subject to a lease that extends beyond its recovery period can have a "strong likelihood" of producing taxable income notwithstanding the fact that its presumptive value is zero. Thus, while the Regulations sanction a loss allocation offset by *gain* attributable to the value

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[45] Assuming properties are reflected on the books at book value. Reg. § 1.704-1(b)(2)(iii)(c) provides: For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property's fair market value." *See* Rev. Rul. 99-43, 1999-2 C.B. 506, where the Service stated that the value-equals-basis rule does not validate the relevant special allocations, which unsuccessfully attempted to shift cancellation-of-indebtedness income to an insolvent partner, because they were agreed to after the property had been revalued on the partnership's books. *See also* MCKEE, *supra* note 15, at ¶ 11.02[2][b][iii].

[46] *See* Richard Lipton and Maher Haddad, *The Wyden Draft Partnership Proposals: Not Much Good but Lots of Bad and Ugly*, 135 J. TAX'N 18 (2021).

of future income, they do not sanction a loss allocation offset by *income* from the property, at least if the property is subject to a long-term lease.[47]

Rather than create a contradictory example, the Regulations should never have promulgated the FMV-Book assumption.[48] Eliminating this assumption can have a large impact in the real estate context. It is common for allocation structures to take advantage of the disparate tax brackets of the partners. Typically, real estate ventures involve shifting depreciation deductions from low-bracket general partners/managing members to high-bracket limited partners/non-managing members.[49] Eliminating the assumption will require these ventures to have a greater economic focus than is currently the case.[50] Of course, if the FMV-Book rule were eliminated, it is not inevitable that the transitory allocation rules will be violated in the case of allocations of depreciation with a subsequent gain chargeback. There still needs to be a strong likelihood of the offset. It depends upon the facts. For any single deal, it may be quite difficult to show this strong likelihood. But, particularly for real estate, investors can be fairly confident that, over a series of investments, on average an investment will prove profitable, and the early depreciation deductions will eventually be offset by favorably taxed gains. Not only does that make the FMV-Book rule difficult to justify, it also raises questions about whether the strong likelihood test is an appropriate standard, as I will discuss in my proposal.

c. *Compliance.* SEE is undoubtedly complex. While I am not aware of any data on point, I do not doubt that many return preparers "wing it at times," particularly in light of the low audit risk for partnerships.[51] But it is a bit simplistic to say, as has been suggested, that the partnership world is divided into "elite" and "forgotten" (by which is meant mostly smaller) partnerships, with the latter unable to implement the Regulations.[52] As noted earlier, for many structures, such as the Brains–Money example, one does need to have command of every nook and cranny of the Regulations. For a genuine economic deal, the substantiality rules likely do not meaningfully

[47] *See* Reg. § 1.704-1(b)(5), Ex. (2), and MCKEE, *supra* note 15, at ¶ 11.02[2][5][ii]. The prior proposed regulations did not back off of this assumption, but the Service apparently could not stomach it in the final regulations. *See* Prop. Reg. § 1.704-1(b)(5) Ex. (2)(i) (1983) and MCKEE, *supra* note 15, at ¶ 11.02[2][5][ii].

[48] ALI Study, *supra* note 3, at 88, suggests that the FMV–Book rule was necessary for administrability. It is not apparent why this is the case.

[49] *See* MCKEE, *supra* note 15, at ¶ 11.02[2][b][iv].

[50] For rules for allocating section 1245 recapture arising from a sale of personal property, *see* Reg. § 1.1245-1(e)(2)(i). Special rules apply to depreciation recapture attributable to property contributed by a partner. See Reg. § 1.1245-1(e)(2)(ii).

[51] In 2017, 0.1% of federal partnership returns were audited. *See IRS Statement – Updated IRS Audit Numbers*, tbl. 2, INTERNAL REVENUE SERV., May 26, 2022, https://www.irs.gov/pub/irs-utl/statement-for-updated-audit-rates-ty-19.pdf [https://perma.cc/HJ7A-934C] [hereinafter Audit Risk].

[52] *See* Monroe, *supra* note 2.

come into play. It can be a fairly straight-forward matter to keep proper capital accounts and make sure they are properly adjusted. There are other deals where true mastery of SEE is required to be in compliance. An example might be a partnership in which different classes of partners share in different proportions (sometimes called "waterfalls"), with each class having different preferred returns. But these latter partnerships also typically involve much larger dollar amounts, and the partnerships can afford the pricy counsel with the needed expertise.

While the substantiality rules are manageable, I do not mean to suggest that repealing the FMV-Book rule is the only needed improvement. As already noted, it can be very difficult to determine what the alternative allocation should be when analyzing substantiality. This is particularly true in complex deals with many layers of allocations. Does the alternative have to be the least tax efficient or merely moderately so? The "strong likelihood" test can be excessively taxpayer-friendly. For this reason, I propose to reformulate the substantiality test, as discussed below in my proposals for reform.

D. To PIP or not to PIP

Recall that SEE is a safe harbor within the more general rule that an allocation must be in accordance with the partner's interest in the partnership ("PIP"). But there is only modest guidance on PIP. The baseline rule is that PIP and the partner's interest in any particular item of partnership income, gain, or loss are generally determined by taking into account all facts and circumstances relating to the economic arrangement of the partners.[53]

The Regulations provide that the following facts and circumstances are ordinarily taken into account for purposes of determining PIP or a partner's interest in any particular item of income, gain, or loss, though the list is not exclusive:

(1) the partners' relative contributions to the partnership;

(2) the partners' interests in the economic profits and losses (if different than that in taxable income and loss);

(3) the interests of the partners in cash flow and other non-liquidating distributions; and

(4) the rights of the partners to distributions of capital upon liquidation.[54]

Although PIP has been an important consideration in determining the partners' distributive shares for over 45 years, there has been less than universal agreement as to the approach and reliability of PIP.[55] This tension may be illustrated by contrasting the comments of the two major treatises on

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[53] *See* Reg. § 1.704-1(b)(3)(i).

[54] Reg. § 1.704-1(b)(3)(ii).

[55] The use of PIP in section 704(b) was added by The Tax Reform Act of 1976, Pub. L. No. 94-455 § 213(d), 90 Stat. 1520, 1547-8 (1976).

partnership taxation. Willis, Pennell, Postlewaite, and Lipton conclude that "There is not a conflict between a partner's interest in the partnership and substantial economic effect. They both rely on the same overriding principle that the tax effects of partnership operations must conform to the economic effect of those operations."[56] On the other hand, McKee, Nelson, and Whitmire caution that "it is far from clear that identical results would in fact be achieved under both the partners'-interests-in-the-partnership rule and the substantial economic effect safe harbor, and thus drafters of partnership agreements who stray from the safe harbor do so at their peril."[57]

The Regulations make it reasonably clear that PIP is determined on an item-by-item basis.[58] Thus if a partner has a 50% overall interest but a 90% interest in depreciation, at least the starting point for PIP for depreciation should be the 90% interest and not the 50% overall interest.[59] None of the current PIP cases have actually gotten that far into the weeds, typically involving ill-advised partnerships that either did not have written agreements or made fundamental errors in their written agreements.[60] There have not been many cases that have looked at PIP, as such, but my research indicates that courts are generally getting to the right answer. In the main, the cases have concluded that allocations that fail SEE are allowed under PIP when they are grounded on solid economics and not allowed when they are not.[61] The sample size is small, but caselaw suggests that PIP is a viable standard.

Some have complained that the regulatory definition of PIP is so cursory as to be of little value.[62] Yet, how much more detailed could it really be? There are myriad ways of structuring legitimate economics in partnerships, and PIP Regulations that cover all of them with specificity was never a realistic or achievable objective.

There was a time when complying with the SEE was seen as virtually mandatory. Why rely on a vague PIP standard when a more detailed safe harbor exists? One probably would not want to use PIP for simpler deals, such as the Brains-Money example above. But as partnerships get larger and more complex, complying with SEE can present a major drafting challenge. Further, even if that drafting challenge is met, will the accountants

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[56] PARTNERSHIP TAXATION, *supra* note 11, at ¶ 10.02[1].

[57] *See* MCKEE, *supra* note 15, at ¶ 11.02[3].

[58] *See* Reg. § 1.704-1(b)(3)(i) and MCKEE, *supra* note 15 at ¶ 11.02[3]. The Regulations exclude from the item-by-item rule allocations that, by their nature, cannot have economic effect (*e.g.*, nonrecourse deductions and deductions of percentage depletion in excess of cost). In these cases, a partner's interest in the partnership is to be determined in accordance with specific rules, which are outside the scope of this rticle. *See* Reg. § 1.704-1(b)(3)(i).

[59] Reg. § 1.704-1(b)(3)(i).

[60] *See* Walter D. Schwidetzky, *In Defense of the PIP Regulations*, 72 TAX LAW. 519 (2019) [hereinafter *In Defense of PIP*]; *see also* Clark Raymond, *supra* note 14 (where the court got lost in applying PIP and SEE, generally), and Lipton & Gruen, *supra* note 14.

[61] *See In Defense of PIP*, *supra* note 60.

[62] *See* Monroe, *supra* note 2.

maintaining the books and filing the returns be able to implement it (I speak from experience)?[63] It can be quite difficult to make the capital accounts come out correctly after taking the partners' underlying economic deal into account. An example would be a partnership with multiple classes of partners, each with different allocation preferences, some of which change over time. Working through all of the allocations and making sure the capital accounts have the correct balances in light of the underlying economic arrangement has made for many a lawyer's sleepless night. It is easier to focus on where the cash should go. If Partner A invested X dollars, and the partnership succeeds, to what kind of return is A entitled and how much should A receive on liquidation of the partnership? Most lawyers find the latter easier to draft; they can "follow the cash" instead of slugging their way through SEE.

Even if this is true, given PIP's vague confines, isn't ignoring SEE too risky? In the early going, the answer was yes, but over time, perhaps encouraged by the low rate of audit for partnership returns, larger partnerships have moved away from SEE and toward "target allocations." Target allocations do not comply with SEE and rely instead on PIP. While I am not aware of any hard data in this regard, my own casual surveys of American Bar Association (ABA) Tax Section members and general experience in the area indicate that target allocations are the preferred approach for larger partnerships.[64] I discuss target allocations next.

III. Target Allocations

Detailed discussions of target allocations can be found elsewhere, but some discussion is unavoidable.[65] Target allocations arose out of the drafting

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[63] I helped prepare the limited partnership agreement for a partnership that purchased a major radio station and wrote the tax opinion for the Regulation D disclosure memorandum. The agreement complied with SEE. The limited partners did not have DROs. Nonetheless, in the first year they were given negative capital accounts. I called the accountant and told him that was not allowed. The next year they had still bigger negative capital accounts. Fortunately, it did not matter as the losses were suspended under I.R.C. § 469. The partnership was not a great success and was liquidated a few years later, allowing the losses to be deducted under I.R.C. § 469(g).

[64] *See* Rosow & Hughes, *supra* note 2, indicating that compliance with SEE is the exception (probably meaning in the context of larger partnerships).

[65] Arguably the leading article on target allocations is Daniel Goldberg, *The Target Method for Partnership Special Allocations and Why It Should Be Safe-Harbored*, 69 TAX LAW., 663 (2016) [hereinafter Goldberg]. Oddly, there is not universal agreement as to terminology. Alternatives to target allocations include the target method, targeted capital accounts, forcing the capital accounts method of allocation, and the layer cake method of allocation, among others. *See* Goldberg at 689. *See also* William G. Cavanagh, *Targeted Allocations Hit the Spot*, 129 TAX NOTES FED. (TA) 89 (Oct. 4, 2010); Todd D. Golub, *Target Allocations: The Swiss Army Knife of Drafting (Good for Most Situations—But Don't Bet Your Life on it)*, TAXES: THE TAX MAG. 157 (Mar. 2009) [hereinafter Golub]; Terrence Floyd Cuff, *Working with Target Allocations—Idiot Proofing or Drafting for Idiots?*, 35 REAL EST. TAX'N 116 (2008). Terence Floyd Cuff, *Some Selected Issues in*

challenges created by SEE. Target allocations, in a sense, invert SEE. Rather than basing distributions on capital account balances as required by the economic effect rules, it bases capital account balances on intended distributions. The parties agree on how current and liquidating distributions will be made, and income and loss are allocated to the capital accounts to ensure that there is a sufficient balance in the capital account to cover the distribution (especially on liquidation of a partnership interest). Typically, "target capital accounts" are kept following the same rules as are required for SEE. What is missing is the obligation to liquidate in accordance with capital account balances, violating the economic effect test.

For purposes of this discussion (and to avoid unhelpful complexity), I will assume any distribution is in cash. Example:[66] G and L form a limited partnership. G, the general partner, contributes $10,000 to the partnership, and L, the limited partner, contributes $90,000. Upon obtaining a nonrecourse loan from a commercial bank in the amount of $900,000, the partnership purchases a building on leased land for $1.0 million (leaving no working capital in this simple example). Assume Partnership operations result in operating income (rents in the amount of $150,000) being exactly equal to operating expenses (maintenance, repairs, land lease payments, loan interest in the aggregate amount of $150,000), so that net losses equal depreciation deductions for the year. Assume for computational simplicity that straight-line depreciation is allowed over a ten-year recovery period, ignoring the mid-month convention, so that each year's depreciation is $100,000. The deal between G and L is that losses will be allocated 10% to G and 90% to L, income will be allocated in the same manner until allocations of income equal prior allocations of losses, and thereafter income will be allocated 50-50. Similarly, distributions will be made 10-90 until each partner has recovered his original capital contributions ($10,000 to G and $90,000 to L), and thereafter the partners will share distributions equally. To implement this approach with "target capital accounts," the partnership agreement might provide that profits will be allocated in the following order of priority: First, to any partners having negative balances in their respective target capital accounts, in proportion to such balances, in amounts sufficient to bring these negative balances to zero. Second, to the partners who are entitled to the distributions under the partnership agreement to the extent necessary so that the target capital account balances of those partners are at least equal to the amounts remaining to be distributed to them under the

Drafting Real Estate Partnership and LLC Agreements, in PRAC. L. INST.: THE CORP. TAX PRACTICE SERIES: TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCING, REORGANIZATIONS & RESTRUCTURINGS CH. 52 (Louis S. Freeman Ed., 2007)[hereinafter, Cuff, *Selected Issues*]; ROBERT L. WHITMIRE ET AL., STRUCTURING & DRAFTING PARTNERSHIP AGREEMENTS: INCLUDING LLC AGREEMENTS, ¶ 5.05[2] (4th ed. 2023) [hereinafter STRUCTURING & DRAFTING].

[66] I borrow this example from Goldberg, *supra* note 65, at 669–70.

partnership agreement. If there are not sufficient profits to fully achieve these allocations, the same formula will be followed to the extent of available profits. If profits exceed what is necessary to achieve these allocations, then the excess in this fact pattern would be allocated 50-50. Losses, on the other hand, might be allocated first among those partners whose target capital account balances exceed the balances of those partners' respective contributions, in proportion to (and to the extent of) their respective excesses, and second, in this fact pattern, 10% to G and 90% to L.[67]

Often, target allocations will generate the same capital accounts balances as SEE. But the beauty of target allocations is that a partnership is not required to liquidate in accordance with capital account balances. A partner might be paid more or less than that balance, though this can generate a taxable gain or (in liquidation) a loss, assuming capital accounts are equal to the partners' bases in their partnership interests.[68] In more complex deals, target allocations are typically believed to be easier to draft.[69] Part of what makes the drafting easier is that the scrivener has to provide the economic terms of the deal only once in the distribution section of the partnership agreement. The allocations are forced to conform to the distributions to be made, and, at least where there is sufficient gain, cannot be in conflict with them. Indeed, some call target allocations the "forced allocation method."[70] While SEE often requires the drafter to anticipate the future, target allocations operate after the fact, that is, after the events that give rise to them have occurred. Provided it is clear what the economic deal is among the partners in the event of a hypothetical liquidation, the drafter can focus directly on building up or reducing the balances of the partners' year-end capital accounts so that they ideally equal the amounts the partners would receive under the hypothetical year-end liquidation.[71]

A more complex example shows the drafting problems that SEE can create:[72] Suppose G and L enter into a real estate venture, under which G and L get their investment back first ($10,000 to G, $90,000 to L) proportionately, from distributions, and thereafter share further distributions

[67] There would also need to be provisions addressing the allocation of nonrecourse deductions that might arise if the book value of the property drops below the outstanding loan amount. To discuss them at this point would have added unhelpful complexity. *See* Reg. § 1.704-2 and PARTNERSHIP TAXATION, *supra* note 11, at ¶ 5.07.

[68] Under section 731, a money distribution in excess of a partner's basis in the partnership interest ("outside basis") generates a taxable gain; in liquidation, if a distribution consists only of money, accounts receivable, and inventory, and if the amount of money and carryover basis in the accounts receivable and inventory in the aggregate are less than the outside basis, the partner recognizes a loss. Any gain or loss is treated as gain or loss on the disposition of the partnership interest, a capital asset. *But see* I.R.C. § 751(b).

[69] *See* Goldberg, *supra* note 65, at 667–68.

[70] *See* STRUCTURING & DRAFTING, *supra* note 65.

[71] *See* Goldberg, *supra* note 65.

[72] I again borrow this example from Goldberg, *supra* note 65, at 705.

50-50. Times become bad, rents are down, so the partnership cannot satisfy its expenses, including servicing its mortgage. The partners find a savior (Savior 1), who invests $100,000 and become entitled, as a priority, to the return of his investment and an 8% interest equivalent, before G and L will get any distributions (under their earlier arrangement).

Business continues to be disappointing, so in order to save the project from foreclosure, the partners, now G, L, and Savior 1, find a new savior, Savior 2, who negotiates the following deal: Savior 2 gets his investment back first plus a 10% interest equivalent preference, before the existing distribution order among Savior 1, G, and L becomes operative, with the following modification: Savior 2 also becomes entitled to an additional 10% of all other distributions to Savior 1, G, and L, that is, any amounts that go out to those other partners would cause 10% of that amount to be distributed to Savior 2. None of this is particularly unrealistic. I, for one, would not want to have to draft the provisions necessary to implement this agreement under SEE, especially since I would have to provide assurances that the priorities outlined above and understood by the partners will be accomplished. As indicated earlier, when practitioners complain about the complexity of SEE, it tends to be in this context, *i.e.* implementing complex allocation structures. If I am using target allocations, on the other hand, my job would be easier, I "just" need to make sure the money goes out correctly, and then force the allocations to align the capital accounts correctly.

While more complex deals seem to give rise to target allocations, they can also make sense in some simpler deals. An example: Assume a partnership in which the general partner and the limited partner normally split profits and losses 20%-80%. But if certain performance standards are met, liquidation proceeds are split 30%-70%. Assume that all of the assets of the partnership are sold prior to liquidation. Under the economic effect test, depending on the facts, it may be impossible to allocate enough gain to the general partner to cover his liquidation proceeds.[73] Thus, the current Regulations, if followed rigidly, could prevent the partners from implementing what is otherwise an entirely unobjectionable economic agreement. Target allocations, on the other hand, present no such problem. The distribution rights prevail. While target allocations try to get the capital accounts to match the liquidating distributions, they do not insist on it. Target allocations do not require partners to receive the balance in their capital accounts on liquidation. If the capital account balances do not match the partners' liquidating distributions, as noted above, the partners will recognize gain or loss to the extent permitted

[73] Some partnership agreements that wish to comply with the substantial economic effect test contain "savings clauses" designed to address circumstances such as these. These savings clauses can create problems of their own, however. See Goldberg, *supra* note 65, at 714–17.

under section 731 on the liquidation distributions.[74] That said, for most simpler deals, SEE works well, is legally safer, and typically is the wiser approach to use.

Target allocations can also backfire, particularly for a service partner who receives a profits interest in the partnership in exchange for services. Normally the service partner does not recognize income on receipt of the profits interest.[75] If that is the case, the capital account of the service partner normally starts at zero. If the intent is that the service partner receives, for example, 20% of the value of the future appreciation of the property held by the partnership, the targeted capital account approach may (depending upon how it is drafted) force allocations of other income to the service partner to build the service partner's capital account up to the 20% level. This could occur because the appreciation in the partnership property has not yet been recognized, but an event in the partnership agreement requiring the service partner to be at the 20% level has been triggered. In this event, the service partner may receive income before being entitled to receive cash and thus will be required to use his own funds to pay tax on this "phantom" income. Drafter emptor.

Likely, most partnership tax practitioners use target allocations and are apparently comfortable that target allocations represent PIP.[76] Other advisors rely upon the economic effect equivalence test to support target allocations.[77] This reliance is decidedly dubious as it can only be justified if the partnership would have gotten the same outcome had it liquidated in accordance with traditional capital account balances.[78] Yet one of the main reasons for using target allocations is to avoid liquidating in accordance with capital account balances.

There is nothing inherently offensive about target allocations in legitimate economic deals. Target allocations just provide an alternative—some would say superior—method for tracking the partners' deal. Given how common target allocations have become, there is a good argument for adding a safe harbor for target allocations to the Section 704(b) Regulations.[79] To my knowledge, there are no cases involving target

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[74] While target allocations currently appear to be fairly popular, there are also advisors who view them with skepticism. See Cuff, *Selected Issues*, *supra* note 65; STRUCTURING & DRAFTING, *supra* note 65.

[75] See Rev. Proc. 93-27, 1993-2 C.B. 343, and PARTNERSHIP TAXATION, *supra* note 11, Ch. 8. For these purposes, a profits interest is defined as an interest that would not give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership at the time of the receipt of the partnership interest.

[76] *See Terence Cuff Interviewed by Jerald David August*, 49 CORP. TAX'N 38, 42 (Mar.-Apr. 2022) [hereinafter *Cuff Interview*].

[77] *See* PARTNERSHIP TAXATION, *supra* note 11, at ¶ 5.03.

[78] PARTNERSHIP TAXATION, *supra* note 11, at ¶ 5.03.

[79] See Goldberg, *supra* note 65, at 715–16.

allocations. There are two explanations for this, both of which could be correct: the pathetically low audit rate for partnerships,[80] and the fact that a well-designed, legitimate target allocation should meet the PIP standard,[81] making a Service challenge improbable.

I do not want to leave readers with the impression that target allocations are the promised land. In addition to the fact that target allocations fail SEE and are thus riskier to use, there is a lack of consensus on how to draft target allocations (or even what to call them). The Regulations have special rules for allocating nonrecourse deductions, *i.e.* deductions attributable to nonrecourse debt.[82] It is not clear how target allocations work in this context.[83] And, of course, there is zero authority supporting (or, admittedly, opposing) target allocations. Given how widely target allocations seem to be used, the Service should issue guidance in this regard.

IV. Related Party Allocations: Wyden Proposals Get This (Mostly) Right

Before I move on to the heart of this Article, I need to digress briefly to discuss allocations among related parties. The Section 704(b) Regulations are premised on the assumption that partners deal with each other at arm's length. Related party allocations raise very different issues, which are not directly relevant to my proposals, and have been ably addressed by others.[84] But inasmuch as the Wyden Proposals contains a proposal in this regard, some brief coverage is appropriate.

If the partners are closely related (*e.g.*, two subsidiaries wholly owned by the same parent), they can agree to allocations that make little economic sense but save taxes for the related partners as a group. [85] The Substantiality Regulations in their current form are ill-suited to deal with related-partner allocations. As a result, these regulations can easily be abused by related partners.

Example: Assume taxpayers A and B are equal partners in the AB partnership. A expects to be in the 50% tax bracket over the next several years.[86] B, on the other hand, expects to be in the 15% tax bracket. The partnership earns both taxable and tax-exempt income. But, unlike the substantiality example discussed earlier, income is not predictable. If the

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[80] *See Audit Risk*, *supra* note 51.

[81] *See In Defense of PIP*, *supra* note 60, at 528–29.

[82] *See* Reg. § 1.704-2 and PARTNERSHIP TAXATION, *supra* note 11, at ¶ 5.07.

[83] *See Cuff Interview*, *supra* note 76. There are also reportedly issues with GAAP. *Id.*

[84] A leading article in this area is Emily Cauble and Gregg D. Polsky, *The Problem with Abusive Related-Party Allocations*, 16 FLA. TAX REV. 479 (2014) [hereinafter Cauble & Polsky]. I am indebted to Professors Cauble and Polsky for the following discussion.

[85] *See* I.R.C. §§ 267(b),707(b).

[86] This example is based on Reg. § 1.704-1(b)(5), Ex. 5, which uses this now fictitious 50% tax bracket. Even today it is possible for a taxpayer to approach this tax bracket if state and federal income taxes are combined, and the taxpayer lives in a state with high income taxes.

partnership allocates the tax-exempt income to A and the taxable income to B, the allocations likely pass the substantiality test because, on a present value, after tax basis, it is likely that one partner will be better off and one worse off than if each received a 50% allocation of each type of income.[87] Given this lack of predictability, normally neither A nor B would agree to this allocation if they were dealing at arm's length. But what if A and B are related? Perhaps A and B are brother-sister corporations with identical owners. Now, since they are effectively one economic unit, whether A or B comes out better economically is no longer of great relevance, and A and B can focus on making allocations that save them the most in taxes in the aggregate.

Oddly, there is nothing in the Section 704(b) Regulations that definitively addresses this issue. Regulation 1.704-1(b)(1)(iii) states: "[A]n allocation that is respected under [the substantial economic effect rules] nevertheless may be reallocated under other provisions, such as *section 482* . . . ." [88] A similar statement is contained in an example in the Regulations.[89] Thus, rather than stating that the allocation lacks substantiality, the Regulations punt the issue to section 482. That is in some ways understandable. Section 482 is designed to address tax issues that arise between related parties and allows the Service to reallocate tax items to prevent evasion of taxes or clearly to reflect the income. If section 482 and its brutally detailed Regulations could be counted on to stop A and B, then it could make sense to not also burden the Section 704(b) Regulations with parallel provisions. But this may not be the case. The lack of authority makes the analysis challenging,[90] but in the view of some the critical issue under section 482 is whether B and C acquired their partnership interests on arm's length terms; as long as they paid fair value for what they received, which can be resolved with appraisals, they may pass muster under section 482.[91] Under this interpretation of section 482, it could be a straight-forward matter to comply and receive the preferred allocation.

That said, section 482 is broadly written:

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[87] *See* Cauble & Polsky, *supra* note 84, at 492.

[88] Emphasis supplied. F.S.A. (Sept. 10, 1993), 1993 WL 1469410 states: "Given the present facts, it is important to examine the economic relationship of the partners of the Partnership. While the substantiality regulations do not specifically address the issue of related partners, Regulation section 1.704- 1(b)(2)(iii)(a) does require the Service to consider each partner's tax attributes." This statement could be read to mean that related-party tax issues are fair game under the substantiality rules. But given that this F.S.A. is almost 30 years old and stands alone, it cannot be seen as a meaningful challenge to related parties under the Section 704(b) Regulations.

[89] Reg. § 1.704-1(b)(5), Ex. 28.

[90] There are a handful of cases involving partnerships and section 482 that predate the current Regulations. *See, e.g.*, Gettler v. Commissioner, 34 T.C.M. (CCH) 442, Aladdin Indus., Inc. v. Commissioner, 41 T.C.M. (CCH) 1515, and Cappuccilli v. Commissioner, 668 F2d 138 (2d Cir. 1981).

[91] *See* Cauble & Polsky, *supra* note 84, at 495.

> ...the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect income...

Query whether this language is broad enough to give the Service the authority to simply undo a special allocation and require proportional allocation of the different types of income. If that were the case, perhaps a parallel provision in the Section 704(b) Regulations would not be necessary.[92] The problem is the uncertainty. At a minimum, the Service should provide specific guidance if it wishes to go down this path.

Could the Service choose to challenge the related-party allocation under the substantiality rules? Possibly not under the current Regulations, which in this context look to a "partner's *tax* attributes."[93] The relatedness of the partners is not, as such, a *tax* attribute, but a business-law attribute.[94] One could perhaps stretch the regulatory language to mean any attribute that can have a tax impact, but it would be just that, a stretch. Further, if the Service could successfully challenge the allocation under the substantiality rules, how would any reallocation occur under PIP? As long as the partners' separate partner status is respected, it may be difficult to devise a sensible alternative. The PIP rules look to items such as the partners' relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other non-liquidating distributions, and the rights of the partners to distributions of capital upon liquidation, though the Regulations note that there may be other relevant facts and circumstances.[95] At least under the specified facts and circumstances, it might be difficult to reallocate between related partners as their existing allocations may well align with those factors.[96] Note that PIP does not require that partners receive consistent allocations of all types of income and deduction.[97] For the Service to be confident of its ability to challenge related party structures under the substantiality Regulations, Treasury would need to

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[92] Cauble & Polsky, *supra* note 84, citing Regulation section 1.482-1(b)(1) in support of their view that section 482 can be avoided at least where income is sufficiently variable, noting that this Regulation states: "In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." But in the regulatory example, B and C likely would not have made the deal if they had not been related. Accordingly, the Regulation may not resolve the question. What is missing is clear guidance in the allocation context, which the Service is long overdue in providing.

[93] *See* Reg. § 1.704-1(b)(2)(iii).

[94] *See* Cauble & Polsky, *supra* note 84, at 496–97 to the same effect.

[95] *See* Reg. §§ 1.704-1(b)(3)(i)-(ii).

[96] *See* Cauble and Polsky, *supra* note 84, at 497–98 to the same effect.

[97] *See In Defense of PIP*, *supra* note 61.

amend the Regulations, and then the Service would still be forced to address the issue on a case-by-case basis.

The Service could challenge the allocations under the Partnership Anti-Abuse Regulations,[98] which give the Service very broad authority to restructure the transaction, including disregarding the partnership, not treating a purported partner as a partner, adjusting the partnership's method of accounting, and reallocating income and loss.[99] These Regulations have been heavily criticized, and their validity has been questioned.[100] No case has invoked the Partnership Anti-Abuse Regulations,[101] though these Regulations provide that it is a negative factor if substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another.[102] Even if the Partnership Anti-Abuse Rule provided the Service with a valid tool to address related party allocations, the Service would still be required to do so on a case-by-case basis. A better solution is to have a bright-line rule that restricts allocations among related partners.

Two somewhat similar proposals have been made to formally address the issue of related partners. The Wyden Proposals provide that if partners are members of a controlled group (within the meaning of section 267(f)) and together own 50% or more of partnership capital or profits, the partnership must consistently allocate all items based on partner "net contributed capital," essentially based on relative capital contributions.[103] Professors Cauble and Polsky have made a similar, more detailed proposal (looking at equity value rather than net capital contribution), but without the 50% threshold.[104] The Wyden Proposals are to be commended for addressing the issues of related parties, but with regard to the threshold, the position of Professors Cauble and Polsky is more persuasive. Related-party allocations can be problematic even if the related parties own less than 50% of the partnership. The dollar values may still be large. The non-related partners may care little how allocations are made amongst the related partners. Further, how is the 50% threshold determined? Depending on the allocation structure, operations, and distributions made by a partnership, that might be

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[98] Reg. § 1.701-2.

[99] *See* PARTNERSHIP TAXATION, *supra* note 11, at ¶ 13.03.

[100] *See, e.g.*, Sheldon I. Banoff, *Anatomy of an Anti-Abuse Rule: What's Really Wrong with Reg. Section 1.701-2*, 95 TAX NOTES TODAY 56-84 (Mar. 22, 1995); Richard M. Lipton, *The Partnership Anti-Abuse Regs Revisited: Is There Calm After the Storm?*, 83 J. TAX'N. 68, 68 (1995); *see also*, James B. Sowell, *The Partnership Anti-Abuse Rules: Where Have We Been and Where Are We Going?*, 89 TAXES 69 (2011); Andrea Monroe, *What's in a Name: Can the Partnership AntiAbuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401 (2010); McKee, *supra* note 15, at ¶ 1.05[2][a].

[101] *See* McKee, *supra* note 15, at ¶ 1.05[2][a]. A larger number of cases make note of the Anti-Abuse Regulations, but none have invoked it.

[102] *See* Reg. § 1.701-2(c).

[103] *See* Wyden Proposals, *supra* note 5.

[104] *See* Cauble & Polsky, *supra* note 84, at 502–11.

challenging to reliably calculate. One can debate the other details, which I will leave to others, but what is required is a robust system that requires related parties to use fixed allocations.

That said, it should be noted that related party rules can overreach. For example, assume a father and son, both with substantial personal resources and in high tax brackets, want to each invest $1 million in a venture, with the understanding that the father would have preference as to both loss allocations and distributions. I am told fact patterns such as these are not uncommon.[105] There is nothing inherently offensive about this structure, but it could run afoul of new related party allocation rules. One could well conclude that having related party rules apply to these less problematic structures is a price worth paying to stop the more abusive conduct of related parties. But even if one wanted to address the issue, drafting a formal exception could be challenging and create an unwieldy regulation. A better solution might be rule that would allow related parties to apply to the Service for an exemption in appropriate circumstances.

V. Misguided Criticisms of Section 704(b) Allocations

The many articles that have been written criticizing the section 704(b) regulatory regime are usually plagued by the same problems: a lack of understanding of how the real world operates and, or an apparent lack of understanding of the section 704(b) regulatory structure. This misapprehension can lead to unrealistic hypotheticals that are used to attack the current system and to misguided proposals for "reform."

A. *Problematic Examples*

Here are some of the problematic examples in the literature (the example numbering is my own):

Example 1: "A and B each invest $50 in AB partnership. The partnership expends and deducts $100 in year one. It expects to earn $106 in year two. The entire $100 loss in year one and the first $100 of income in year two are allocated to A. The remaining $6 income in year two is split evenly between A and B. . . . As explained below, this may be valid under current law (though the regulations are unclear)."[106]

Assuming the partners are acting at arm's length, B would never agree to allow A to have the losses in year 1 unless B could not use them, and even then it would be unlikely, as commonly the loss would qualify as a net operating loss that B could carry forward indefinitely under section 172. Further, if B could be persuaded to agree because of his personal tax

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[105] This example is drawn from discussions held by the author with members of the Mannes Greenberg Tax Society.

[106] *See* Gergen, *supra* note 2, at 5.

circumstance, the Regulations are clear – the allocation would be disallowed as transitory. One example in the Regulations is almost exactly on point.[107]

Example 2: "AB partnership owns Blackacre, which produces $100 rent per year. A and B are equal partners. Ninety percent of the rental income is specially allocated to B in year one. One hundred percent of the rental income is specially allocated to A in year three.[108] All income allocated is currently distributed."[109]

As with Example 1, A would normally not agree to this as a 50% partner, unless something else is going at the partner level that would make it rational to do so, and then it would again be a prohibited transitory allocation. The author did not address this issue or explain what happened in year 2 (presumably equal allocation). To be fair, the author did not claim that the example would pass muster, but instead was trying to show how the transaction could be similar to a loan. But why use an invalid allocation for this purpose, and why not address the transitory allocation issue?

Example 3: "ABC[110] is considering an investment of $1,000 to develop a mine which will produce $160 income per year for nine years. ABC has sufficient net operating losses carried over from prior years so that it will not pay taxes for many years. ABC enters into a partnership with DEF, which has a 40% marginal rate, to develop the mine. ABC contributes $850 and DEF contributes $150. Under the partnership agreement, 100% of the mine development expense is allocated to DEF and 100% of the income is allocated to DEF until its capital account is restored to zero. Thereafter, 80% of the income is allocated to ABC and 20% is allocated to DEF. .... The allocations in [this example] are probably valid. They are modeled after example two of the § 704(b) regulations, which holds that a similar plan involving the disproportionate allocation of depreciation deductions to one partner with a gain chargeback does not violate the rule against transitory allocations."[111]

These allocations likely would violate the transitory allocation rules for the first five years of the deal but for the FMV-Book rule.[112] As already discussed, the FMV-Book rule often lives at some distance from reality and should be eliminated. It is not clear from the example, however, if the author is specifically criticizing this rule. If so, I (and most) would heartily agree. It is a bit of an odd choice of facts, however. Mining most likely involves depletion more than depreciation. Unless percentage depletion were available,[113]

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[107] *See* Reg. § 1.704-1(b)(5), Ex. 8.

[108] It was not specified what happens in year two, presumably equal allocation.

[109] *See* Gergen, *supra* note 2, at 7.

[110] The example does not specify what kind of an entity ABC is, but it should not make any difference.

[111] *See* Gergen, *supra* note 2, at 23–24.

[112] *See* Reg. § 1.704-1(b)(2)(iii)(c).

[113] *See* I.R.C. § 613.

depletion deductions are not fixed, but based on how much mining is done.[114] Depletion deductions are thus not as predictable as depreciation deductions and likely would make it harder for the proposed "tax dodge" to work. That said, the FMV-Book rule is not explicitly limited to depreciation and conceivably could be applied in the depletion context. Read generously, the example awkwardly makes a valid point—*to wit*, that the FMV-Book rule needs to go.

Example 4: "Taxpayer A is an equal member of Partnership ABC which produces $300 of income from the rental of its vacant land. A also possesses a $300 expiring net operating loss from a prior year in a different activity. The partners agree to allocate to A all of the partnership's income for the year in return for A's agreement to relinquish his rights to $300 of partnership income in subsequent taxable years."[115]

The authors rightly complain that this structure is abusive. What they do not appear to realize is that the Regulations agree. It clearly constitutes a transitory allocation and would not be allowed, yet this issue was not addressed with regard to the cited example.[116]

Example 5: This example admittedly is very similar to one in the Regulations.[117] "*S* and *T* form a general partnership solely to acquire and lease machinery that is 5-year recovery property under section 168. Each contributes $100,000, and the partnership obtains an $800,000 recourse loan to purchase the machinery . . . . The partnership agreement further provides that (a) partnership net taxable loss will be allocated 90 percent to *S* and 10 percent to *T* until such time as there is partnership net taxable income, and thereafter S will be allocated 90 percent of such taxable income until he has been allocated partnership net taxable income equal to the partnership net taxable loss previously allocated to him, (b) all further partnership net taxable income or loss will be allocated equally between S and *T*, and (c) distributions of operating cash flow will be made equally between S and *T*.[118] The partnership enters into a 12-year lease with a financially secure corporation under which the partnership expects to have a net taxable loss in each of its first 5 partnership taxable years due to cost recovery deductions with respect to the machinery and net taxable income in each of its following 7 partnership taxable years, in part due to the absence of such cost recovery deductions.

[114] *See* Reg. § 1.611-2. I used to write oil and gas tax opinions as a lawyer, taught oil and gas tax as an adjunct professor, and wrote my first article as an assistant professor in this area: Walter Schwidetzky, *Oil and Gas Taxation: The Pool of Capital Doctrine, A Peace Proposal*, 61 TUL. L. REV. 519 (1987).

[115] *See* ALI Study, *supra* note 3, at 79; I have modified the example slightly; subsequent to the discussion of this example, the ALI Study discusses the substantiality rules without ever noting that this example would violate those rules.

[116] *See* Reg. § 1.704-1(b)(5) Ex. (8)(ii).

[117] *See* Reg. § 1.704-1(b)(5) Ex. 2.

[118] *See* Berger, *supra* note 2, at 135.

There is a strong likelihood that the partnership's net taxable loss in partnership taxable years 1 through 5 will be $100,000, $90,000, $80,000, $70,000, and $60,000, respectively, and the partnership's net taxable income in partnership taxable years 6 through 12 will be 40,000, $50,000, $60,000, $70,000, $80,000, $90,000, and $100,000, respectively."

The author fairly notes that it is hard to fathom a business purpose to this structure. Again, this is an unlikely fact pattern. Why would T agree to a preferential allocation to S if T is putting up half of the money? Normally, T would not, and if T did, it would likely be because of tax considerations taking place at the partner level, which would raise substantiality issues. The Regulations hold that this allocation structure does not violate the transitory allocation rules, but only because the eventual offset happens after year 5. In reality, it would be very difficult to make reliable projections over 5 years out (or over 2 years, for that matter). Even in a longer-term equipment lease with a reliable lessee, where income and depreciation deductions are predictable, it would be difficult to be confident of the economics so far out. The equipment could fail, the lessee likely will have some rights to terminate the lease, etc. That said, at least this structure occurs, though it is uncommon, which may be why the Regulations address it. (An example might be a triple-net lease to a Fortune 500 company.) This example would be less objectionable if it discussed the potential substantiality issue and the improbability of the fact pattern, but those factors did not even get a passing mention beyond questioning the business purpose to the structure. That said, of the examples that I am covering, this might be the most defensible, the high rung of a low ladder.

As this discussion shows, it is difficult to create a real-world example that violates the substantiality rules, makes economic sense, primarily is not tax driven, and involves unrelated parties. That alone points to the viability of SEE.

B. *Why Using S Corporation Rules for Allocations Will Not Work*

One of the most common proposals is to require partnerships to have fixed allocation systems, such as those that exist for S corporations.[119] These proposals all live at some distance from the real world. Commonly, deals do not present themselves in a way that would allow such a system to meet the partners' needs.

[119] *See* Monroe, *supra* note 2; Jackel, *supra* note 3; Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1997); Gergen, *supra* note 2; ALI Study, *supra* note 3, at 183–86 (would allow certain preferred interests).

1. *Example 6 (The Real World)*

A and B form a limited partnership to drill for oil and gas.[120] A is the general partner; B is the limited partner. A contributes $10,000; B invests $990,000. The partnership expects to sustain losses in the early years, but then start to show substantial profits, though there are no such thing as assured profits from an oil well. This is a variation on the Brains-Money partnership. A is the brains partner, and B is the money partner.

Would B agree to invest if he did not get (on these facts) 99% of any early losses, or something similar? Highly unlikely. Would A bother to raise the money if she could only get a long-term interest of 1%? Again, highly unlikely. What kind of deal are the parties likely to strike? On these simple facts, a probable allocation system would be to allocate 99% of the losses to B and 99% of any subsequent income, until income equals prior losses. The other 1%, of course, goes to A. Once income equals prior losses there would be a flip, at which point A would receive a larger interest, perhaps 50%. Who else but the money partner, *i.e.*, the person who funded them, should get the lion's share of the losses?[121] To allocate the loss to any other partner would give that person a windfall and likely a loss she could not fully use. But A at some point needs to get paid and would be. This allocation structure is unobjectionable both from economic and tax policy points of view.

It has been suggested that the important question is whether the partners would have made the same deal had there been no tax benefits.[122] While perhaps a useful analytical tool, it would be impossible to know if an investor would have made an investment without the tax benefits because that alternative universe did not exist when the investment was made. There are few things in the business or investment world that do not have tax consequences. A preferable perspective is whether the allocations are primarily driven by the economics, as is the case with the example. If so, they should be allowed. Allocations primarily driven by the tax benefits should not be. How does one tell the difference? The Section 704(b) Regulations do so via the substantiality rules, for the most part successfully. But there is ample room for improvement, as I argue below.

It would not be possible to do Example 6 with an S corporation or under proposals for partnership allocation reform that adopt essentially the same system and make fixed allocations based on capital contributions. There is no fixed percentage in Example 6 that either the money or brains partner would agree to at the outset, as noted above. In literally a 2-person deal, it might be possible to live with an S corporation-like allocation structure, by giving the brains partner some kind of option to buy an increased partnership interest

[120] Today, the parties might well use a manager-directed LLC with A as the manager, though limited partnerships have hardly gone out of style.

[121] To similar effect, *see* Berger, *supra* note 2, at 132–34.

[122] Berger, *supra* note 2, at 132.

downstream. But the grant and, or exercise of the option can have tax consequences[123] (unlike, typically, shifting allocations in a partnership), and as the number of players increases, the use of options becomes impractical in any event.[124] An allocation structure that does not provide flexibility will mean that many legitimate deals will not get done, even when grounded in solid economics. Oddly, this real-world issue is not often discussed in articles that want to move to a fixed allocation structure. Perhaps the best evidence for the importance of flexible allocation structures is the fact that the average S corporation has about 1 ½ shareholders.[125] If the S corporation allocation structure worked well in the business world, that number would be much higher.[126]

2. *Entity-Level Taxation?*

This is an article on partnership allocations, not an article on how to restructure business entity taxation, generally. In something of an end-around, one thoughtful article proposes to tax all privately held businesses (including wholly owned corporations, limited liability companies, and unorganized sole proprietorships) at the entity level under a uniform rate schedule, regardless of the form of organization.[127] Unlike many of the reform proposals for Subchapter K, this approach has merit. The income of all privately held businesses would be taxed the same, and the proposal would simplify business income taxation. But note that in this universe, Example 6 would be much less likely to occur. B would be much less interested in participating if losses did not pass through to him. It would significantly increase the relative cost of B's investment. At a minimum, B would need a larger return, that in turn would make the deal harder to do, and fewer such deals would get done. I will leave for another article the questions of whether the benefits of the proposed system would outweigh these types of detriments.

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[123] *See* Reg. § 1.83-7; *see* BITTKER ET AL., FED. INC. TAX'N OF INDIV, § 40 (June 2023); PARTNERSHIP TAXATION, *supra* note 11, Ch. 10.

[124] *See* Berger, *supra* note 2, at 130–34, making an analogous point.

[125] As of 2017, 1.62 to be precise. *See Table 7. Portfolio Income, Rental Income, and Total Net Income, by Major Industry, Tax Year 2017*, INTERNAL REVENUE SERV., last accessed Sept. 9, 2023, https://www.irs.gov/pub/irs-soi/17co07ccr.xlsx [https://perma.cc/5BR6-25ZM].

[126] There is no hard data of which I am aware on why S corporations are used, but it is believed to be primarily to avoid Social Security and Medicare taxes. S corporations are also used for "capital gain freezes." *See* Walter Schwidetzky, *Integrating Subchapters S and K, Just Do It*, 62 TAX LAW. 749 (2009) (discussed in David E. Watson, P.C. v. Commissioner, 668 F.3d 1008 (8th Cir. 2012)); *see* Walter D. Schwidetzky, *Is it Time to Give the S Corporation a Proper Burial?*, 15 Va. Tax Rev. 591 (1996).

[127] McMahon, *supra* note 4.

VI. The Wyden Proposals on Partnership Allocations

The Wyden Proposals on partnership allocations are quite brief, so much so that I can quote the relevant portions verbatim:

> The partnership tax rules afford tremendous flexibility in the allocation of partnership items among partners. The IRC and regulations provide two sets of rules circumscribing the allocation of partnership items – the "partners interest in the partnership" (PIP) standard and the SEE safe harbor. Both are based on the general principle of economic substance, and both are intended to align tax allocations with the underlying economic arrangement. However, the flexibility of current law has resulted in complexity for taxpayers and the IRS. The following provisions will substantially simplify the administration of partnership allocations and will as a result reduce taxpayer flexibility in this area, thereby curtailing abuse....The concept of SEE was added to the IRC to prevent abuse while preserving flexibility in the allocation of partnership items. However, the SEE regulations contain presumptions that can divorce tax and economics. The regulatory process has been unable to provide administrable rules that prevent tax-motivated allocations under the SEE standard. Moreover, neither the tax policy aims of simplicity nor administrability justify the disconnect between tax and economics. The safeguard itself has been the cause of complexity and proven difficult for the Service to properly audit and administer....The [Wyden Proposals] removes the SEE test for partnership allocations under Subchapter K and....requires that all partnership allocations be made in accordance with the PIP. PIP exists under current law and is based on the facts and circumstances of the economic arrangement (e.g., each partner's contributions and rights to distributions). It is expected that the Secretary will issue updated and simplified regulations addressing PIP. ...The provision will remove optionality of current law, better prevent the shifting of tax attributes between partners, simplify the rules governing partnership allocations, and allow the Service to better focus audit and enforcement efforts.

Were it only this easy. It is not, and if implemented, the proposal likely could prove unenforceable. The proposal seems to suggest that SEE is more flexible than PIP, which is roughly backwards. The more flexible standard is actually PIP, which is why partners rely on it when using target allocations. The SEE rules restrict flexibility; they do not enhance it. They can be highly complex, but as I have noted, the more a deal is based on genuine economics the less likely it is that this complexity will pose a burden.

The Wyden Proposals quoted above state, "the SEE regulations contain presumptions that can divorce tax and economics." And there is *one* such presumption, the FMV-Book rule, which admittedly needs to go. But this hardly provides a basis for wholesale change.

As the Wyden Proposals also note,

> [t]he regulatory process has been unable to provide administrable rules that prevent tax-motivated allocations under the SEE standard. Moreover, neither the tax policy aims of simplicity nor administrability justify the disconnect between tax and economics. The safeguard itself has been the cause of complexity and proven difficult for the Service to properly audit and administer.

But the SEE rules are, in fact, administrable. They provide a mostly sensible set of rules that in many deals are straight-forward to apply. As the deals get more complex with differing classes of partners and waterfalls, administering the SEE rules admittedly gets much harder for the Service, but that administrative task is not wholly out of reach. What is true is that the Service has not properly administered and audited SEE, not because it cannot, but because it has lacked the resources to do so. When the Service has chosen to litigate allocation issues, it has had a good success rate.[128] Indeed, the Service has chosen to litigate some highly complex cases,[129] something that would hardly occur with rules that are not administrable. What would be fair to say is that the Service cannot properly administer SEE with current staffing levels, but that is an argument for increased staffing, and perhaps having a separate partnership tax division,[130] not for the wholesale elimination of the rules that have been used for decades. Partnership tax advisors usually have a solid understanding of how SEE operates, and countless partnership agreements rely on SEE. That admittedly does not mean that SEE is a perfect set of rules, and I will propose ways they can be improved without throwing the baby out with the bathwater.

The Wyden Proposals state that "[i]t is expected that the Secretary will issue updated and simplified regulations addressing PIP." But, it is not possible (as I noted above) to definitively define PIP. There are just too many variables. What it is possible to do is to create a safe harbor, currently SEE. But if we eliminated SEE, we would need a new safe harbor. What would it look like? It would probably look a lot like SEE. The Service could perhaps replace SEE with target allocations. But that would not make the Regulations meaningfully simpler. Given how long SEE has been around and on how widely it has been used, it makes more sense to add a safe harbor for target allocations than to eliminate SEE. That step admittedly would make the Regulations more extensive and to that extent more complex, but given how widely target allocations apparently are being used, it would not likely add a

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[128] *See In Defense of PIP*, *supra* note 60; Elliott Manning, *Partnerships — Conceptual Overview*, 710-3rd TAX MGMT. PORT. (BNA) IV.

[129] *See, e.g.*, Chemtech Royalty Assoc., L.P. v. United States, 766 F.3d 453 (5th Cir. 2014), Southgate Master Fund, LLC v. United States, 659 F.3d 466 (5th Cir. 2011), and *Castle Harbour*, *supra* note 32. For an excellent discussion of these cases, *see* Burke & McCouch, *supra* note 32.

[130] *See* Monte A. Jackel, *The IRS Needs a New, Separate Partnership Tax Division*, 179 TAX NOTES FED. (TA) 615 (Apr. 24, 2023).

significant additional burden for practitioners. And, target allocations may be easier to administer than SEE for the same reason that practitioners often prefer them, perhaps making the addition of a target allocation safe harbor a net win for the Service and taxpayers. The bottom line is that it is naïve to think that any replacement safe harbor would be significantly simpler than SEE. The reason for much of the complexity in SEE is to prevent abuse, hence the existence, for example, of the separate substantiality test. Any replacement safe harbor would also need anti-abuse rules and would have a comparable level of complexity.

The last thing anyone concerned with administrability would want is a PIP standard without a safe harbor. Some practitioners would see that as an opportunity to run with the ball, while others would hate the lack of specific guidance. The Service auditing personnel could be overwhelmed, forced to make case-by-case judgment calls. It could also be a challenge for the courts. It is true that the courts have done a decent job with PIP to date,[131] but PIP cases have not been that common. If PIP became the only rule, there would be far more cases, many in Federal district court where the judges often lack tax expertise. Case law likely would be all over the map. Over time, the courts and the Service likely would create de facto safe harbors to ease decision making. They might even create competing de facto safe harbors. A de jure safe harbor makes infinitely more sense.

Finally, the Wyden Proposals state that "[t]he provision will remove optionality of current law, better prevent the shifting of tax attributes between partners, simplify the rules governing partnership allocations, and allow the Service to better focus audit and enforcement efforts." In light of the discussion above, it seems unlikely that the proposed changes would achieve any of these objectives.

Why do the Wyden Proposals fall short? I do not have a definitive answer. As I have discussed elsewhere, part of the problem may be that the Wyden Proposals see the world through the prism of large (or even very large) partnerships.[132] These partnerships appear to currently rely mostly on PIP, albeit through the use of target allocations.[133] Perhaps this reliance on PIP caused the Wyden Proposals to focus on PIP as well, though it is perplexing why they would adopt PIP without a target allocation safe harbor. The sophisticated counsel larger partnerships typically have may have made the Wyden Proposals less concerned about any burdens rule changes might have

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[131] *In Defense of PIP, supra* note 60.

[132] *See Partnership Debt, supra* note 9; Walter Schwidetzky, *The Wyden Proposal: Unfriendly to Small Partnerships but a Good First Step,* 172 TAX NOTES FED. (TA) 2189 (Sep. 27, 2021). For an alternative view, *see* Jackel, *supra* note 3, and Monte A. Jackel, *New Wyden Partnership Tax Proposals Deserve Consideration,* 173 TAX NOTES FED. (TA) 1709 (Dec. 20, 2021).

[133] While there is no hard data of which I am aware, I come to this conclusion as a result of numerous discussions that I have had with tax lawyers and casual surveys I have done at ABA Tax Section meetings.

on practitioners. As noted earlier, and as is true for large businesses generally, these large partnerships do own the lion's share of partnership assets, but smaller partnerships remain important players. But Regulations designed only with large partnerships in mind would do the partnership tax world a large disservice. There is no hard data on how many partnerships use SEE versus target allocations, but I would not be surprised if the vast majority of smaller and mid-sized partnerships still use SEE.[134] Eliminating SEE would be a nightmare for them. It might be possible to grandfather SEE in some fashion but that would make the partnership tax world more complex, not less so. The bottom line is that eliminating SEE makes no sense. What does make sense is to improve it, as I will discuss next.

VII. Rational Reform of Section 704(b) Allocations

I have three proposals for reforming the Section 704(b) Regulations:

A. *New Definition of Substantiality*

1. *Present Value Post Tax Rule*

The present value post tax rule is awkwardly formulated. The economic effect is *not* substantial if there is a *strong likelihood* that after-tax economic consequences of *no partner* will, in present value terms, be *substantially diminished.* Some see this as a triple negative.[135] "Strong likelihood" lives close to "near certainty" and creates an unnecessary pro-taxpayer bias. We have come to learn the hard way that aggressive planning accompanies liberal substantiality rules. I propose that we reformulate and rein in the present value post tax test as follows:

Where it is probable that an allocation causes a partner's economic consequences to be significantly enhanced, the economic effect of the allocation is only substantial if it is probable that another partner's economic consequences will be significantly diminished. For this purpose, the economic consequences shall be determined on a present value, post-tax basis. In making this determination, the proposed allocation shall be compared to such consequences as would apply if the allocation were not contained in the partnership agreement. Any alternative used for this comparison need not be the least tax efficient provided it is driven primarily by economic realities. If a partnership agreement allows for allocations to vary, notice of this fact and a general description of the allocation must be provided to the IRS. In addition to any other penalties that might apply, an additional 10% penalty shall apply to any increased tax that arises when a partnership is found to have made an allocation that lacks substantiality, unless there is substantial

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[134] I remain skeptical of target allocations under current law; *see Cuff Interview, supra* note 76; *see also,* Cuff *Selected Issues, supra* note 65.

[135] *See* Polsky, *supra* note 2, at 102.

authority for the partnership's position. In defending against the penalty, the burden of proof is on the partnership and its partners.

The proposed language makes the present value post tax more neutral, moderately lowering the bar for finding that the economic effect of an allocation is not substantial. Instead of a strong likelihood, it needs to only be probable that another partner's economic consequences are not significantly diminished. But this analysis need only be made if it is also probable that the allocation causes another partner's economic consequences to be significantly enhanced. Thus, an allocation that might be of modest benefit to a partner might not trigger the analysis. But if the partnership is gaming the tax system, it should not be a heavy lift to prove it. There inevitably are still uncertainties. Whether economic consequences are significantly enhanced or diminished is a fact question that would have to addressed on a case-by-case basis, but it is a more workable standard (and I would argue a more understandable standard) than the current definition of substantiality. If an allocation is disallowed, my proposal does not eliminate the difficulty that can arise in searching for an alternative allocation but attempts to make this job easier and more reliable by providing that the alternative need not be the least tax efficient but must be economically driven.[136] But a primary objective of my proposed substantiality provisions is to keep partnerships from gaming the tax system in the first instance. The proposed tightening of the definition of substantiality should reduce taxpayers more aggressive tendencies. Further, by requiring disclosure, applying an additional penalty, and having the burden of proof with regard to the penalty be on the partnership (it normally is on the Service[137]), my hope is that the "intimidation effect" will keep partnerships on the straight (if perhaps not narrow) path, lowering the administrative burden on the Service. In the interest of fairness, however, I do not provide for strict liability,[138] but allow the partnership to avoid the penalty upon a showing of substantial authority for the partnership's position.

2. *Shifting and Transitory Allocations*

Recall, that the present value post tax test applies even if the shifting or transitory allocation tests also apply. While I would keep both of those latter tests as a backstop, they are likely to be less important in light of the reformulation of the first test. Nonetheless, I would tighten the transitory allocation test. Instead of requiring that the offset happen "in large part" within the first five years—another example of excessively liberal rules, I propose to have it happen in a "significant amount" within five years and

[136] *See supra* notes 49–51 and accompanying text.

[137] *See* I.R.C. § 7491(c).

[138] *See* Eric Lopresti, *What's Wrong with Strict Liability and Nonmonetary Penalties? The Case for Reasonable Fault-Based Civil Tax Penalties and Procedural Protections*, 72 TAX LAW. 589 (2019).

would define that as 50% or more of the initial allocation(s). This brighter-line rule is fair and should make administration easier.

B. *Limit Allocations to "Bottom-Line" Items*

A significant problem with section 704(b) allocations is the extent of their application, which is pretty much the waterfront of partnership income and expenses, subject to the substantiality rules. Most infamously, depreciation may be allocated to one partner and be offset by gain allocated to that same partner even within the 5-year transitory limit, due to the FMV-Book rule. Repealing the FMV-Book rule would be a step in the right direction, but an insufficient one. As long as most expenses can be allocated in virtually any way, the temptation will be great to look for ways to game the system. At current partnership audit rates,[139] that temptation is still greater. And even if the Service were able to do audits at a robust level, which most would argue would be a good thing, it would often still be playing catch-up, and would have to dedicate substantial resources to section 704(b) enforcement. I propose, therefore, to amend section 704(b) to provide that a partnership may only allocate partnership taxable income, taxable loss, and net tax-exempt income (in the partnership universe sometimes known as "bottom-line" items).[140] Tax credits[141] may be allocated in the same manner that taxable income or loss is allocated.

It would no longer be possible to specially allocate constituent parts of bottom-line items such as depreciation, and thus the FMV-Book rule and the challenges of dealing with gain chargebacks would be mooted. This approach would significantly simplify the allocation universe while allowing legitimate economic deals to get done. The administrative burden on the Service should be reduced. The more tax driven portions of the sale-leaseback universe would likely see their size reduced, a good thing in light of all of the litigation

[139] *See Audit Risk, supra* note 51.

[140] Section 702 requires certain items to be stated separately by the partnership when it submits Schedule K-1s to its partners. These separately stated items (also called variable effect items) can potentially affect different partners differently. Items that do not have a variable effect are lumped together into what are commonly called "bottom-line" income and loss and are also listed on the Schedule K-1. None of these rules are affected by my proposal.

[141] The allocation of tax credits cannot have SEE since they do not affect capital accounts. Nonetheless, the Regulations provide that if a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for such year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise thereto) shall be in the same proportion as such partners' respective distributive shares of such loss or deduction (and adjustments). *See* Reg. § 1.704-1(b)(4)(ii).

and challenges this area has produced.[142] At the same time, the Brains-Money deal remains viable.

While relevant hard data and case law[143] are lacking, it stands to reason that the more flexibility section 704(b) provides, the more motivation sophisticated, wealthier partnerships will have to push the envelope. Small and medium-sized businesses are unlikely to engage in these more sophisticated transactions. The dollars involved would tend to make them less necessary, and they likely could not afford the pricy tax counsel necessary to implement them. Accordingly, the biggest impact of the proposed change likely will be the small percentage of large, "elite" partnerships, not a group most would say is worthy of special consideration in the tax code.[144] By making life for these larger partnerships a bit harder, life for the Service audit arm will be made much easier. The large partnerships will have to increase their focus on solid economic deals, hardly a bad thing.

C. *Target Allocations*

Under my proposal, it would still be possible to have different classes of partners with different preferred returns. Accordingly, some of the drafting challenges that currently exist with SEE could still arise. Target allocations has become the preferred the solution, and there is nothing inherently objectionable about them. Any revised Regulations should contain a target allocation safe harbor, addressing the uncertainties discussed earlier. If we were writing on a clean sheet, there might be an argument for having target allocations as the only safe harbor, but we are not. Too much water has gone over the dam to make wholly repealing SEE a viable option. Crafting a safe harbor for target allocations may prove challenging. As they have, in a sense, been operating in the shadows, different practitioners may approach target allocations differently. It may be no simple matter to achieve wide consensus for any particular safe harbor, but given the apparent prevalence of target allocations, it is a challenge worth undertaking.

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[142] *See generally* Victoria Eve Kelly, *Real Estate Leases*, 593-3rd TAX MGMT. PORT. (BNA) VII.C; Marvin Milich, *The Real Estate Sale-Leaseback Transaction: A View toward the 90S*, 21 REAL EST. L. J. 66 (1992).

[143] Miniscule audit rates lead to a miniscule number of judicial decisions. There are few published decisions on section 704(b), and those that do exist tend to involve unsophisticated taxpayers who may either lack a written agreement or have one that fails to comply with the Regulations' economic effect test. *See In Defense of PIP*, *supra* note 60; *see also*, Clark Raymond, *supra* note 14, and Lipton & Gruen, *supra* note 14. There are a small number of cases involving more sophisticated partnerships, but those typically look (directly or indirectly) at whether a valid partnership was formed, typically finding that it had not. *See, e.g., Castle Harbour*, *supra* note 32; *see also*, Burke & McCouch, *supra* note 32. There is essentially no case law on substantiality. *See supra* note 32.

[144] *See* Monroe, *supra* note 2.

VIII. Conclusion

Unless we move to an across-the-board entity level tax, Subchapter K is needed and is here to stay. The proposals that would throw the baby out with the bathwater and to a greater or lesser extent repeal Subchapter K are political nonstarters and ignore how deals present themselves in the real world. My proposal, on the other hand, is aligned with how the real world operates, while also seeking to modernize and reform SEE. It would bring target allocations formally into the fold and make SEE less capable of abuse, while permitting legitimate economic deals to take place. I believe its incremental approach makes it politically viable. There is no substitute for a dramatic increase in the Service's enforcement of Subchapter K, which has been woefully lacking due to egregious underfunding. But under my proposal, the burden of an appropriate level of enforcement should be less than it would be under the current rules. The Wyden Proposals may have fallen a bit short on reforming partnership allocations, but they are to be commended for seeking to reform and bring attention to Subchapter K. Perhaps they will be the catalyst that is needed to bring comprehensive reform to Subchapter K, the necessity of which is hard to dispute.

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§734 Adjustment to basis of undistributed partnership property where section 754 election or substantial basis reduction.

Internal Revenue Code

§ 734 Adjustment to basis of undistributed partnership property where section 754 election or substantial basis reduction.

(a) General rule.

The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership or unless there is a substantial basis reduction with respect to such distribution.

(b) Method of adjustment.

In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect or with respect to which there is a substantial basis reduction, the partnership shall—

(1)

increase the adjusted basis of partnership property by—

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1) , and

(B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732 , or

(2)

decrease the adjusted basis of partnership property by—

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2) , and

(B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732 , over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732(d)).

Paragraph (1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect.

(c) Allocation of basis.

The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755 .

(d) Substantial basis reduction.

(1) In general.

For purposes of this section , there is a substantial basis reduction with respect to a distribution if the sum of the amounts described in subparagraphs (A) and (B) of subsection (b)(2) exceeds $250,000.

(2) Regulations.

For regulations to carry out this subsection , see section 743(d)(2) .

(e) Exception for securitization partnerships.

For purposes of this section , a securitization partnership (as defined in section 743(f)) shall not be treated as having a substantial basis reduction with respect to any distribution of property to a partner.

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Key Issue 32B: Adjusting the Basis of Partnership Property When a Section 754 Election Is in Effect.

Section 754 Election Basics

When a partnership makes an election under IRC Sec. 754, it must adjust the basis of partnership property under IRC Sec. 743(b) when a partnership interest is sold or exchanged (including upon a partner's death). When the Section 754 election is in effect, the partnership increases its basis in partnership assets by the excess of the transferee's outside basis over the transferee's share of the partnership property's adjusted basis. If the transferee partner's share of the partnership property's adjusted basis exceeds the transferee's outside basis, the partnership must decrease its basis in partnership assets. In any case, the adjustment to the basis of partnership assets under IRC Sec. 743(b) is specific to the transferee partner. It does not affect the basis of partnership property with respect to any other partner.

The Section 754 election also requires the partnership to adjust the basis of its undistributed assets in certain cases when cash or other property is distributed to partners. In this case, the basis adjustments are made under IRC Sec. 734. (See Key Issue 33C.)

Warning: The Section 754 election applies to all distributions and transfers during the tax year with respect to which the election is initially made, and to all such transactions in any subsequent years. (The election can only be revoked with the Commissioner's consent.) The election can increase *or decrease* the basis of partnership property depending on whether such property has appreciated or depreciated.

Note: In some situations, mandatory basis adjustments must be made even if a Section 754 election is not in effect. See Key Issue 32C.

Section 754 Election Can Alleviate Problems Caused by Inside/Outside Basis Differences

Immediately after formation, a partnership's inside basis in partnership assets and its partners' combined outside bases are equal. Usually, this equality does not continue for the partnership's entire life. For example, if a taxpayer purchases a partnership interest from an existing partner, the FMV, *not* the adjusted basis, of the partnership's assets will determine the new partner's purchase price and basis. Without a Section 754 election, the sale of the partnership interest has no effect on the partnership's inside bases in those assets. At that point, the partners' outside bases and the inside basis of the partnership assets are not equal.

If the transferee partner wants to avoid this result, it is necessary to somehow increase the partnership's inside basis in its assets. This basis adjustment can be made if the partnership makes the election under IRC Sec. 754. This election increases the inside basis of assets with respect to the transferee partner. The transferee partner then has a basis in partnership assets that is similar (but not necessarily identical) to what the basis would have been if the partner had purchased an undivided interest in partnership assets. Worksheet W102 is a carryforward balance sheet that can be used to keep track of the inside basis of partnership assets.

Partnerships can make the Section 754 election when a partner dies, when a partner purchases an interest, or when a partnership interest is *exchanged* [IRC Sec. 743(b)]. However, not all exchanges trigger a basis adjustment.

For the basis adjustment rules, any distribution of a partnership interest is treated as an *exchange* [IRC Sec. 761(e)]. For instance, when a corporation distributes a partnership interest to a shareholder or when a partnership distributes an interest in *another* partnership to a partner, the transaction is considered an *exchange* that triggers a basis adjustment if the partnership has a Section 754 election in effect.

When a partnership interest is acquired by contributing cash or property to the partnership or by gift, no basis adjustment is made under Section 743, because that is not a sale or exchange of the partnership interest under the Section 754 rules.

Special Rules Applicable upon Death of a Partner

Several special rules apply if a transfer of a partnership interest results from a partner's death. Generally, the beneficiary of a deceased partner's partnership interest take a tax basis in the inherited partnership interest to equal to the interest's date-of-death value (or the value on the alternate valuation date if the executor of the deceased partner's estate so elects). This will almost always result in a difference between the beneficiary's share of inside basis in partnership assets and the beneficiary's basis in the partnership interest (outside basis). However, the outside basis increase does not apply to value attributable to income in respect of a decedent (IRD). IRD is income that was earned but not yet recognized for federal income tax purposes at the time of death (for example unrecognized installment sale gains, accrued interest and declared but not yet received dividends). IRD is taxed to the estate or beneficiary when it is recognized. If the deceased partner's interest was community property, the 50% share of the partnership interest owned by the surviving spouse can receive a basis adjustment (as well as the 50% share owned by the deceased partner) (Rev. Rul. 79-124). The tax year of a partnership closes for a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise.

Making the Section 754 Election

See Election E202 for how to make or revoke the Section 754 basis adjustment election.

Warning: Failure to report income consistent with the election gives the IRS the option of invalidating the election.

Although a Section 754 election can be beneficial for partners who acquire interests in partnerships with appreciated assets, making the election often requires additional recordkeeping and reporting. So, in addition to the fact that it is only revokable with IRS permission, the administrative costs of making a Section 754 election must also be considered.

Example 32B-1: Deciding Whether to Make a Section 754 election.

Lowrent Associates is an investment partnership comprised of 14 neighbors. The partnership owns a portfolio of marketable securities worth $70,000, with a $58,500 basis. Over the past two years, eight of the partners have moved, selling their interests to the new neighbors. This year, three more are moving and will sell their interests to the other partners. Even though the partnership could make a Section 754 election, the potential benefit is relatively small compared with the recordkeeping necessary to track the various basis adjustments, particularly when the basis adjustment for any single partner transfer would be so small.

Late Elections

Reg. 301.9100-2 grants an automatic 12-month extension for filing a Section 754 election. To take advantage of the extension, an amended return with the election attached must be filed within 12 months from the original election deadline. Furthermore, any affected partners must report their income consistent with the election, either on an original or amended return. However, partnerships subject to the centralized audit regime generally cannot file amended returns [IRC Sec. 6031(b)]. Instead, these partnerships must report changes to a previously filed Form 1065 on an administrative adjustment request (AAR). An AAR is not an amended return. While it appears that the IRS will allow affected partnerships to file a late Section 754 election using an AAR, there is no authority for that position. Practitioners should be alert for guidance on this issue.

Practice Tip: If the automatic 12-month extension deadline has passed under Reg. 301.9100-2, a partnership can obtain an extension of time to file a Section 754 election under Reg. 301.9100-3. To comply with the regulation, the partnership must request an extension from the IRS, establish a good reason for the delay, prove that the partnership acted reasonably and in good faith, and show that granting the extension will not prejudice the interests of the IRS. The IRS has been very reasonable in granting such extensions.

Protective Elections

In many cases, it may not be clear whether a Section 754 election was made previously. In those situations, there appears to be no downside to filing a *protective* election. To the extent that there was no prior election, the protective election serves as an effective Section 754 election. If, in fact, a prior election was filed, then the election is in effect and the subsequent filing of a second election has no tax effect on the partnership. Further,

PQR has a Section 754 election in effect. Alice's basis adjustment is $40,000. This adjustment is the difference between Alice's $122,000 outside basis ($100,000 cash plus a 1/3 interest in $66,000 of partnership liabilities) and her $82,000 share of the inside basis (Alice's 1/3 share of the $246,000 inside adjusted basis of partnership property).

If all of the assets of PQR were sold for their FMV, the partnership would receive $366,000 cash. From that, the partnership would pay the $66,000 of liabilities ($6,000 + $60,000), leaving $300,000 available for distribution to the partners. Thus, Alice would receive 1/3 of that, or $100,000 cash from the hypothetical sale.

Since there would be no tax loss on the sale, no allocation to Alice would be necessary. However, on the sale of the assets, there would be tax gain of $40,000 (Alice's 1/3 share of the $366,000 FMV minus the partnership's basis of $246,000).

Alice's previously taxed capital is $60,000 ($100,000 + 0 − $40,000).

Alice's basis in her share of the partnership property (inside basis) equals $82,000. This is the sum of her previously taxed capital of $60,000 plus $22,000, which is her share of the partnership's liabilities. Since her basis in her partnership interest (outside basis) is $122,000, her basis adjustment will be $40,000 ($122,000 − $82,000).

Note: The basis adjustment must be allocated among the partnership's assets. See the discussion on how to allocate the adjustment later in this key issue.

Calculating the Basis Adjustment When Partner Has a Negative Tax-basis Capital Account

When the transferor partner has a negative tax-basis capital account, the basis adjustment will be increased by the absolute value of the negative capital account.

Example 32B-3: Calculating the basis adjustment when there is a negative capital account.

Moe, Larry and Curly equally own the Loser Partnership. On the last day of the year, Larry sold his 1/3 interest to Joey. The purchase price was $20,000 cash plus an assumption of $90,000 of partnership liabilities (Joey's 1/3 share of $10,000 + $260,000). The purchase price is based on the following year end balance sheet:

	Tax Basis	FMV
Assets:		
Cash	$ 15,000	$ 15,000
Accounts receivable	35,000	35,000
Inventory	45,000	50,000
Equipment	70,000	55,000
Land	15,000	60,000

	Tax Basis	FMV
Building	60,000	115,000
Total	$ 240,000	$ 330,000
Liabilities and capital:		
Accounts payable	$ 10,000	$ 10,000
Long-term debt	260,000	260,000
Capital:		
Moe	(10,000)	20,000
Larry	(10,000)	20,000
Curly	(10,000)	20,000
Total	$ 240,000	$ 330,000

Loser has a Section 754 election in effect. Joey's basis adjustment is $30,000. This adjustment is the difference between Joey's $110,000 outside basis ($20,000 cash plus 1/3 of the $270,000 partnership liabilities) and his $80,000 share of the inside basis (Joey's 1/3 of the $240,000 inside basis of partnership property).

Joey's adjusted basis in the partnership property equals the sum of his share of the partnership's previously taxed capital, plus his share of partnership liabilities. Joey's share of previously taxed partnership capital equals (1) the cash he would receive from a liquidation of the partnership following a hypothetical sale, plus (2) the tax loss, including any remedial allocations under Reg. 1.704-3(d), allocated to him from the hypothetical sale, minus (3) the tax gain, including any remedial allocations under Reg. 1.704-3(d), allocated to him from the hypothetical sale.

If all of Loser's assets were sold for their FMV, the partnership would receive $330,000 cash. From that, the partnership would pay the $270,000 in liabilities ($10,000 + $260,000), leaving $60,000 available for distribution to the partners with Joey receiving 1/3 of that, or $20,000 cash from the hypothetical sale.

Since there would be no tax loss on the sale, nothing would be allocated to Joey. However, the asset sale would have a $30,000 tax gain (Joey's 1/3 of the $330,000 FMV of partnership property minus the partnership's $240,000 basis in its property).

Joey's previously taxed capital is ($10,000) ($20,000 + 0 – $30,000).

Joey's adjusted basis in his share of the partnership property (inside basis) equals $80,000. This is the sum of his previously taxed capital of ($10,000) plus $90,000, which is his share of the partnership's liabilities. Since his basis in the partnership interest (outside basis) is $110,000, his basis adjustment is $30,000 ($110,000 – $80,000).

Allocating Basis Adjustments to Partnership Assets

When a partnership has a Section 754 election in effect, the required Section 743 basis adjustments are allocated among the partnership's assets to reduce the difference between the properties' FMV and their adjusted bases. To that end, adjustments under IRC Sec. 743(b) can result in a positive adjustment allocable to one class and a negative adjustment allocable to another class. This can occur even if the total basis

since Reg. 1.754-1(c) requires IRS consent to revoke the election, the filing of a second election will not revoke the original election.

Calculating the Section 743 Basis Adjustment

In general, the transferee partner's share of partnership property equals the sum of the transferee's interest in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. The transferee partner's interest in the partnership's previously taxed capital is determined through a hypothetical transaction in which the partnership sells its assets in a taxable transaction for cash equal to the FMV of the assets [Reg. 1.743-1(d)(2)]. Worksheet W103 can be used for determining and allocating basis adjustments resulting from the Section 743(b) adjustments for sales or exchanges.

Assuming book capital accounts are maintained under the Section 704(b) regulations explained in Chapter 26, the transferee's interest in previously taxed capital equals: (1) the transferee's capital account adjusted for the hypothetical transaction, plus (2) the tax loss [including any remedial allocations under Reg. 1.704-3(d)] allocated to the transferee from the hypothetical transaction, less (3) the tax gain [including any remedial allocations under Reg. 1.704-3(d)] allocated to the transferee from the hypothetical transaction.

Example 32B-2: Calculating a transferee partner's inside basis (previously taxed capital).

Mark sold his 1/3 interest in the PQR Partnership to Alice on the last day of the year. The purchase price was $100,000 cash plus assumption of Mark's share of the partnership liabilities. The purchase price was based on the partnership's year-end balance sheet as follows:

	Tax Basis	FMV
Assets:		
Cash	$ 11,000	$ 11,000
Accounts receivable	45,000	39,000
Inventory	50,000	70,000
Equipment	110,000	100,000
Land & building	30,000	80,000
Goodwill	—	66,000
Total	$ 246,000	$ 366,000
Liabilities and capital:		
Accounts payable	$ 6,000	$ 6,000
Long-term debt	60,000	60,000
Capital:		
Paul	60,000	100,000
Joanne	60,000	100,000
Mark	60,000	100,000
Total	$ 246,000	$ 366,000

adjustment is zero. Further, the allocation to one item of property within a class of property can be positive while the allocation to another item of property within a class can be negative. Again, this can occur even if the basis adjustment allocable to a class is zero [Reg. 1.755-1(b)(1)].

The basis adjustment allocable to ordinary income property equals the total amount of income, gain, or loss [including any remedial allocations under Reg. 1.704-3(d)] allocated to the transferee partner from the sale of all ordinary income property in a hypothetical transaction. Unrealized receivables under IRC Sec. 751(c) such as depreciation and amortization recapture should be treated as a separate asset that is ordinary income property [Reg. 1.755-1(a)(1)].

In general, the basis adjustment allocable to the capital gain property equals the total basis adjustment less the amount allocated to the ordinary income property, provided, however, that in no event can any decrease in basis allocated to capital gain property exceed the partnership's basis in the capital gain property. If a basis decrease allocated to capital gain property does exceed the partnership's basis in that property, the excess is applied to reduce the basis of ordinary income property. Thus, for any transfer made for less than FMV, the discount or bargain element is assigned to the capital gain property, like negative goodwill [Reg. 1.755-1(b)(2)].

Separate rules are given for allocations within a class for Section 743 adjustments. For allocations within the ordinary income class, the basis adjustment allocable to an item of ordinary income property equals [Reg. 1.755-1(b)(3)(i)]:

$$\text{The income, gain, or loss [including any remedial allocations under Reg. 1.704-3(d)] allocated to the transferee from the hypothetical sale of that item} - \left(\text{Any decrease to the basis adjustment for ordinary income property because the decrease in the partnership's basis in capital gain property exceeded its basis in the capital gain property} \times \frac{\text{FMV of the item of property to the partnership}}{\text{FMV of all items of partnership ordinary income property}}\right)$$

For allocations within the capital gain class, the basis adjustment allocable to an item of capital gain property equals [Reg. 1.755-1(b)(3)(ii)]:

$$\text{The income, gain, or loss [including any remedial allocations under Reg. 1.704-3(d)] allocated to the transferee from the hypothetical sale of that item} - \left(\left[\text{The total gain or loss [including any remedial allocations under Reg. 1.704-3(d)] allocated to the transferee from the hypothetical sale of all capital gain property} \begin{matrix} - \text{ The positive basis adjustment to all items of capital gain property} \\ \text{or} \\ + \text{ The amount of the negative basis adjustment to all items of capital gain property} \end{matrix}\right] \times \frac{\text{FMV of the item of property to the partnership}}{\text{FMV of all items of partnership capital gain property}}\right)$$

Note: Partners receiving partnership interests that are transferred as a result of a partner's death cannot allocate any part of the basis adjustment under IRC Sec. 743(b) to partnership assets that include IRD such as zero-basis receivables, unrecognized gains from installment notes receivable and accrued but unpaid interest income [Reg. 1.755-1(b)(4)]. Amounts paid after the decedent's death in liquidation of the partnership interest attributable to IRC Sec. 751 assets (including recapture and hot assets) are taxed as ordinary income.

Depreciating Section 743 Basis Adjustments

Reg. 1.743-1(j) provides that an increase in the basis of a depreciable asset due to the transfer of a partnership interest is treated as newly purchased depreciable property that is placed in service when the transfer occurs. No change is made to the method or life of the portion of the asset that is not increased. As discussed in Chapter 15, the a positive basis adjustment is potentially eligible for first-year bonus depreciation. If the basis of an asset is decreased as a result of the transfer, the decrease is taken into account over the remaining life of the asset. See Key Issue 15G for additional discussion on depreciating basis adjustments.

Allocating Basis Adjustments to Partnership Section 197 Intangibles

If a Section 754 election is made and there is a partnership interest transfer (not a distribution), the partnership calculates the basis adjustment allocable to goodwill (if any) by using the *residual method* to determine the FMV of goodwill [IRC Sec. 1060(d)]. Then, the normal Section 755 rules apply in allocating the overall basis adjustment to specific partnership assets including goodwill.

The residual method is used, however, only when the partnership interest transferred comprises an applicable asset acquisition as defined in IRC Sec. 1060(c) [Reg. 1.755-1(a)(2)]. An applicable asset acquisition means a direct or indirect transfer of assets constituting a trade or business with respect to which the transferee's basis in the assets is determined wholly by reference to the purchase price.

Reg. 1.755-1 provides that if the partnership's assets constitute a trade or business, the partnership must use the residual method in Reg. 1.1060-1(b)(2) to allocate values to any Section 197 intangibles. A group of assets constitutes a trade or business if the assets' use is an active trade or business under IRC Sec. 355 (dealing with distributions of stock and securities of a controlled corporation) [Reg. 1.1060-1(b)(2)]. The best way to determine if a group of assets constitutes a trade or business is to review Reg. 1.355-3. This regulation excludes the ownership and operation of real or personal property (unless the owner performs significant services in operating and managing the property) from the definition of an active trade or business. This generally eliminates the acquisition of commercial rental property from the Section 1060 rules (but not the acquisition of a hotel or motel).

However, even if the assets do not otherwise qualify under IRC Sec. 355, they constitute a trade or business if goodwill or going concern value could attach to the assets [Reg. 1.1060-1(b)(2)]. For this determination, all the facts and circumstances surrounding the transaction are considered, including the following:

- The existence of assets as a group with a purchase price greater than book value (not including goodwill and going concern value) as shown in the financial records of the purchaser.

- Any related agreements between the buyer and seller for the transfer (e.g., a lease, covenant not to compete, employment contract, or similar agreement).

A trade or business exists if goodwill or going concern value could attach to the group of assets, regardless of whether any value will be allocated to the residual class [Reg. 1.1060-1(b)(2)(iii)]. Factors to be considered in making this determination are the presence of intangible assets, consideration in excess of the actual FMV of the tangible assets, covenants not to compete, employment or management contracts, and other similar agreements between the buyer and seller. The regulations also state that although the transfer of an isolated Section 197 asset will not be subject to IRC Sec. 1060, the presence of Section 197 assets is a factor that

should be considered in determining whether goodwill or going concern value could attach to the transferred assets.

Worksheet W104 can be used to allocate a basis adjustment to goodwill and other Section 197 intangibles.

The amount of a basis adjustment allocated to intangible assets is determined as follows (Reg. 1.755-1):

1. The partnership determines the value of each of its assets other than Section 197 intangibles, based on all the facts and circumstances [Reg. 1.755-1(a)(3)]. However, based on IRC Sec. 7701(g), the FMV of any item of property cannot be less than the amount of any nonrecourse debt to which the property is subject.

2. The gross value of the partnership is determined under Reg. 1.755-1(a)(4). In the case of a basis adjustment under IRC Sec. 743(b) resulting from the transfer of a partnership interest, partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities). In the case of a basis adjustment under IRC Sec. 734(b) resulting from a partnership distribution, partnership gross value equals the value of the entire partnership immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution.

3. If the aggregate value of partnership property other than Section 197 intangibles (as determined in Step 1.) is equal to or greater than partnership gross value (as determined in Step 2.), all Section 197 intangibles are deemed to have a value of zero. In all other cases, the value of the partnership's Section 197 intangibles is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than Section 197 intangibles.

4. The residual Section 197 intangibles value must be allocated first to Section 197 intangibles other than goodwill and going concern value in amounts equal to the FMV of those assets. Any residual value is then assigned to goodwill and going concern value. The FMV assigned to a Section 197 intangible (other than goodwill and going concern value) cannot exceed the actual FMV (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual Section 197 intangibles value is less than the sum of the actual FMVs of all Section 197 intangibles (other than goodwill and going concern value), then the residual Section 197 intangibles value is assigned first to any Section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under flush language of IRC Sec. 751(c) (flush language receivables) to the extent of the basis of those assets and the amount of income that the partnership would recognize if they were sold for their actual FMVs. If the value assigned to Section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual Section 197 intangibles value is allocated among the remaining portions of the Section 197 intangibles (other than goodwill and going concern value) in proportion to the actual FMVs of such portions.

Note: The definition of *flush language receivables* includes items treated as unrealized receivables under IRC Sec. 751(c) (other than rights to payment for goods delivered or services rendered) such as Section 1245 and 1250 depreciation recapture (unrecaptured Section 1250 gain subject to a 25% maximum federal income rate is not treated as a flush language receivable); soil and water conservation recapture; potential ordinary gain from the transfer of a franchise, trademark, or trade name; depletion, intangible drilling cost, and mining cost recapture; accumulated DISC income recapture, accumulated earnings and profit recapture in certain controlled foreign corporations under IRC Sec. 1248; ordinary income from the sale of market discount bonds or short-term obligations, recapture on the disposition of property subject to a Section 467 rental agreement; gain taxed as ordinary income on the disposition of Section 126 property (property acquired, improved, or otherwise modified by the application of certain cost-sharing program payments excluded from gross income); and certain uncompleted contracts accounted for as long-term contracts.

Example 32B-4: Calculating partnership gross value for allocating basis adjustments resulting from transfers.

Northern Lights Partnership has two equal partners, Aurora and Sky. It operates a lighting supply company with the following balance sheet:

	Basis	FMV
Inventory	$ 50,000	$ 100,000
Building	250,000	500,000
Patent	10,000	360,000
Total assets	$ 310,000	$ 960,000
Liability	$ 150,000	$ 150,000
Capital accounts:		
Aurora	80,000	405,000
Sky	80,000	405,000
Total liabilities and equity	$ 310,000	$ 960,000

Sky sells her interest to Alice for $450,000 cash. Northern Lights has a Section 754 election in effect. Alice's basis in her partnership interest is $525,000 ($450,000 cash + 50% of the $150,000 liability). However, for computing the partnership gross value, Alice's basis must be reduced by the amount attributable to partnership liabilities. Thus, Alice's basis for this purpose is $450,000, the amount paid for the interest.

Partnership gross value is $1,050,000, the amount necessary to provide Alice with a liquidating distribution equal to $450,000, computed as follows:

Partnership gross value	$ 1,050,000
Less: Liabilities	(150,000)
Net to be distributed	$ 900,000
50% to Alice	$ 450,000

In short, the partnership's gross value equals the amount necessary to reduce the transferee partner's basis (reduced by any allocation of partnership liabilities) to zero. In this case, since Alice is a 50% owner, the partnership gross value must be sufficient to pay both Alice and Aurora $450,000 (50% of the net distribution, plus the $150,000 debt).

Special Rules for Determining Partnership Gross Value

In determining a partnership's gross value under the regulations, these special rules apply:

1. Where a partnership interest is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to the special rules applicable to IRD, and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing IRD [Reg. 1.755-1(a)(4)(i)(C)].

2. In the case of a transfer that is a substituted basis transaction (i.e., the transferee's basis in the partnership is determined in whole or in part by reference to the transferor's basis or to the basis of other property held at any time by the transferee), partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment [Reg. 1.755-1(a)(4)(ii)].

3. In certain circumstances involving transfers of partnership interests, such as where income or loss with respect to particular Section 197 intangibles is allocated differently among partners, partnership gross value may vary depending on the FMV or particular Section 197 intangibles held by the partnership. In these situations, the regulations require the partnership to use a reasonable method, consistent with the purposes of the regulations, to determine partnership gross value [Reg. 1.755-1(a)(4)(i)(B)].

Transfers of Partnership Interest

For transfers of partnership interests that are not substituted basis transactions, assets with respect to which the transferee partner has no interest in income, gain, losses, or deductions are not taken into account in allocating basis adjustments to capital assets. Additionally, in no event may a decrease in basis allocated to an item of capital gain property exceed the partnership's adjusted basis in that item. If the amount of a decrease allocable to a particular capital asset exceeds the partnership's adjusted basis in that asset, the transferee's negative basis adjustment in that asset is limited to the partnership's adjusted basis, and the excess is applied to reduce the remaining basis, if any, of other capital gain assets prorata in proportion to the partnership's adjusted basis in such assets [Reg. 1.755-1(b)(3)(iii)].

Example 32B-5: Allocating a basis adjustment resulting from a transfer of a partnership with goodwill.

Liz and Pat are equal partners in Gothic Distributors Partnership (GDP), a general partnership that distributes comic books. GDP's only assets are inventory, two buildings (Buildings I and II), and goodwill. The partnership has no liabilities. The GDP partnership agreement provides that Liz and Pat share all income and loss from the partnership equally, except depreciation is allocated 2/3 to Liz and 1/3 to Pat, and gain from the disposition of the buildings will be charged back 2/3 to Liz and 1/3 to Pat to the extent of

accrued depreciation. Liz transfers half of her GDP interest (i.e., a 25% interest in the partnership) to Kay for $550,000 at a time when the partnership's inventory has a FMV of $1 million and a book and tax basis of $900,000 and Buildings I and II each have a FMV of $500,000 and a book and tax basis of $300,000. The partnership has deducted $150,000 of accrued depreciation on each of Building I and II that has been allocated $100,000 to Liz and $50,000 to Pat under the terms of the partnership agreement. At the time of the transfer Liz's capital account is $700,000 and Pat's is $800,000. Accordingly, half of Liz's $700,000 capital account ($350,000) is transferred to Kay. Kay's accountant needs to determine how much of Kay's basis adjustment will be allocated to goodwill.

Because each partner's gain with respect to the inventory and buildings is different, a partnership gross value cannot be determined without assuming values for GDP's individual assets. Accordingly, the allocation of Kay's basis adjustment must be made under the special rule of Reg. 1.755-1(a)(4)(i)(B). To begin the allocation process, the FMV of the partnership's assets other than goodwill must be determined based on facts and circumstances [Reg. 1.755-1(a)(3)].

Based on the information provided, the FMV of the inventory is $1 million and the FMV of each building owned by GDP is $500,000. These FMVs would result in a liquidating distribution to Kay of $500,000 for her 25% interest. The book gain from the sale of the inventory would be $100,000 (FMV of $1 million − basis of $900,000). The book gain from the sale of each building would be $200,000 (FMV of $500,000 − basis of $300,000). The book gain on each building attributed to the accrued depreciation would be allocated $50,000 to Pat and $50,000 each to Liz and Kay under the terms of the partnership agreement. The remaining $50,000 of gain on the deemed sale of each building would be allocated $25,000 to Pat and $12,500 each to Liz and Kay. The $100,000 gain on the deemed sale of the inventory would be allocated $50,000 to Pat and $25,000 each to Liz and Kay. The $150,000 book gain allocated to Kay ($25,000 from the inventory + $125,000 from the buildings) plus the $350,000 capital account transferred from Liz would give Kay an interest in the liquidation value of the partnership of $500,000.

The value of GDP's goodwill must be determined using the residual method. The value of the partnership's Section 197 intangibles is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than Section 197 intangibles.

Because the FMV of the partnership's assets other than Section 197 intangibles under the residual method is not sufficient to cause a liquidating distribution to Kay equal to the basis of her purchased interest ($550,000), the additional value necessary to cause such a distribution is allocated to goodwill. Kay's 25% share of the additional value is $50,000, so the value allocated to goodwill is $200,000. Accordingly, Kay's basis adjustment is calculated using a FMV of $1 million for partnership inventory, a FMV of $500,000 for each of the buildings owned by the partnership, and a FMV of $200,000 for partnership goodwill.

Example 32B-6: Allocating a basis adjustment resulting from a transfer of a partnership with no goodwill.

Assume the same facts as in Example 32B-5 except that Kay purchased her interest for $450,000. Kay's basis in her partnership interest ($450,000) is less than her share of the $500,000 liquidation value of the assets in the first four asset classes (as determined under the Section 1060 rules). In this case, there is no partnership goodwill. The FMV of the buildings (the residual class) for purposes of allocating the basis

adjustment is reduced by the amount that would result in the liquidation value of Kay's interest being $450,000. This requires Kay's share of the liquidation value of the buildings to be $75,000 ($450,000 − Kay's inherited capital account of $350,000 − Kay's $25,000 share of the gain on the deemed sale of inventory). Kay's $75,000 share of the book gain on the buildings is allocated $37,500 to each building. In order for Kay to be allocated $37,500 of book gain from the sale of each building, the total book gain with respect to each building would have to be $112,500 ($112,500 × 1/3 = $37,500). Adding this book gain to the current book value of each building results in a FMV for each building of $412,500 ($300,000 + $112,500).

Kay's basis adjustment must be allocated among partnership assets using a $1 million FMV for the inventory and a $412,500 FMV for each of the partnership's buildings. There is no allocation to partnership goodwill.

Note: See Key Issue 15G for a discussion of amortizing a basis adjustment to Section 197 intangible assets.

Allocating Basis Adjustments in Tiered Partnership Arrangements

In the case of tiered partnerships, both partnerships must make the Section 754 election for a distribution or transfer of a partnership interest at the upper-tier partnership level to trigger a basis adjustment at the lower-tier partnership level [Rev. Rul. 78-2, clarified and amplified by Rev. Rul. 87-115; Prop. Reg. 1.743-1(l)(1) provides guidance on the application of Section 743(b) basis adjustments in tiered partnerships that is consistent with Rev. Rul. 87-115]. (See also IRS Ann. 87-103, which amended the facts of Rev. Rul. 87-115 but does not affect this discussion.) The IRS has adopted a similar approach in applying IRC Sec. 734(b) to distributions by tiered partnerships (Rev. Rul. 92-15).

Example 32B-7: Allocating basis adjustments with respect to tiered partnerships.

Doug buys Terry's interest in Storage King Partnership which operates a small warehouse. Doug agrees to assume Terry's share of the partnership debt and pay him $62,500 cash. Terry determined his sales price by reference to the following partnership balance sheet:

Assets	Tax Basis	FMV	Liabilities and Capital	Tax Basis	FMV
Cash	$ 9,000	$ 9,000	Accounts payable	$ 20,000	$ 20,000
Accounts receivable	30,000	30,000	Mortgage	80,000	80,000
Inventory	45,000	65,000	Capital:		
Forklift A	20,000	19,000	Jim (40%)	60,000	100,000
Forklift B	20,000	21,000	Dan (25%)	37,500	62,500
Building	80,000	130,000	Blake (10%)	15,000	25,000
Lock 'n Leave LLC Partnership	46,000	76,000	Terry (25%)	37,500	62,500
Total	$ 250,000	$ 350,000	Total	$ 250,000	$ 350,000

Doug has a $25,000 basis adjustment to allocate, calculated as follows:

Doug's outside basis is:	
Cash paid for partnership interest	$ 62,500
Assumption of accounts payable (25% of $20,000)	5,000
Assumption of mortgage (25% of $80,000)	20,000
Total outside basis (A)	$ 87,500
Doug's inside basis is:	
Terry's tax basis capital account	$ 37,500
25% of partnership liabilities	25,000
Total inside basis (B)	$ 62,500
Overall basis basis adjustment (A) − (B)	$ 25,000

The ordinary income that would be allocated to Doug on a sale of the partnership's assets is $5,000 (the difference between the FMV and basis of Doug's share of partnership inventory). The remaining $20,000 basis adjustment is allocable to the partnership's capital gain property, including the interest in Lock 'n Leave. The basis adjustment allocable to the partnership interest is $7,408 [($7,500 appreciation in Lock n' Leave ÷ $20,250 overall appreciation in capital assets) × $20,000 basis adjustment allowable to capital gain property]. Assuming Lock n' Leave makes a Section 754 election, the $7,408 basis adjustment can be allocated to its assets.

Assume Lock n' Leave makes a Section 754 election and has the following balance sheet on the date Terry transfers his interest:

Assets	Tax Basis	FMV	Capital	Tax Basis	FMV
Cash	$ 30,000	$ 30,000	Storage King (40%)	$ 46,000	$ 76,000
Inventory	85,000	160,000	Mini's Warehouse (60%)	69,000	114,000
Total	$ 115,000	$ 190,000	Total	$ 115,000	$ 190,000

Because Lock n' Leave made a Section 754 election, the partnership can increase the basis of its property by the excess of Doug's basis in Lock n' Leave (after the basis adjustment)—$18,908 ($46,000 × .25 + $7,408)—over Doug's $11,500 interest in the basis of Lock n' Leave's property (25% × 40% × $115,000). Therefore, the basis adjustment allocable to Lock n' Leave's assets is $7,408, the same as the basis adjustment made by Storage King to its investment in the partnership. The basis adjustment is allocated to the assets of Lock n' Leave under the rules of IRC Sec. 755. Since the partnership has only one appreciated asset, the entire $7,408 basis adjustment is allocated to the inventory.

Allocating Basis Adjustments to Partnership Property after Transferred Basis Exchanges

In Prop. Reg. 1.755-1(b)(5), the IRS issued basis adjustment allocation rules that apply to Section 743(b) basis adjustments to partnership property resulting from *transferred basis exchanges* occurring after January 15, 2014. A transferred basis exchange occurs when the transferee's basis in the acquired partnership interest is determined in whole or in part by reference to the transferor's basis in that interest and from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by

the transferee. Such exchanges (also known as *substituted basis exchanges*) are wholly or partially tax free (i.e., they are nonrecognition transactions in whole or in part).

For instance, the Prop. Reg. 1.755-1(b)(5) rules apply if (1) a partnership interest is contributed to a corporation in a Section 351 transaction, (2) a partnership interest is contributed to another partnership in a Section 721(a) transaction, or (3) a partnership interest is distributed by a partnership in a Section 731(a) transaction.

Allocating Basis Adjustments between Classes of Partnership Property

When the total Section 743(b) basis adjustment is zero, no adjustment to the basis of partnership property is made [Prop. Reg. 1.755-1(b)(5)(ii)(A)].

When there is a basis increase it must be allocated between capital gain property and ordinary income property in proportion to and to the extent of the gross gain or gross income [including any remedial allocations under Reg. 1.704-3(d)] that would be allocated to the transferee partner (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. Any remaining increase must be allocated between the classes in proportion to the FMV of all property in each class [Prop. Reg. 1.755-1(b)(5)(ii)(B)].

Allocating Basis Adjustments within Classes of Partnership Property

If there is a basis decrease, it must be allocated between capital gain property and ordinary income property in proportion to and to the extent of the gross loss [including any remedial allocations under Reg. 1.704-3(d)] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all property in each class. Any remaining decrease must be allocated between the classes in proportion to the transferee's shares of the adjusted bases of all property in each class (after the adjustment explained in the immediately preceding sentence) [Prop. Reg. 1.755-1(b)(5)(ii)(C)].

If there is a basis increase within a class of partnership property, it is allocated first to properties with unrealized appreciation in proportion to the transferee's share of such unrealized appreciation (to the extent attributable to the acquired partnership interest) before the increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase is allocated among the properties within the class in proportion to their FMV.

If there is a basis decrease within a class, it must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the unrealized depreciation (to the extent attributable to the acquired partnership interest) before the decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease is allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (after the adjustment explained in the immediately preceding sentence) [Prop. Reg. 1.755-1(b)(5)(iii)(B)].

When a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis of all assets in that class, the basis of the property is reduced to zero (but not below zero). When a transferee's negative basis adjustment cannot be allocated to any asset, the negative adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made [Prop. Reg. 1.755-1(b)(5)(iii)(C)].

Example 32B-8: Allocating basis adjustment resulting from contribution of partnership interest to another partnership.

Alice is one of three equal partners in LTP Partnership. LTP owns two assets: accounts receivable with a $300,000 adjusted basis and $240,000 FMV, and a nondepreciable capital asset with a $60,000 adjusted basis and a $240,000 FMV. LTP has no liabilities.

Alice contributes her interest in LTP to UTP Partnership in a Section 721 transaction. At the time of the transfer, she has a $90,000 basis in her LTP interest. Under IRC Sec. 723, UTP's initial basis in the LTP interest equals Alice's basis in her LTP interest, $90,000. This is a transferred basis exchange.

LTP has a Section 754 election in effect. The resulting Section 743(b) basis adjustment equals the difference between UTP's $90,000 basis in the LTP interest (outside basis) and UTP's share of the adjusted basis of LTP's property (inside basis). UTP's share of the inside basis equals the sum of UTP's share of LTP's liabilities (zero) plus UTP's one-third share of LTP's previously taxed capital of $120,000 [($480,000 cash from the hypothetical sale of UTP's interest in LTP + $60,000 tax loss from the hypothetical sale of the accounts receivable − $180,000 tax gain from the hypothetical sale of the capital asset) × 1/3]. Therefore, the Section 743(b) basis adjustment to LTP's property resulting from the transfer is a negative $30,000 ($90,000 − $120,000).

The tax loss that would be allocated to UTP from the hypothetical sale of LTP's ordinary income asset (the accounts receivable) is $20,000 [1/3 × ($300,000 basis − $240,000 FMV)]. The hypothetical sale of LTP's capital asset would result in a tax gain. Therefore, the first $20,000 of the $30,000 negative basis adjustment must be allocated to the ordinary income asset (the receivables).

Because LTP has no other ordinary income assets, the remaining $10,000 negative basis adjustment must be allocated between the ordinary income asset and the capital asset in proportion to UTP's share of the adjusted basis of such assets (after taking into account the $20,000 negative basis adjustment that was already allocated to the receivables). Therefore, an additional $8,000 negative basis adjustment ($10,000 × $80,000 ÷ $100,000) must be allocated to the receivables, and a $2,000 negative basis adjustment ($10,000 × $20,000 ÷ $100,000) must be allocated to the capital asset.

Note: These basis adjustments to the basis of LTP's assets only affect UTP. The other two partners in LTP are unaffected.

Transferring a Partnership Interest after a Basis Adjustment Was Made for the Transferor

If a partnership interest is transferred more than once, a transferee partner's basis is determined without regard to any prior transferee's Section 743 basis adjustment. A partner who gifts property with respect to which the partner has a basis adjustment is treated as transferring the portion of the basis adjustment attributable to the gifted partnership interest [Reg. 1.743-1(f)].

Example 32B-9: Multiple transfers of a partnership interest.

Andy, Barbara and Cathy form Parkhill Partners. Andy and Barbara each contribute $1,000 and Cathy contributes land with a basis and FMV of $1,000. When the land is worth $1,300, Andy sells his interest to Ted for $1,100 (one third of $3,300, the FMV of the partnership's property). Parkhill makes a Section 754 election for the year of the transfer, so Ted has a Section 743 basis adjustment of $100.

After the land has further appreciated to $1,600, Ted sells his partnership interest to Sally for $1,200 (one-third of $3,600, the FMV of Parkhill's property). Sally has a Section 743 basis adjustment of $200. This amount is determined without regard to Ted's basis adjustment.

During the following year, Sally gifts 50% of her interest in Parkhill to Natalie. Sally is treated as transferring 50% of her $200 Section 743 basis adjustment to Natalie with the gift of the partnership interest.

Distributing Property for which Basis Adjustments Have Been Made

In general, a partner's basis in distributed property is the property's adjusted basis to the partnership immediately before such distribution, which includes any previous Section 734 basis adjustments made in connection with previous distributions [IRC Sec. 732(a)(1); Reg. 1.732-2(a)]. See Key Issue 33C for discussion of Section 734 basis adjustments when certain distributions are made. But, when property for which a Section 743 basis adjustment has been made (due to a sale or exchange of a partnership interest) is distributed, the following rules apply:

- A partner who receives a distribution of property with respect to which the partner has a Section 743 basis adjustment takes the adjustment into account in determining the basis of the distributed property [Reg. 1.743-1(g)(1)].

- A partner who receives a distribution of property with respect to which another partner has a Section 743 basis adjustment does not take the other partner's basis adjustment into account. The partner with the basis adjustment reallocates the basis adjustment under the Section 755 rules to remaining partnership property [Reg. 1.743-1(g)(2)].

- If a partner receives a liquidating distribution from a partnership when the partnership holds assets with respect to which the distributee partner has a Section 743 basis adjustment, any basis adjustment for that partner made to property that the partner does not receive in the liquidating distribution is reallocated to the properties that the partner does receive in liquidation [Reg. 1.743-1(g)(3)].

- If a partner receives a distribution of property (including money) with respect to which the partner has no basis adjustment in exchange for the partner's interest in property with respect to which the partner does have a basis adjustment, and does not use the entire adjustment to determine the basis of the distributed property, the partnership applies any unused basis adjustment to the basis of remaining partnership property. (This provision does not apply to the extent the Section 751 hot asset rules apply to the distribution.)

Contributing Property for which Basis Adjustments Have Been Made [Reg. 1.743-1(h)]

• If an upper tier partnership contributes property with respect to which a basis adjustment has been made to a lower tier partnership, the basis adjustment is considered contributed to the lower tier partnership, regardless of whether the lower tier partnership has a Section 754 election in effect. The basis adjustment of both the upper tier and lower tier partnership must be segregated and allocated solely to the transferee.

• If a partnership transfers property with respect to which there is a basis adjustment to a corporation in a Section 351 exchange, the corporation takes the basis adjustment into account when determining its basis in the transferred assets. However, to the extent the basis adjustment reduces any gain recognized on the contribution by the transferring partnership, it is not available to increase the basis of the corporation's assets. The partnership's basis in the stock received in a Section 351 exchange is determined without reference to the basis adjustment attached to property contributed to the corporation. However, a partner with a basis adjustment with respect to property transferred by a partnership to a corporation in a Section 351 exchange has a basis adjustment with respect to the stock received by the partnership.

In CCA 201726012 and CCA 202240017, the IRS concluded that when a corporation transfers a partnership interest either to its shareholders in a complete liquidation to which IRC Sec. 332(a) applies or to another corporation in a Type A or Type D merger (under IRC Sec. 368), the transfer is a sale or exchange for IRC Sec. 743(b) purposes, meaning that the partnership must adjust its basis in its assets (with respect to the transferee partner) if a Section 754 election is in effect. These Section 743(b) basis adjustments are not subject to reallocation under the IRC Sec. 704(b) substantial economic effect rules (see Chapter 26) because they are personal to the transferee partner.

Tax Return Filing and Notification Requirements When a Section 754 Election Is in Effect

Form 1065 Schedule B line 10a asks if the partnership is making or has previously made (and not revoked) a Section 754 election. If the answer is yes, enter the effective date of the election.

Form 1065 Schedule B line 10b asks if the partnership made an optional basis adjustment under Section 743(b) for the tax year. If the answer is yes, enter in the blank spaces on line 10b the total aggregate net positive amount and the total aggregate net negative amount of such Section 743(b) adjustments for all partners made in the tax year. The partnership must also attach a statement showing the computation and allocation of each basis adjustment. See Illustration 32-3 for an example of such a statement.

A partner who acquires an interest by sale or exchange in a partnership with a Section 754 election in effect has to notify the partnership in writing within 30 days of the transfer. In the case of a transfer upon death, the transferee partner has one year from the date of death to notify the partnership in writing. A partnership with a Section 754 election in effect must attach a statement to its return any year that a basis adjustment is triggered by a sale or exchange]. See Election E202 for details.

The partnership may rely upon these written notices to determine the transferee partner's basis adjustments. The partnership is not required to make the adjustment unless it has received the written notices. However, the

partnership is treated as having received written notice if any partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest [Regs. 1.743-1(k)(3) and (4)].

If the transferee partner does not provide written notice, the partnership must attach a statement to its return in the year that is otherwise notified of the transfer. The statement must set forth the name and TIN, if known, of the transferee. In addition, on the first page of the partnership's return and on the first page of any schedule or information statement relating to the transferee partner's share of income, deductions, credits, etc., the following caption must prominently appear: RETURN FILED PURSUANT TO REG. 1.743-1(k)(5). Then, the partnership can report the transferee partner's share of partnership items without any adjustment being made for the transferee partner's benefit. If the written notice is subsequently received, the partnership must make the applicable adjustments to the basis of the partnership property, as of the date of transfer, in any amended return otherwise to be filed by the partnership or in the next regularly filed annual return. At that time, the partnership must provide sufficient information for the transferee partner to file amended returns to properly reflect the Section 743 basis adjustment [Reg. 1.743-1(k)(5)].

When an interest in a partnership that holds depletable oil and gas properties and has a Section 754 election in effect is transferred, the transferee partner must include a statement with the partner's return for the year of the transfer. The statement must show the calculation of the transferee partner's total basis adjustment amount and how that amount was allocated to specific properties [Reg. 1.743-1(k)(1)(ii)]. (See Practice Aid O501 for a sample transferee partner statement.)

Reporting the Effect of Section 743 Basis Adjustments to the Transferee Partner

Positive Section 743 income adjustments (the excess of all Section 743 adjustments allocated to a transferee partner that increase that partner's taxable income over all the Section 743 adjustments that decrease that partner's taxable income) are reported on Schedule K, Line 11, Other Income (code F) and on the transferee partner's Schedule K-1, box 11 (code F). Negative Section 743 income adjustments (the excess of all Section 743 adjustments that decrease the transferee partner's taxable income over adjustments that increase the partners's taxable income) are reported on Schedule K, line 13d, Other Deductions (code V) and on the transferee partner's Schedule K-1, box 13 (code V). The partnership must also report each partner's remaining Section 743(b) basis adjustment (net of any cost recovery) as a single amount for all asset categories on Schedule K, Line 20, using Code U. In addition, a statement must be attached to each partner's Schedule K-1 for Box 20, Code U showing the amount of each Section 743 basis adjustment (net of cost recovery) by asset grouping. A statement similar to the one shown in Illustration 32-3, updated for each year, should suffice.

Allocating Depreciation Recapture Income to a Partner with a Basis Adjustment

A partnership disposing of Section 1245 property for which a partner has a Section 743 basis adjustment must apply special rules [Reg. 1.1245-1(e)(3)(ii)]. Those rules require that the partner be allocated a share of the common partnership adjusted basis for the disposed property and a share of the amount realized in proportion to the partner's share of partnership gain on the sale. If the partner purchased the partnership interest when the partnership owned the depreciable property and a Section 754 election was in effect, only the recapturable depreciation taken after the date the partnership interest was acquired by the partner is taken into account in making the allocation to the partner [Reg. 1.1245-1(e)(3)(ii)].

The partner's adjusted basis in the disposed property is the portion of the partnership's adjusted basis allocated to the partner, increased or decreased by the partner's optional basis adjustment with respect to the property on the date of disposition [Reg. 1.1245-1(e)(3)(iii)].

The partner's recomputed basis with respect to the property disposed of is the sum of the partner's adjusted basis in the property increased by the depreciation expense allocated to the partner, including depreciation on the Section 743 basis adjustment allocated to the disposed property [Reg. 1.1245-1(e)(3)(iv)].

Example 32B-10: Determining the recapture allocated to a partner with a basis adjustment.

Peter, Paul, and Mary are equal partners in Magic Dragon partnership, which made a Section 754 election in a prior year. On January 1, 20X1, Joe Puff purchased Mary's interest. On the date of acquisition, Magic had a Section 1245 property with an original cost of $50,000 and accumulated depreciation of $5,000. Joe has a $10,000 Section 743 basis adjustment as a result of acquiring Mary's interest in the Section 1245 property. For 20X1 and 20X2, the partnership deducts $4,500 of depreciation on the property, of which $1,500 is allocated to Joe. In addition, Joe deducts $1,000 of depreciation in each year on his stepped-up basis under IRC Sec. 743. On March 15, 20X3, Magic sells the property for $66,000.

Since the partnership's $50,000 recomputed basis ($36,000 adjusted basis plus $14,000 of depreciation deductions) is less than the amount realized, the excess of recomputed basis over adjusted basis ($14,000) is subject to recapture. However Joe's recapture is only $2,000, computed as follows:

(1) Adjusted Basis:	
Joe's portion of the partnership's basis (1/3 of $36,000)	$ 12,000
Joe's Section 743 basis adjustment ($10,000 – $2,000)	8,000
Joe's Adjusted Basis	$ 20,000
(2) Recomputed Basis	
Joe's adjusted basis	$ 20,000
Joe's portion of Magic's 20X1-20X2 depreciation	3,000
Joe's depreciation on his Section 743 basis adjustment	2,000
Joe's Recomputed Basis	$ 25,000
(3) Joe's allocation of amount realized by Magic ($66,000 × 1/3)	$ 22,000
(4) Joe's recapture income on line 11 (code R) is the lesser of line (2) or (3) – line (1)	$ 2,000

Basis Adjustment Case Study

Ten years ago, Mary Slumlord, Chris Cockroach, and Skip Towne formed Dilapidated Center, L.P., a limited partnership, to purchase a shopping center. Mary became a 1% general partner and a 32 1/3% limited partner. Chris and Skip each became 33 1/3% limited partners. Each contributed $100,000 cash for their interest. In the following year, Dilapidated acquired a shopping center for $2,500,000. Breakyourlegs Bank provided a $2,200,000 nonrecourse loan on very generous repayment terms. Neither Dilapidated nor any of the partners were liable for the mortgage. The debt was (and is) qualified nonrecourse financing. Since inception, Dilapidated has allocated income, deductions, gains, and losses in accordance with the partners' interests in the

partnership. Dilapidated elected to depreciate the shopping center using straight-line depreciation and elected the accrual method of accounting.

In Year 1, Tax World, a new theme park, opened next to the shopping center, causing the property to appreciate considerably. Unfortunately, it also caused the city to enact a number of zoning changes requiring Dilapidated to make some significant improvements over the next five years. In October Year 2, Skip decided he did not want to own an interest in Dilapidated anymore, since the partnership would need to make substantial improvements in the near future. Neither Mary nor Chris wanted to buy his interest, so he found an unrelated third party, Nick Naive, who was willing to pay Skip $500,000 for his interest. The sale closed on December 31, Year 2, when Nick gave Skip a check for $500,000. As part of the sale, Dilapidated agreed to make a Section 754 election. The balance sheet of Dilapidated as of the sale date is as follows:

	Tax Basis	FMV
Cash	$ 75,000	$ 75,000
Rent receivable	25,000	25,000
Shopping center (including land)	2,600,000	3,400,000
Less: Accumulated depreciation	(1,200,000)	—
Total assets	$ 1,500,000	$ 3,500,000
Mortgage payable—Nonrecourse	$ 2,100,000	$ 2,100,000
Capital:		
Mary Slumlord	(200,000)	466,666
Chris Cockroach	(200,000)	466,667
Skip Towne	(200,000)	466,667
Total liabilities and capital	$ 1,500,000	$ 3,500,000

Skip will recognize a $700,000 gain from the sale computed as follows:

Cash sales price	$ 500,000	
Relief from liabilities (1/3 of $2,100,000)	700,000	
Total sales price		$ 1,200,000
Less:		
Tax basis capital account	(200,000)	
Liabilities	700,000	
Total outside basis		(500,000)
Tax gain		$ 700,000

The gain is the absolute sum of the negative tax basis capital and the cash received. Of this gain, $400,000 is subject to a maximum 25% federal income tax rate as unrecaptured Section 1250 depreciation (1/3 × $1,200,000), while the remaining $300,000 gain is Section 1231 gain, eligible for long-term capital gain treatment if there are no unrecaptured Section 1231 losses.

Since Dilapidated made a Section 754 election, Nick is entitled to a basis adjustment. This adjustment is the difference between Nick's outside basis of $1.2 million ($500,000 cash paid plus a one-third share of the $2,100,000 qualified nonrecourse mortgage) and his share of the adjusted basis of partnership property (inside basis of the partnership's assets).

Nick's adjusted basis in the partnership property equals the sum of his share of the partnership's previously taxed capital, plus his share of partnership liabilities. Nick's share of previously taxed partnership capital equals (a) the cash he would receive from a liquidation of the partnership following a hypothetical sale, plus (b) the tax loss, including any remedial allocations under Reg. 1.704-3(d), allocated to him from the hypothetical sale, minus (c) the tax gain, including any remedial allocations under Reg. 1.704-3(d), allocated to him from the hypothetical sale. In this case, there are no Section 704 adjustments to worry about, which simplifies the calculation considerably.

If all of Dilapidated's assets were sold for their FMV, the partnership would receive $1,400,000 cash after payment of the mortgage, which is the only liability. This cash would be available for distribution to the partners, which means Nick would be entitled to his one-third share, or $466,667 cash from the hypothetical sale, computed as follows:

FMV of Shopping Center	$ 3,400,000
FMV of Rents Receivable	25,000
FMV of Cash	75,000
Total FMV	3,500,000
Less: Mortgage	(2,100,000)
Cash Available for Distribution to Partners	$ 1,400,000
Nick's share of cash	$ 466,667

Since there is no tax loss on the sale, no allocation to Nick is necessary. However, on the sale of the partnership's assets, there would be a $2 million tax gain, of which Nick would be allocated $666,667, his one-third share, is calculated as follows:

FMV of Shopping Center	$ 3,400,000
FMV of Rents Receivable	25,000
FMV of Cash	75,000
Total FMV	3,500,000
Less: Basis	
Shopping Center ($2,600,000 − $1,200,000)	(1,400,000)
Rents Receivable	(25,000)
Cash	(75,000)
Tax Gain	$ 2,000,000
Nick's 1/3 share	$ 666,667

Nick's previously taxed capital is ($200,000), computed as follows:

Cash Nick would receive on liquidation	$ 466,667

Plus any tax loss allocated to Nick	—
Minus any tax gain allocated to Nick	(666,667)
Previously taxed capital	$ (200,000)

Thus, Nick's adjusted basis in the partnership property equals $500,000. This is the sum of his previously taxed capital of ($200,000) plus $700,000, which is his share of the partnership's liabilities. Since his outside basis in the partnership interest is $1,200,000, his basis adjustment is $700,000 ($1,200,000 − $500,000).

The basis adjustment must be allocated among the partnership's assets to reduce the difference between the assets' FMV and their bases. Since the only asset with a basis less than its FMV is the shopping center, the entire $700,000 basis adjustment is allocated to it. This means Nick is allocated additional depreciation based on the portion of the $700,000 basis adjustment allocated to the building, since the portion allocated to land is not depreciable. The positive adjustment is treated as a new depreciable asset, which means it will have a 39-year life and will be depreciated under MACRS. The annual depreciation expense related to the basis adjustment is reported on box 13 (code V) of Nick's Schedule K-1. The partnership should also report to Nick each year his Section 743(b) basis adjustment (net of cost recovery) by asset grouping on Schedule K-1, box 20, code U. The the partnership and partners to must file notices with the IRS and attach certain calculations to the partnership's tax return. See Illustrations 32-1 through 32-3. (See Election E202 for blank versions of these statements.)

Basis Adjustment Case Study: Active Trade or Business

Five years ago, Sally Softsell, Marvin Markup and Peter Product formed Fast Feet Food, LLC (FFF), which is classified as a partnership for federal income tax, to operate convenience food stores. Each contributed $100,000 cash for their one-third interest in the LLC. During the next few years, FFF also acquired two convenience stores and operated them. To finance the stores, FFF borrowed a $1,500,000 mortgage from Usury Plus Bank. No principal was due for five years. Neither FFF nor any of the members were liable for the mortgage. The debt was (and is) qualified nonrecourse financing. Since inception, FFF has allocated income, deductions, gains and losses strictly in accordance with the members' interests in the LLC. FFF depreciated the stores using straight-line depreciation and elected the accrual method of accounting.

On December 31 of the current year, Stu Sucker purchased Peter's one-third interest for $200,000. As part of the sale, FFF agreed to make a Section 754 election. The FFF balance sheet at the time of sale is as follows:

	Tax Basis	FMV
Cash	$ 75,000	$ 75,000
Accounts receivable	25,000	25,000
Inventory	150,000	200,000
Store 1 (Including land)	650,000	800,000
Less: Accumulated depreciation	(110,000)	
Store 2 (Including land)	675,000	750,000
Less: Accumulated depreciation	(115,000)	
Trademark	—	200,000

	Tax Basis	FMV
Goodwill	—	350,000
Total Assets	$ 1,350,000	$ 2,400,000
Mortgage payable—nonrecourse capital	$ 1,500,000	$ 1,500,000
Other Debt	300,000	300,000
Sally Softsell	(150,000)	200,000
Marvin Markup	(150,000)	200,000
Peter Product	(150,000)	200,000
Total liabilities and capital	$ 1,350,000	$ 2,400,000

Peter will recognize a gain of $350,000 on the sale of his LLC interest computed as follows:

Cash Sales Price	$ 200,000	
Relief from Liabilities (1/3 of $1,800,000)	600,000	
Total Sales Price		$ 800,000
Less: Basis		
Tax Basis Capital Account	150,000	
Liabilities	(600,000)	
Total Outside Basis		(450,000)
Taxable Gain		$ 350,000

Since FFF will make a Section 754 election, Stu will be entitled to a basis adjustment with respect to his share of LLC assets. This basis adjustment is the difference between Stu's outside basis of $800,000 ($200,000 cash paid plus a one-third share of the $1,800,000 qualified nonrecourse mortgage) and his share of the adjusted basis of FFF's property.

Stu's adjusted basis in the LLC property equals the sum of his share of FFF's previously taxed capital, plus his share of its liabilities. Stu's share of previously taxed capital equals (a) the cash he would receive from a liquidation of FFF following a hypothetical sale, plus (b) any tax loss, including any remedial allocations under Reg. 1.704-3(d), allocated to him from the hypothetical sale, minus (c) any tax gain, including any remedial allocations under Reg. 1.704-3(d), allocated to him from the hypothetical sale. In this case, there are no Section 704 adjustments to worry about, which simplifies the calculation considerably.

If all FFF assets were sold for their FMV, the LLC would receive $600,000 cash after paying liabilities. This cash would be available for distribution to the members, which means Stu would be entitled to his one-third share, or $200,000 cash from the hypothetical sale, computed as follows:

FMV of Store 1	$ 800,000
FMV of Store 2	750,000
FMV of Trademark	200,000
FMV of Goodwill	350,000

FMV of Inventory	200,000
FMV of Accounts Receivable	25,000
FMV of Cash	75,000
Total FMV	2,400,000
Less: Mortgage and debt	(1,800,000)
Cash available for distribution to partners	$ 600,000
Stu's share of cash	$ 200,000

The sale of the LLC's assets would result in a tax gain of $1,050,000 of which Stu would be allocated $350,000, computed as follows:

FMV of Store 1	$ 800,000
FMV of Store 2	750,000
FMV of Trademark	200,000
FMV of Goodwill	350,000
FMV of Inventory	200,000
FMV of Accounts Receivable	25,000
FMV of Cash	75,000
Total FMV	2,400,000
Less: Basis	
Store 1	(540,000)
Store 2	(560,000)
Trademark	—
Goodwill	—
Inventory	(150,000)
Accounts Receivable	(25,000)
Cash	(75,000)
Taxable Gain	$ 1,050,000
Stu's 1/3 share	$ 350,000
Stu's previously taxed capital is ($150,000), computed as follows:	
Cash Stu would receive on liquidation	$ 200,000
Plus any tax loss allocated to Stu	—
Minus any tax gain allocated to Stu	(350,000)
Previously taxed capital	$ (150,000)

Thus, Stu's adjusted basis in FFF's property equals $450,000. This is the sum of his previously taxed capital of $(150,000) plus $600,000, which is his share of the LLC's liabilities. Since his basis in his LLC interest (his outside basis) is $800,000, his Section 743 basis adjustment will be $350,000 ($800,000 − $450,000).

The basis adjustment must be allocated among the LLC's assets to reduce the difference between the FMV of the assets and their bases. Since there are several assets with a FMV greater than basis, the positive basis adjustment is allocated among those assets in accordance with Reg. 1.755-1. The allocation of LLC gross value is as follows:

Computation of LLC Gross Value

Amount needed to provide a liquidating distribution equal to Stu's basis (3 × $200,000)	$ 600,000
LLC debt	1,800,000
LLC gross value	$ 2,400,000

The LLC gross value is allocated as follows:

Fast Feet Food, LLC
Allocation of LLC Gross Value

	Total FMV	Stu's Share of FMV
LLC gross value	$ 2,400,000	$ 800,000
Non-Section 197 Assets:		
Cash	(75,000)	(25,000)
Accounts receivable	(25,000)	(8,333)
Inventory	(200,000)	(66,667)
Store 1	(800,000)	(266,666)
Store 2	(750,000)	(250,000)
Residual to Section 197 intangibles	550,000	183,334
Value of trademark	(200,000)	(66,667)
Residual to Goodwill	$ 350,000	$ 116,667

Since there is sufficient basis adjustment to allocate to each class, including goodwill, the allocation of the basis adjustment is as follows:

Fast Feet Food, LLC
Allocation of Difference

Stu's Share of Ordinary Income Property	Tax Basis	FMV	Difference (Positive Adjustment)
Accounts receivable	$ 8,333	$ 8,333	$ —
Inventory	50,000	66,667	16,667
Totals	$ 58,333	$ 75,000	$ 16,667

Stu's Share of Capital Gain Property	Tax Basis	FMV	Difference (Positive Adjustment)
Store 1 (including land)	$ 180,000	$ 266,666	$ 86,666
Store 2 (including land)	186,667	250,000	63,333
Trademark	—	66,667	66,667
Goodwill	—	116,667	116,667

Stu's Share of Capital Gain Property	Tax Basis	FMV	Difference (Positive Adjustment)
Totals	$ 366,667	$ 700,000	$ 333,333
Total of All Property	$ 425,000	$ 775,000	$ 350,000

The $16,667 basis adjustment for the ordinary income assets will be allocated to the inventory. Both Store 1 and Store 2 (depreciable property) have an increase in basis. The $149,999 ($86,666 + $63,333) basis adjustment made with respect to those assets is treated as a new asset, which means that it will have a 39-year life and will be depreciated SL under MACRS. This additional depreciation should be reported in Box 13 (code V) of Stu's Schedule K-1. The $183,334 ($66,667 + $116,667) adjustment made to intangible assets is amortized over 15 years. The annual amortization is included in the amount reported to Stu on box 13 (code V) of his Schedule K-1. The partnership should also report to Stu his Section 743(b) basis adjustment by asset grouping on Schedule K-1, box 20, code U.

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Federal Regulations

Reg § 1.755-1. Rules for allocation of basis.

Caution: The Treasury has not yet amended Reg § 1.755-1 to reflect changes made by P.L. 108-357

Effective: January 19, 2017. The regulations are applicable on January 19, 2017.

(a) In general.

(1) Scope. This section provides rules for allocating basis adjustments under sections 743(b) and 734(b) among partnership property. If there is a basis adjustment to which this section applies, the basis adjustment is allocated among the partnership's assets as follows. First, the partnership must determine the value of each of its assets under paragraphs (a)(2) through (5) of this section. Second, the basis adjustment is allocated between the two classes of property described in section 755(b). These classes of property consist of capital assets and section 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property. Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class. Basis adjustments under section 743(b) are allocated among partnership assets under paragraph (b) of this section. Basis adjustments under section 734(b) are allocated among partnership assets under paragraph (c) of this section.

(2) Coordination of sections 755 and 1060. If there is a basis adjustment to which this section applies, and the assets of the partnership constitute a trade or business (as described in § 1.1060-1(b)(2)), then the partnership is required to use the residual method to assign values to the partnership's section 197 intangibles. To do so, the partnership must, first, determine the value of partnership assets other than section 197 intangibles under paragraph (a)(3) of this section. The partnership then must determine partnership gross value under paragraph (a)(4) of this section. Last, the partnership must assign values to the partnership's section 197 intangibles under paragraph (a)(5) of this section. For purposes of this section, the term section 197 intangibles includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

(3) Values of properties other than section 197 intangibles. For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

(4) Partnership gross value.

(i) Basis adjustments under section 743(b).

(A) In general. Except as provided in paragraph (a)(4)(ii) of this section, in the case of a basis adjustment under section 743(b), partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).

(B) Special situations. In certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles held by the partnership. In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair

market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

(C) Income in respect of a decedent. Solely for the purpose of determining partnership gross value under this paragraph (a)(4)(i), where a partnership interest is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to section 1014(c) or section 1022(f), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691.

(ii) Basis adjustments under section 743(b) resulting from substituted basis transactions. This paragraph (a)(4)(ii) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

(iii) Basis adjustments under section 734(b). In the case of a basis adjustment under section 734(b), partnership gross value equals the value of the entire partnership as a going concern immediately following the distribution causing the adjustment, increased by the amount of partnership liabilities immediately following the distribution.

(5) Determining the values of section 197 intangibles.

(i) Two classes. If the aggregate value of partnership property other than section 197 intangibles (as determined in paragraph (a)(3) of this section) is equal to or greater than partnership gross value (as determined in paragraph (a)(4) of this section), then all section 197 intangibles are deemed to have a value of zero for purposes of this section. In all other cases, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles. The residual section 197 intangibles value must be allocated between two asset classes in the following order—

(A) Among section 197 intangibles other than goodwill and going concern value; and

(B) To goodwill and going concern value.

(ii) Values assigned to section 197 intangibles other than goodwill and going concern value. The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the extent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

(iii) Value assigned to goodwill and going concern value. The fair market value of goodwill and going concern value is the amount, if any, by which the residual section 197 intangibles value exceeds the aggregate value of the partnership's section 197 intangibles (other than goodwill and going concern value).

(6) Examples. The provisions of paragraphs (a)(2) through (5) are illustrated by the following examples, which assume that the partnerships have an election in effect under section 754 at the time of the transfer and that the assets of each partnership

constitute a trade or business (as described in §1.1060-1(b)(2)). Except as provided, no partnership asset (other than inventory) is property described in section 751(a), and partnership liabilities are secured by all partnership assets. The examples are as follows:

Example (1).

(i) A is the sole general partner in PRS, a limited partnership having three equal partners. PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two other assets with fair market values (determined using all the facts and circumstances) as follows: inventory worth $1,000,000 and a building (a capital asset) worth $2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is $50,000. PRS has one liability of $1,000,000, for which A bears the entire risk of loss under section 752 and the regulations thereunder. D purchases A's partnership interest for $650,000, resulting in a basis adjustment under section 743(b). After the purchase, D bears the entire risk of loss for PRS's liability under section 752 and the regulations thereunder. Therefore, D's basis in its interest in PRS is $1,650,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $650,000 ($1,650,000--$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $2,950,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $650,000).

(iii) Under paragraph (a)(3) of this section, the inventory has a fair market value of $1,000,000, and the building has a fair market value of $2,000,000. Thus, the aggregate value of partnership property other than section 197 intangibles, $3,000,000, is equal to or greater than partnership gross value, $2,950,000. Accordingly, under paragraphs (a)(3) and (5) of this section, the value assigned to each of the partnership's assets is as follows: inventory, $1,000,000; building, $2,000,000; Intangibles 1 and 2, $0; and goodwill and going concern value, $0. D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example (2).

(i) Assume the same facts as in Example 1, except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that D purchases A's interest in PRS for $1,000,000. After the purchase, D's basis in its interest in PRS is $2,000,000.

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $1,000,000 ($2,000,000--$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $4,000,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $1,000,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $1,000,000 (the excess of partnership gross value, $4,000,000, over the aggregate value of assets other than section 197 intangibles, $3,000,000 (the sum of the value of the inventory, $1,000,000, and the value of the building, $2,000,000)). The partnership must determine the values of section 197 assets by allocating the residual section 197 intangibles value among the partnership's assets. The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example (3).

(i) Assume the same facts as in Example 1, except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that D purchases A's interest in PRS for $750,000. After the purchase, D's basis in its interest in PRS is $1,750,000. Also assume that Intangible 1 was originally purchased for $300,000, and that its adjusted basis has been decreased to $50,000 as a result of amortization. Assume that, if PRS were to sell Intangible 1 for $300,000, it would recognize $250,000 of gain that would be treated as an unrealized receivable under the flush language in section 751(c).

(ii) D's basis in the transferred partnership interest (reduced by the amount of such basis that is attributable to partnership liabilities) is $750,000 ($1,750,000--$1,000,000). Under paragraph (a)(4)(i) of this section, partnership gross value is $3,250,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to D equal to $750,000).

(iii) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $250,000 (the amount by which partnership gross value, $3,250,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $3,000,000). Intangible 1 has potential gain that would be treated as unrealized

receivables under the flush language of section 751(c). The flush language receivables value in Intangible 1 is $300,000 (the sum of PRS's basis in Intangible 1, $50,000, and the amount of ordinary income, $250,000, that the partnership would recognize if Intangible 1 were sold for its actual fair market value). Because the residual section 197 intangibles value, $250,000, is less than the flush language receivables value of Intangible 1, Intangible 1 is assigned a value of $250,000, and Intangible 2 and goodwill and going concern value are assigned a value of zero. D's section 743(b) adjustment must be allocated under paragraph (b) of this section using these assigned fair market values.

Example (4). Assume the same facts as in Example 1, except that the fair market values of Intangible 1 and Intangible 2 are each $300,000, and that A does not sell its interest in PRS. Instead, A contributes its interest in PRS to E, a newly formed corporation wholly-owned by A, in a transaction described in section 351. Assume that the contribution results in a basis adjustment under section 743(b) (other than zero). PRS determines that its value as a going concern immediately following the contribution is $3,000,000. Under paragraph (a)(4)(ii) of this section, partnership gross value is $4,000,000 (the value of PRS as a going concern, $3,000,000, increased by the partnership's liability, $1,000,000, immediately after the contribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $1,000,000 (the amount by which partnership gross value, $4,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $3,000,000). Of the residual section 197 intangibles value, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). E's section 743(b) adjustment must be allocated under paragraph (b)(5) of this section using these assigned fair market values.

Example (5). G is the sole general partner in PRS, a limited partnership having three equal partners (G, H, and I). PRS has goodwill and going concern value, two section 197 intangibles other than goodwill and going concern value (Intangible 1 and Intangible 2), and two capital assets with fair market values (determined using all the facts and circumstances) as follows: Vacant land worth $1,000,000, and a building worth $2,000,000. The fair market value of each of Intangible 1 and Intangible 2 is $300,000. PRS has one liability of $1,000,000, for which G bears the entire risk of loss under section 752 and the regulations thereunder. PRS distributes the land to H in liquidation of H's interest in PRS. Immediately prior to the distribution, PRS's basis in the land is $800,000, and H's basis in its interest in PRS is $750,000. The distribution

causes the partnership to increase the basis of its remaining property by $50,000 under section 734(b)(1)(B). PRS determines that its value as a going concern immediately following the distribution is $2,000,000. Under paragraph (a)(4)(iii) of this section, partnership gross value is $3,000,000 (the value of PRS as a going concern, $2,000,000, increased by the partnership's liability, $1,000,000, immediately after the distribution). Under paragraph (a)(5) of this section, the residual section 197 intangibles value of PRS's section 197 intangibles is $1,000,000 (the amount by which partnership gross value, $3,000,000, exceeds the aggregate value of partnership property other than section 197 intangibles, $2,000,000). Of the residual section 197 intangibles value, $300,000 is assigned to each of Intangible 1 and Intangible 2, and $400,000 is assigned to goodwill and going concern value (the amount by which the residual section 197 intangibles value, $1,000,000, exceeds the fair market value of section 197 intangibles other than goodwill and going concern value, $600,000). PRS's section 734(b) adjustment must be allocated under paragraph (c) of this section using these assigned fair market values.

(b) Adjustments under section 743(b).

(1) Generally.

(i) Application. For basis adjustments under section 743(b) resulting from substituted basis transactions, paragraph (b)(5) of this section shall apply. For basis adjustments under section 743(b) resulting from all other transfers, paragraphs (b)(2) through (4) of this section shall apply. For transfers subject to section 334(b)(1)(B), see §1.334-1(b)(3)(iii)(C)(1) (treating a determination of basis under §1.334-1(b)(3) as a determination not by reference to the transferor's basis solely for purposes of applying section 755); for transfers subject to section 362(e)(1), see § 1.362-3(b)(4)(i) (treating a determination of basis under §1.362-3 as a determination not by reference to the transferor's basis solely for purposes of applying section 755); for transfers subject to section 362(e)(2), see §1.362-4(c)(3)(i) (treating a determination of basis under §1.362-4 as a determination by reference to the transferor's basis for all purposes). Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

(ii) Hypothetical transaction. For purposes of paragraphs (b)(2) through (b)(4) of this section, the allocation of the basis adjustment under section 743(b) between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss (including remedial allocations under §1.704-3(d)) that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the hypothetical transaction). See §1.460-4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.

(2) Allocations between classes of property.

(i) In general. The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction. The amount of the basis adjustment to capital gain property is equal to—

(A) The total amount of the basis adjustment under section 743(b); less

(B) The amount of the basis adjustment allocated to ordinary income property under the preceding sentence; provided, however, that in no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under §1.704-3(d) from the hypothetical transaction) in capital gain property. In the event that a decrease in basis allocated to capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.

(ii) Examples. The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example (1).

(i) A and B form equal partnership PRS. A contributes $50,000 and Asset 1, a nondepreciable capital asset with a fair market value of $50,000 and an adjusted

tax basis of $25,000. B contributes $100,000. PRS uses the cash to purchase Assets 2, 3, and 4. After a year, A sells its interest in PRS to T for $120,000. At the time of the transfer, A's share of the partnership's basis in partnership assets is $75,000. Therefore, T receives a $45,000 basis adjustment.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	**Fair Market value**
Capital Gain Property:		
Asset 1	$25,000	$75,000
Asset 2	100,000	117,500
Ordinary Income Property:		
Asset 3	40,000	45,000
Asset 4	10,000	2,500
Total	175,000	240,000

(iii) If PRS sold all of its assets in a fully taxable transaction at fair market value immediately after the transfer of the partnership interest to T, the total amount of capital gain that would be allocated to T is equal to $46,250 ($25,000 section 704(c) built-in gain from Asset 1, plus fifty percent of the $42,500 appreciation in capital gain property). T would also be allocated a $1,250 ordinary loss from the sale of the ordinary income property.

(iv) The amount of the basis adjustment that is allocated to ordinary income property is equal to ($1,250) (the amount of the loss allocated to T from the hypothetical sale of the ordinary income property).

(v) The amount of the basis adjustment that is allocated to capital gain property is equal to $46,250 (the amount of the basis adjustment, $45,000, less ($1,250), the amount of loss allocated to T from the hypothetical sale of the ordinary income property).

Example (2).

(i) A and B form equal partnership PRS. A and B each contribute $1,000 cash which the partnership uses to purchase Assets 1, 2, 3, and 4. After a year, A sells its partnership interest to T for $1,000. T's basis adjustment under section 743(b) is zero.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	Fair Market value
Capital Gain Property:		
Asset 1	$500	$750
Asset 2	500	500
Ordinary Income Property:		
Asset 3	500	250
Asset 4	500	500
Total	2,000	2,000

(iii) If, immediately after the transfer of the partnership interest to T, PRS sold all of its assets in a fully taxable transaction at fair market value, T would be allocated a loss of $125 from the sale of the ordinary income property. Thus, the amount of the basis adjustment to ordinary income property is ($125). The amount of the basis adjustment to capital gain property is $125 (zero, the amount of the basis adjustment under section 743(b), less ($125), the amount of the basis adjustment allocated to ordinary income property).

(3) Allocation within the class.

(i) Ordinary income property. The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; reduced by

(B) The product of—

(1) Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to the last sentence of paragraph (b)(2)(i) of this section; multiplied by

(2) A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

(ii) Capital gain property. The amount of the basis adjustment to each item of property within the class of capital gain property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; minus

(B) The product of—

(1) The total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

(2) A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

(iii) Special rules.

(A) Assets in which partner has no interest. An asset with respect to which the transferee partner has no interest in income, gain, losses, or deductions shall not be taken into account in applying paragraph (b)(3)(ii)(B) of this section.

(B) Limitation in decrease of basis. In no event may the amount of any decrease in basis allocated to an item of capital gain property under paragraph (b)(3)(ii)(B) of this section exceed the partnership's adjusted basis in that item (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under §1.704-3(d) from the hypothetical transaction). In the event that a decrease in basis allocated under paragraph (b)(3)(ii)(B) of this section to an item of capital gain property would otherwise exceed the partnership's adjusted basis in that item, the excess must be applied to reduce the remaining basis, if any, of other capital gain assets pro rata in proportion to the bases of such assets (as adjusted under this paragraph (b)(3)).

(iv) Examples. The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example (1).

(i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section. Of the $45,000 basis adjustment, $46,250 was allocated to capital gain property. The amount allocated to ordinary income property was ($1,250).

(ii) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 1 is $37,500.

(iii) Asset 2 is a capital gain asset, and T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 2 is $8,750.

(iv) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(v) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

Example (2).

(i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section, except that A sold its interest in PRS to T for $110,000 rather than $120,000. T, therefore, receives a basis adjustment under section 743(b) of $35,000. Of the $35,000 basis adjustment, ($1,250) is allocated to ordinary income property, and $36,250 is allocated to capital gain property.

(ii) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(iii) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

(iv) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Asset 2 is a capital gain asset, and

T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. The total amount of gain that would be allocated to T from the sale of the capital gain assets in the hypothetical transaction is $46,250, which exceeds the amount of the basis adjustment allocated to capital gain property by $10,000. The amount of the adjustment to Asset 1 is $33,604 ($37,500 minus $3,896 ($10,000 x $75,000/ 192,500)). The amount of the basis adjustment to Asset 2 is $2,646 ($8,750 minus $6,104 ($10,000 x $117,500/192,500)).

(4) Income in respect of a decedent.

(i) In general. Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) or section 1022(f), the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under section 691. See §1.742-1. Accordingly, if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis adjustment under section 743(b) is allocated to these assets. See §1.743-1(b).

(ii) The provisions of this paragraph (b)(4) are illustrated by the following example:

Example.

(i) A and B are equal partners in personal service partnership PRS. In 2004, as a result of B's death, B's partnership interest is transferred to T when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows (based on all the facts and circumstances):

Assets

	Adjusted Basis	Fair Market Value
Section 197 Intangible	$2,000	$5,000
Unrealized Receivables	0	15,000
Total	$2,000	$20,000

Liabilities and Capital

	Adjusted Per Books	Fair Market Value
Capital:		
A	1,000	10,000

	Adjusted Per Books	Fair Market Value
B	1,000	10,000
Total	$2,000	$20,000

(ii) None of the assets owned by PRS is section 704(c) property, and the section 197 intangible is not amortizable. The fair market value of T's partnership interest on the applicable date of valuation set forth in section 1014 is $10,000. Of this amount, $2,500 is attributable to T's 50% share of the partnership's section 197 intangible, and $7,500 is attributable to T's 50% share of the partnership's unrealized receivables. The partnership's unrealized receivables represent income in respect of a decedent. Accordingly, under section 1014(c), T's basis in its partnership interest is not adjusted for that portion of the interest which is attributable to the unrealized receivables. Therefore, T's basis in its partnership interest is $2,500.

(iii) Under paragraph (a)(4)(i)(C) of this section, solely for purposes of determining partnership gross value, T's basis in its partnership interest is deemed to be $10,000. Under paragraph (a)(4)(i) of this section, partnership gross value is $20,000 (the amount that, if assigned to all partnership property, would result in a liquidating distribution to T equal to $10,000).

(iv) Under paragraph (a)(5) of this section, the residual section 197 intangibles value is $5,000 (the excess of partnership gross value, $20,000, over the aggregate value of assets other than section 197 intangibles, $15,000). The residual section 197 intangibles value is assigned first to section 197 intangibles other than goodwill and going concern value, and then to goodwill and going concern value. Thus, $5,000 is assigned to the section 197 intangible, and $0 is assigned to goodwill and going concern value. T's section 743(b) adjustment must be allocated using these assigned fair market values.

(v) At the time of the transfer, B's share of the partnership's basis in partnership assets is $1,000. Accordingly, T receives a $1,500 basis adjustment under section 743(b). Under this paragraph (b)(4), the entire basis adjustment is allocated to the partnership's section 197 intangible.

(5) Substituted basis transactions.

(i) In general. This paragraph (b)(5) applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the

transferor's basis in that interest. For exchanges on or after June 9, 2003, this paragraph (b)(5) also applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee. For example, this paragraph (b)(5) applies if a partnership interest is contributed to a corporation in a transaction to which section 351 applies, if a partnership interest is contributed to a partnership in a transaction to which section 721(a) applies, or if a partnership interest is distributed by a partnership in a transaction to which section 731(a) applies.

(ii) Allocations between classes of property. If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5). If there is an increase in basis to be allocated to partnership assets, such increase must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. Where, under the preceding sentence, an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase shall be allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class. If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. Where, under the preceding sentence, a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease shall be allocated to each class in proportion to the net loss which would be allocated to the transferee from the sale of all assets in each class.

(iii) Allocations within the classes.

(A) Increases. If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the

extent of the transferee's share of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

(B) Decreases. If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

(C) Limitation in decrease of basis. Where, as the result of a transaction to which this paragraph (b)(5) applies, a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.

(D) Carryover adjustment. Where a transferee's negative basis adjustment under section 743(b) cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(iv) Examples. The provisions of this paragraph (b)(5) are illustrated by the following examples:

Example (1). A is a member of partnership LTP, which has made an election under section 754. The three partners in LTP have equal interests in capital and profits. Solely in exchange for a partnership interest in UTP, A contributes its interest in LTP to UTP in a transaction described in section 721. At the time of the transfer, A's basis in its partnership interest ($5,000) equals its share of inside basis (also $5,000). Under section 723, UTP's basis in its interest in LTP is $5,000. LTP's only two assets on the date of contribution are inventory with a

basis of $5,000 and a fair market value of $7,500, and a nondepreciable capital asset with a basis of $10,000 and a fair market value of $7,500. The amount of the basis adjustment under section 743(b) to partnership property is $0 ($5,000, UTP's basis in its interest in LTP, minus $5,000, UTP's share of LTP's basis in partnership assets). Because UTP acquired its interest in LTP in a substituted basis transaction, and the total amount of the basis adjustment under section 743(b) is zero, UTP receives no special basis adjustments under section 743(b) with respect to the partnership property of LTP.

Example (2).

(i) A purchases a partnership interest in LTP at a time when an election under section 754 is not in effect. The three partners in LTP have equal interests in capital and profits. During a later year for which LTP has an election under section 754 in effect, and in a transaction that is unrelated to A's purchase of the LTP interest, A contributes its interest in LTP to UTP in a transaction described in section 721 (solely in exchange for a partnership interest in UTP). At the time of the transfer, A's adjusted basis in its interest in LTP is $20,433. Under section 721, A recognizes no gain or loss as a result of the contribution of its partnership interest to UTP. Under section 723, UTP's basis in its partnership interest in LTP is $20,433. The balance sheet of LTP on the date of the contribution shows the following:

Assets

	Adjusted basis	Fair Market value
Cash	$5,000	$5,000
Accounts Receivable	10,000	10,000
Inventory	20,000	21,000
Nondepreciable capital asset	20,000	40,000
Total	55,000	76,000

Liabilities and Capital

	Adjusted per books	Fair Market value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of UTP's interest in LTP and UTP's share of the adjusted basis to LTP of partnership property. UTP's interest in the previously taxed capital of LTP is $15,000 ($22,000, the amount of cash UTP would receive if LTP liquidated immediately after the hypothetical transaction, decreased by $7,000, the amount of tax gain allocated to UTP from the hypothetical transaction). UTP's share of the adjusted basis to LTP of partnership property is $18,333 ($15,000 share of previously taxed capital, plus $3,333 share of LTP's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is $2,100 ($20,433 minus $18,333).

(iii) The total amount of gain that would be allocated to UTP from the hypothetical sale of capital gain property is $6,666.67 (one-third of the excess of the fair market value of LTP's nondepreciable capital asset, $40,000, over its basis, $20,000). The total amount of gain that would be allocated to UTP from the hypothetical sale of ordinary income property is $333.33 (one-third of the excess of the fair market value of LTP's inventory, $21,000, over its basis, $20,000). Under this paragraph (b)(5), LTP must allocate $2,000 ($6,666.67 divided by $7,000 times $2,100) of UTP's basis adjustment to the nondepreciable capital asset. LTP must allocate $100 ($333.33 divided by $7,000 times $2,100) of UTP's basis adjustment to the inventory.

(c) Adjustments under section 734(b).

(1) Allocations between classes of property.

(i) General rule. Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and

the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

(ii) Special rule. Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.

(2) Allocations within the classes.

(i) Increases. If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values.

(ii) Decreases. If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).

(3) Limitation in decrease of basis. Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property is reduced to zero (but not below zero).

(4) Carryover adjustment. Where, in the case of a distribution, an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(5) Cross reference. See §1.460-4(k)(3)(v)(B) for a rule relating to the computation of unrealized appreciation or depreciation in a contract accounted for under a long-term contract method of accounting.

(6) Example. The following example illustrates this paragraph (c):

Example.

(i) A, B, and C form equal partnership PRS. A contributes $50,000 and Asset 1, nondepreciable capital gain property with a fair market value of $50,000 and an adjusted tax basis of $25,000. B and C each contributes $100,000. PRS uses the cash to purchase Assets 2, 3, 4, 5, and 6. Assets 2 and 3 are nondepreciable capital assets, and Assets 4, 5, and 6 are inventory that has not appreciated substantially in value within the meaning of section 751(b)(3). Assets 4, 5, and 6 are the only assets held by the partnership that are subject to section 751. The partnership has an election in effect under section 754. After seven years, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted basis	**Fair Market value**
Capital Gain Property:		
Asset 1	$25,000	$75,000
Asset 2	100,000	117,500
Asset 3	50,000	60,000
Ordinary Income Property:		
Asset 4	40,000	45,000
Asset 5	50,000	60,000
Asset 6	10,000	2,500
Total	275,000	360,000

(ii) Allocation between classes. Assume that PRS distributes Assets 3 and 5 to A in complete liquidation of A's interest in the partnership. A's basis in the partnership interest was $75,000. The partnership's basis in Assets 3 and 5 was $50,000 each. A's $75,000 basis in its partnership interest is allocated between Assets 3 and 5 under sections 732(b) and (c). A will, therefore, have a basis of $25,000 in Asset 3 (capital gain property), and a basis of $50,000 in Asset 5 (section 751 property). The distribution results in a $25,000 increase in the basis of capital gain property. There is no change in the basis of ordinary income property.

(iii) Allocation within class. The amount of the basis increase to capital gain property is $25,000 and must be allocated among the remaining capital gain assets in proportion to the difference between the fair market value and basis of each. The fair market value of Asset 1 exceeds its basis by $50,000. The fair market value of Asset 2 exceeds its basis by $17,500. Therefore, the basis of Asset 1 will be increased by $18,519

($25,000, multiplied by $50,000, divided by $67,500), and the basis of Asset 2 will be increased by $6,481 ($25,000 multiplied by $17,500, divided by $67,500).

(d) Required statements. See §1.743-1(k)(2) for provisions requiring the transferee of a partnership interest to provide information to the partnership relating to the transfer of an interest in the partnership. See §1.743-1(k)(1) for a provision requiring the partnership to attach a statement to the partnership return showing the computation of a basis adjustment under section 743(b) and the partnership properties to which the adjustment is allocated under section 755. See §1.732-1(d)(3) for a provision requiring a transferee partner to attach a statement to its return showing the computation of a basis adjustment under section 732(d) and the partnership properties to which the adjustment is allocated under section 755. See §1.732-1(d)(5) for a provision requiring the partnership to provide information to a transferee partner reporting a basis adjustment under section 732(d).

(e) Effective/applicability dates.

(1) Generally. Except as provided in paragraphs (b)(5) and (e)(2) of this section, this section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999.

(2) Special rules. Paragraphs (a) and (b)(3)(iii) of this section apply to transfers of partnership interests and distributions of property from a partnership that occur on or after June 9, 2003. The provisions of paragraphs (a)(4)(i)(C) and (b)(4)(i) of this section relating to section 1022 are effective on and after the date January 19, 2017.

T.D. 6175 , 5/23/56 , amend T.D. 8847 , 12/14/99 , T.D. 9059 , 6/6/2003 , T.D. 9137 , 7/15/2004 , T.D. 9759 , 3/25/2016 , T.D. 9811 , 1/18/2017 .

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Guam Society of CPAs
August 19, 2024
Partnership Taxation

1. Foxman v. Commissioner of Internal Revenue, 41 T.C. 535 (1964)—Partnerships—Transfer of Interest—Sale of Partner's Interest
2. Crane v. Commissioner of Internal Revenue, 67 S.Ct. 1047 (1947)
3. Commissioner of Interna Revenue v. Tufts, 103 S.Ct. 1826 (1983)
4. I.R.C. Sec/ 704—Partner's distributive share
5. Treas. Reg. Sec. 1.704-1—Partner's distributive share
6. The Section 704(e) Income Allocation Rules
7. Allocations When a Partner's Interest Changes; The Varying Interest Rules
8. Real-World Reform of Partnership Allocations
9. I.R.C. Sec 734—Adjustment to basis of undistributed partnership property where section 754 election of substantial basis reduction
10. Adjusting the Basis of Partnership Property When a Section 754 Election Is In Effect
11. Treas. Reg. Sec. 1.755-1—Rules for allocation of basis
12. Sham Partnerships and Equivocal Transactions
13. Treas. Reg. Sec. 1.751-1—Unrealized receivables and inventory
14. Integrating Subchapters K and S—Just Do It
15. Tax Reform in a "World Without Chevron": Will Tax Regulations Withstand the Review of Justice Gorsuch?
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17. Partnership Liabilities
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19. Operation of a Partnership: Allocation of Partnership Income and Losses
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22. Contributions of Property: Section 704(c) and Section 704(c) Principles
23. Basis Adjustments Related to Distributions
24. Tax Classification of Economic Relationships
25. Liquidating Payments to a Retiring Partner/Member or a Decedent's Successor
26. Foreign Partnerships. Foreign Partners, and Partnerships with Tax-Exempt Entities

Sham Partnerships and Equivocal Transactions

KAREN C. BURKE* & GRAYSON M.P. McCOUCH**

Abstract

Corporate tax shelters proliferated during the 1990s, exploiting the flexible partnership tax rules of Subchapter K to defer or eliminate tax on hundreds of billions of dollars of corporate income. The corporate tax shelters were typically structured as a financing transaction in which a U.S. corporation leased its own assets back from a partnership, generating a stream of deductible business expenses while shifting taxable income to a tax-indifferent party such as a foreign bank. Since the transaction allowed the U.S. corporation to raise capital in a tax-advantaged manner in connection with its regular business operations, it was assumed that the transaction had economic substance. Nevertheless, in scrutinizing these shelters, courts have invoked a sham partnership doctrine, derived from the longstanding *Culbertson* intent test, which disregards a partnership that lacks a bona fide purpose (or, alternatively, a purported partner whose interest does not constitute a bona fide equity participation). This Article examines the structure of a tax shelter that purportedly allowed U.S. corporations (including Dow Chemical and General Electric) to deduct rental and royalty payments for the use of assets contributed to a partnership, while permanently exempting from taxation a circular flow of income to and from the partnership. The Article traces the evolution of the bona fide intent test that several courts have recently applied, independently of the economic substance doctrine, to recast similar transactions involving illusory partnership interests. The Article also argues that the partnership anti-abuse rule continues to play a significant role as a backstop to the judicial anti-abuse doctrines.

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I. Introduction

During the 1990s, promoters of corporate tax shelters aggressively marketed highly structured transactions to Fortune 500 companies, exploiting flexible partnership tax provisions to defer or eliminate tax on hundreds of billions of dollars of corporate income.[1] While the template for a particular transaction was typically sold only to a handful of large corporations, the potential net effect on corporate tax revenue was significant. Moreover, compared to the shelters traditionally used by individuals, the corporate tax shelters seemed less vulnerable to challenge because they purported to have at least a modicum of economic substance.[2] The corporate shelter was typically structured as a financing transaction in which a U.S. corporation leased its own assets back from a partnership, generating a stream of deductible business expenses while shifting taxable income to a tax-indifferent party such as a foreign bank. To achieve the desired tax results, the parties had to be recognized as members of a valid partnership. Since the transaction allowed the U.S. corporation to raise capital in a tax-advantaged manner in connection with its regular business operations, it was widely assumed that the shelter would withstand scrutiny under the economic substance doctrine.[3]

Although Congress enacted piecemeal statutory amendments to address specific technical aspects of the shelter transactions, the amendments generally applied only prospectively and therefore had no direct effect on preenactment transactions. Moreover, although it ultimately became clear that

[1] *See generally* Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES (TA) 1775 (June 21, 1999). The rise of corporate tax shelters may be attributable in part to corporate managers who perceived corporate tax departments as profit centers and sought to minimize tax liabilities as they did other business costs. *See* Edward D. Kleinbard, *Corporate Tax Shelters and Corporate Tax Management*, 51 TAX EXECUTIVE 235, 238 (1999).

[2] Dana L. Trier, *Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem*, 78 TAXES 62, 64 (Mar. 2000). On retail tax shelters in the 1990s, see Karen C. Burke & Grayson M.P. McCouch, *COBRA Strikes Back: Anatomy of a Tax Shelter*, 62 TAX LAW. 59 (2008) [hereinafter *COBRA Strikes Back*].

[3] See Joseph Bankman, *The Economic Substance Doctrine*, 74 S. CAL. L. REV. 5, 22-23 (2000).

abusive transactions involving the partnership tax provisions could not survive judicial scrutiny, the development and elaboration of judicial anti-abuse rules were delayed for several years as disputed transactions progressed through a lengthy process of audit, assessment, trial, and appeal. Meanwhile, in an attempt to stem the tide of abusive shelters involving partnerships, the Treasury in 1994 promulgated regulations setting forth a broad and controversial partnership anti-abuse rule.[4] More recently, Congress codified the economic substance doctrine and imposed strict liability penalties for transactions that violate that doctrine or any "similar rule of law."[5] The various anti-abuse doctrines invoked by courts—including economic substance, substance over form, and sham transaction—often overlap, resulting in some confusion concerning their scope and application, and the confusion extends to the interaction of these judicial doctrines with the partnership anti-abuse rule and the codified economic substance doctrine.

This Article considers the recent evolution of the "sham partnership" doctrine, which courts have applied to disregard a partnership that lacks a bona fide business purpose or, alternatively, to disregard a purported partner whose interest does not constitute a bona fide equity participation.[6] Part II examines the structure of a generic tax shelter that purportedly allowed a U.S. corporation to deduct rental and royalty payments for the use of assets that it contributed to a partnership, while permanently exempting from taxation a circular flow of income to and from the partnership. Part III traces the evolution of the bona fide intent test that several courts have applied recently to recast similar transactions involving illusory partnership interests. Part IV analyzes recent judicial decisions that reaffirm the sham partnership doctrine as a refinement of the longstanding *Culbertson* intent test and apply the doctrine independently of the economic substance doctrine.[7] Finally, Part V argues that the partnership anti-abuse rule continues to play a significant role as a backstop to the judicial anti-abuse doctrines.

II. The *Chemtech* Transaction

In the early 1990s, Goldman Sachs developed a tax shelter and marketed it to several Fortune 500 companies, including Merck and Dow, under the

[4] *See* Reg. § 1.701-2. For a retrospective view of the anti-abuse rule, see generally James B. Sowell, *The Partnership Anti-Abuse Rules: Where Have We Been and Where Are We Going?*, 89 TAXES 69 (Mar. 2011); *see also* Andrea Monroe, *What's in a Name: Can the Partnership Anti-Abuse Rule Really Stop Partnership Tax Abuse?*, 60 CASE W. RES. L. REV. 401 (2010).

[5] The "clarification" in section 7701(o) specifies a two-pronged test that applies "[i]n the case of any transaction to which the economic substance doctrine is relevant." I.R.C. § 7701(o); *see also* I.R.C. § 6662(b)(6); Notice 2014-58, 2014-44 I.R.B. 746 (providing guidance on the meaning of "transaction" under section 7701(o) and "similar rule of law" under section 6662(b)(6)); Notice 2010-62, 2010-40 I.R.B. 411.

[6] The sham partnership doctrine may be viewed as a variant of the substance-over-form and sham transaction doctrines. *See, e.g.*, Jasper L. Cummings, Jr., *The Sham Transaction Doctrine*, 145 TAX NOTES (TA) 1239 (Dec. 15, 2014) (commenting on Notice 2014-58).

[7] Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

generic label of Special Limited Investment Partnerships (SLIPs).[8] Reduced to its simplest terms, the SLIPs transaction purported to allow a U.S. corporation, with the cooperation of foreign banks, to "redepreciate" assets that had already been fully depreciated. To accomplish this dubious feat, the corporation contributed assets to a partnership and simultaneously leased the same assets back from the partnership. Of the rental payments received from the corporation, the partnership paid a portion to the foreign banks as a fixed priority return on their investment and loaned the rest of the payments to the corporation. Thus, the cash flow was largely circular: Except for a relatively small amount diverted to the foreign banks, the bulk of the rental payments returned to the corporation in the form of loans. For tax purposes, however, nearly all of the partnership's taxable income was allocated to the foreign banks, leaving only a tiny sliver of taxable income to be reported by the corporation.

The net effect of the SLIPs transaction, if it worked according to plan, was to allow the corporation to deduct the entire amount of its rental payments without including a corresponding share of the taxable income from those payments. By exploiting the partnership rules, the transaction generated a deliberate mismatching of taxable income and deductions, shifting the former to the foreign banks while preserving the latter for the corporation. The foreign banks had no objection to this arrangement, as long as they received a guaranteed fixed return on their investment, because their share of taxable income was exempt from U.S. income tax; they were "tax-indifferent" parties. For its part, the corporation stood to benefit from large artificial tax depreciation deductions with minimal offsetting taxable income and no interruption in its use and control of the leased assets.[9]

The *Chemtech* transaction illustrates the basic mechanics of a typical SLIPs transaction.[10] In 1993, Dow and several of its subsidiaries (collec-

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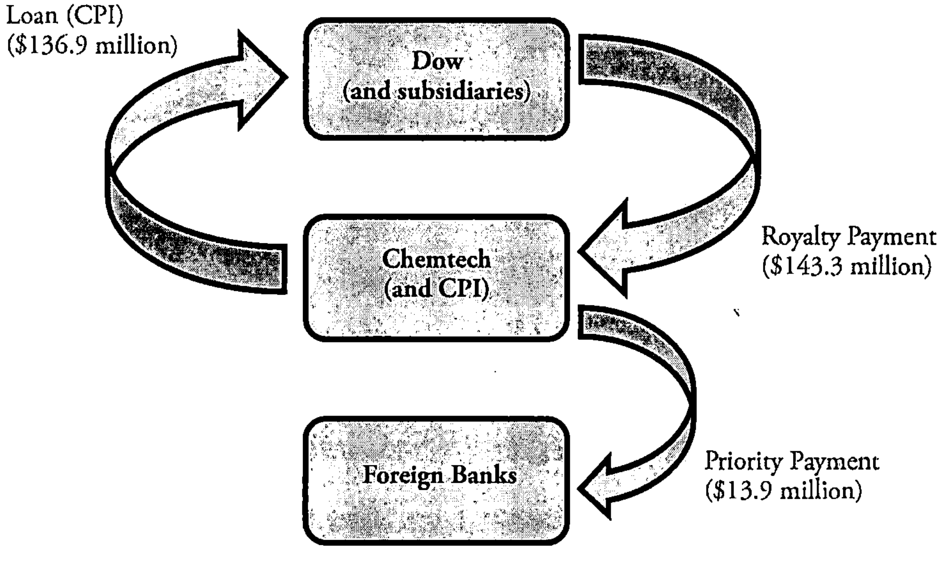
[8] *See* Jesse Drucker, *Bermuda Triangle: How Merck Saved $1.5 Billion Paying Itself for Drug Patents*, WALL ST. J., Sept. 28, 2006, at A1. Although the Merck transaction was never publicly disclosed, Merck agreed in 2007 to pay $2.3 billion to settle outstanding tax issues for the tax years 1993-2001, including Merck's use of "minority equity interest financing transactions." IR-News Rel. 2007-35, *available at* https://www.irs.gov/uac/Merck-Agrees-to-Pay-IRS-$2.3-Billion. Other companies that purchased SLIPs included International Paper.

[9] The artificial deductions arose from the disparity between book and tax depreciation as a result of the "ceiling rule" of section 704(c). *See infra* note 14 and accompanying text; Chemtech Royalty Assoc., L.P. v. United States, 2013-1 U.S.T.C. ¶ 50,204, at 83,499, 111 A.F.T.R.2d 953, 955 (M.D. La. 2013) (*Chemtech I*) (referring to SLIPs as a "lease strip" tax shelter); *see also* Bankman, *supra* note 1, at 1779 (describing "step-down preferred").

[10] Dow engaged in two related SLIPs transactions, *Chemtech I* (1993-1998) and *Chemtech II* (1998-2003). *See Chemtech I*, 2013-1 U.S.T.C. at 83,499-507, 111 A.F.T.R.2d at 955-64; Chemtech Royalty Assoc., L.P. v. United States, 766 F.3d 453, 455-59 (5th Cir. 2014) (*Chemtech II*). In developing the SLIPs transaction, Goldman Sachs worked closely with the law firm of Andrews & Kurth. The ultimate goal of SLIPs was to locate "equity that was tax deductible," which one Andrews & Kurth lawyer referred to as the "Holy Grail" of tax planning. *Chemtech I*, 2013-1 U.S.T.C. at 83,498 & n.1, 111 A.F.T.R.2d at 954 & n.l. Dow implemented *Chemtech I* with the assistance of tax lawyers at King & Spalding who also designed and implemented *Chemtech II*.

tively referred to as Dow) contributed low-basis patents with a fair market value of $867 million,[11] as well as $110 million cash and all the stock of a newly-formed shell corporation (CPI), to a newly-formed limited partnership (Chemtech). Shortly afterward, five foreign banks were also admitted as limited partners with a capital investment of $200 million. In 1994, the first full year of Chemtech's operations, Dow paid $143.3 million in royalties to the partnership under a licensing agreement for the use of the patents and claimed a deduction for the same amount. In the same year, the partnership paid the banks $13.9 million as a priority return of just under 7% on their $200 million investment. After paying a management fee to Dow, the partnership, through its subsidiary, Chemtech Portfolio Inc. (CPI), also loaned $136.9 million back to Dow in exchange for Dow's demand notes. The nearly circular cash flows can be illustrated graphically as follows:[12]



[11] Of the 73 patents, 71 had a zero basis and the remaining two had a total basis of $54,000. The low basis reflected deductions previously claimed by Dow for the costs of creating the patents. Dow selected patents with high value and low basis to minimize the number of patents contributed to the partnership. *Chemtech I*, 2013-1 U.S.T.C. at 83,499, 111 A.F.T.R.2d at 955.

[12] The illustration is adapted from a chart in the government's post-trial brief. *See* United States' Post-Trial Brief at A-3 chart 3, *Chemtech I*, 2013-1 U.S.T.C. ¶ 50,204, 111 A.F.T.R.2d 953 (No. 3:05-cv-00944), ECF No. 127.

The major cash flows for the years 1995 through 1997 followed a similar pattern.[13]

For tax purposes, Dow deducted the full amount of its annual royalty payments, which generated a corresponding item of taxable income for the partnership. Of the partnership's 1994 taxable income, however, 94% was allocated to the foreign banks and only 6% to Dow. This lopsided result flowed from the disparity between the high "book" basis of the contributed patents and their low tax basis.[14] For book purposes, the partnership amortized the patents based on their fair market value of $867 million (rather than their tax basis of $54,000), resulting in book income of around $14.7 million.[15] Because the $13.9 million payment to the banks represented 94% of the partnership's book income, the partnership also allocated 94% of its $122.4 million taxable income to the banks.[16] Thus, the banks ended up with an allocation of $115 million of taxable income, an amount far in excess of their share of book income, but because of the banks' foreign status they paid no tax on that amount. In contrast, while Dow deducted the full amount of its $143.3 million royalty payment, it reported taxable income of only $28.1 million, consisting of its 6% allocation of the partnership's taxable income

[13]Although *Chemtech I* operated from 1993 to 1998, the banks were partners for only part of 1993 and 1998. The partnership's cash flows for 1994-1997 are summarized as follows:

Year	Dow's royalty payment (millions)	Banks' 7% priority return (millions)	CPI loans to Dow (millions)
1994	$143.3	$13.9	$136.9
1995	142.8	13.9	150.2
1996	142.1	13.9	146.1
1997	97.9	13.9	110.2
Total	$526.1	$55.6	$543.4

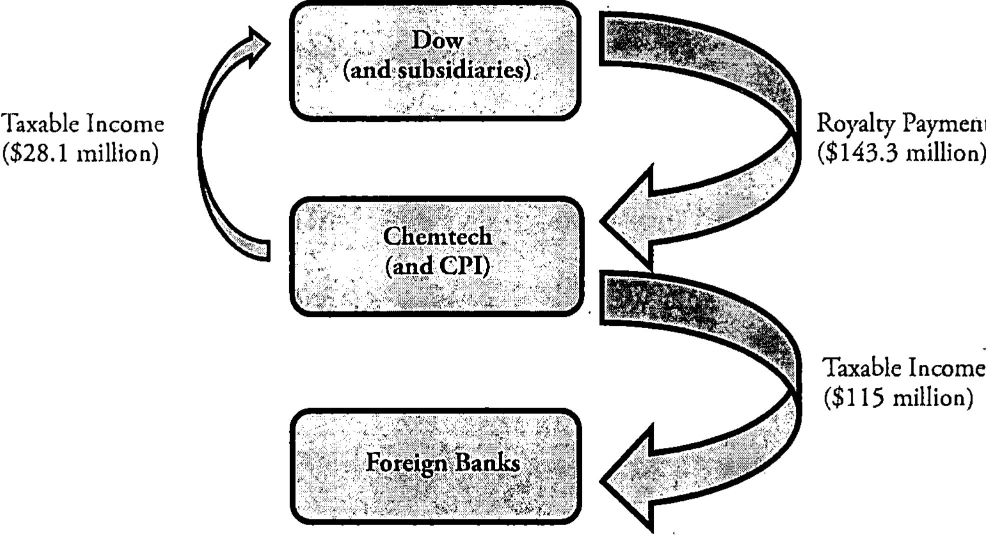
Chemtech I, 2013-1 U.S.T.C. at 83,501-02, 111 A.F.T.R.2d at 957-58. In each of the years 1995–1997, the amount loaned to Dow exceeded Dow's annual royalty payment. The difference was attributable in part to interest earned by CPI on Dow's demand notes.

[14]The anomaly arose from the "ceiling rule" under section 704(c). *See* Reg. § 1.704-3(b)(1) (limiting allocations relating to built-in gain or loss property to the partnership's tax items for the taxable year). The section 704(c) regulations were amended to eliminate this abuse of the ceiling rule for contributions of property after December 21, 1993. *See* Reg. § 1.704-3(a)(10); T.D. 8500, 1994-1 C.B. 183; *see also* Reg. § 1.704-3(a)(1) (Section 704(c) principles "apply only to contributions of property that are otherwise respected," referencing the section 701 anti-abuse rule).

[15]Technically, the noneconomic amortization reflected the book-tax difference between the tax basis (near zero) of the contributed patents and their book basis equal to fair market value at the time of contribution. The inflated book amortization deductions reduced the amount of book income allocated to the foreign banks, leaving them with taxable income far in excess of their book income.

[16]Brief of Appellants at 11, *Chemtech II*, 766 F.3d 453 (No. 13-30887), ECF No. 25.

and management expenses paid to a Dow subsidiary.[17] The flow of taxable income can be illustrated graphically as follows:[18]



The allocations of taxable income for the years 1995 through 1997 followed a similar pattern.[19]

[17] *Chemtech I*, 2013-1 U.S.T.C. at 83,501, 111 A.F.T.R.2d at 957 ("While Dow claimed royalty expense deductions for the money flowing to Chemtech, it did not take into account the income of the bulk of the money flowing *from* Chemtech.") (emphasis in original). During 1993-1998, the partnership loaned Dow a total of $781.6 million (including the banks' capital contributions of $200 million). The management expenses were deducted by the partnership and included in income by the Dow subsidiary.

[18] The illustration is adapted from a chart in the government's post-trial brief. See United States' Post-Trial Brief, *supra* note 12, at A-4 chart 4.

[19] The tax allocations for 1994-1997 are summarized as follows:

Year	Dow's royalty payment (millions)	Chemtech's taxable income (millions)	Banks' taxable income (millions)	Dow's taxable income (millions)
1994	$143.3	$122.4	$115.0	$28.1
1995	142.8	122.4	111.5	31.2
1996	142.1	121.3	103.4	38.6
1997	97.9	81.4	52.6	45.0
Total	$526.0	$447.5	$382.5	$142.9

Chemtech I, 2013-1 U.S.T.C. at 83,501-02, 111 A.F.T.R.2d at 957-59. Between 1993 and 1998, Dow claimed total royalty deductions of $646 million but the partnership reported book profits of only $61.7 million due to very large book amortization deductions ($476.1 million). *Chemtech II*, 766 F.3d at 457.

In 1998, the foreign banks withdrew from the partnership, and Dow purchased their interests for $210 million (equal to their original investment of $200 million plus a $10 million premium).[20] At that time, the banks had an aggregate basis in their partnership interests of $578 million (equal to their original investment of $200 million, increased by taxable income allocations of $439 million and reduced by distributions of $61 million).[21] Thus, the banks sustained a taxable loss of $368 million ($578 million less $210 million) on the sale of their partnership interests, reflecting the difference between their allocable share of taxable income and their share of book income. Had a section 754 election been in effect, the partnership's basis in its assets would have been stepped down by the amount of the banks' realized loss. The partnership had not yet made a section 754 election, however, and so the banks' built-in loss was preserved in the partnership's high inside basis.

After the withdrawal of the foreign banks, the partnership embarked on a new shelter transaction under the name *Chemtech II*.[22] The goal of *Chemtech II* was to distribute CPI stock to a Dow subsidiary in a tax-free redemption of the subsidiary's partnership interest, but only after shifting the partnership's basis in the CPI stock to a depreciable asset that could be used to generate a fresh cycle of deductible lease payments. A threshold concern was that, because the $700 million of Dow demand notes held by CPI presumably constituted marketable securities, a distribution of the CPI stock would give rise to a large taxable gain under section 731(c).[23] To circumvent this problem, Dow substituted its own deeply-subordinated note payable in 33 years for the Dow notes held by CPI.[24] In preparation for the redemption of its subsidiary, Dow also contributed a depreciable asset with a low basis—a fully-depreciated Louisiana chemical plant—to the partnership, and the partnership made a section 754 election.[25] The partnership then distributed the high-basis CPI stock in redemption of the low-basis Dow subsidiary's

[20]The banks withdrew in 1998 because their U.S. tax exemption was adversely affected by the promulgation of new regulations subjecting "hybrid entities" to a 30% withholding tax. *See Chemtech I*, 2013-1 U.S.T.C. at 83,502-03, 111 A.F.T.R.2d at 958.

[21]*See* Plaintiff's Post-Trial Brief at 45, *Chemtech I*, 2013-1 U.S.T.C. ¶ 50,204, 111 A.F.T.R.2d 953 (No. 3:05-cv-00944), ECF No. 128 (Appendix I).

[22]The partners of the reorganized partnership were two Dow subsidiaries and a U.S. affiliate of one of the foreign banks involved in the original transaction. *See Chemtech II*, 766 F.3d at 458.

[23]Under section 731(c), the distribution of an interest in an entity is treated as a distribution of cash if substantially all of the entity's assets consist (directly or indirectly) of marketable securities, money, or both. I.R.C. § 731(c)(2)(B)(v).

[24]Dow (which was both the borrower and lender on the notes) apparently believed that no business purpose was required for the note conversion. The redeemed Dow subsidiary received the patents originally contributed by Dow as well as $4.5 million cash and 70% of the CPI stock. *See Chemtech II*, 766 F.3d at 458 n.15.

[25]The transaction exploited the mismatch between the partnership's high basis in the CPI stock and Dow's outside basis. The high basis of the CPI stock reflected the partnership's annual contributions of excess cash to CPI, which then loaned the cash back to Dow.

interest, triggering a $381 million basis step-up for the partnership's assets under section 734(b).[26]

The *Chemtech II* transaction exploited the section 754 election to shift basis from a nondepreciable asset (the CPI stock) to a depreciable asset (the chemical plant).[27] In effect, the transaction was designed to boost the basis of the chemical plant in the partnership's hands, thereby generating accelerated depreciation deductions sufficient to offset nearly all the rental income paid by Dow to lease the plant back from the partnership.[28] As in the original transaction, the cash flow was largely circular: Dow paid rent to the partnership for the use of the chemical plant and deducted the full amount of its rental payments, and the partnership paid its excess cash (*i.e.*, the amount of Dow's rental payments less the bank's priority return and management expenses) to its subsidiary CPI II, which loaned the excess cash back to Dow. For tax purposes, 99% of the depreciation deductions were allocated to Dow, and the remaining 1% was allocated to the bank.[29]

In 1999, the first full year of *Chemtech II*'s operations, Dow deducted $69 million of rental payments, the partnership paid the bank its annual fixed return of $12.75 million, and CPI II loaned $57.4 million excess cash back

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[26]The basis step-up ($381 million) was equal to the difference between the basis of the distributed CPI stock ($463 million) and the Dow subsidiary's outside basis ($82 million). Although the basis of the distributed CPI stock was stepped down in the hands of the Dow subsidiary, the Dow notes held by CPI retained their high basis. Prior to enactment of section 732(f) in 1999, Dow could eliminate the built-in gain in the CPI stock through a tax-free liquidation of CPI that would preserve intact the high basis of the Dow notes. *See* I.R.C. §§ 332(a), 334(b)(1), 337(a). *But cf.* I.R.C. § 732(f) (reducing the basis of corporate assets upon certain distributions of stock to a corporate partner).

[27]The basis step-up allocated to the chemical plant ($363 million) was roughly equal to the banks' built-in loss ($368 million) when they withdrew from the partnership. As a technical matter, the inside basis adjustment could not have occurred if a section 754 election had been in effect when Dow purchased the banks' partnership interests.

[28]The tax allocations for 1998-2003 are summarized as follows:

	Depreciation (millions)	Taxable income (or loss) (millions)	Dow rental deductions (millions)
Chemtech II	$349.7	$62.9	
Dow	342.4	(5.2)	$415.3
Bank	7.3	68.1	

Government's Combined Answering and Opening Brief at 27, *Chemtech II*, 766 F.3d 453 (No. 13-30887), ECF No. 31.

[29]The allocation of taxable income to the bank did not differ significantly from its share of book (economic) income. Dow justified the special allocation of depreciation deductions on the ground that the bank shared none of the economic risk of loss attributable to the chemical plant.

to Dow.[30] Dow also reported a $59 million tax loss, since Dow's share of the partnership's depreciation exceeded its share of the partnership's rental income. The depreciation deduction declined in subsequent years as the partnership recovered its basis in the chemical plant, and Dow began to report increasing amounts of taxable income. During the years from 1998 to 2003, Dow reported an overall tax loss from *Chemtech II* of $5.2 million, and CPI II loaned Dow a total of $356.5 million, slightly less than Dow's total rental payments.[31] Indeed, the tax benefits of *Chemtech II* appeared so lucrative that Dow officials considered creating another shelter, *Chemtech III*, to generate more tax losses.[32]

Over a ten-year period, Dow claimed more than $1 billion of tax deductions for royalty and rental payments to the partnership. After payments to the banks totaling $139 million, the partnership's remaining cash of more than $900 million flowed back to Dow.[33] Nevertheless, Dow paid very little tax on its share of the partnership's income, and the high basis of the Dow notes held by CPI offered Dow the possibility of permanent tax exemption (rather than mere deferral) for the income flowing back to Dow from the partnerships.[34] In essence, the *Chemtech* transactions demonstrate a technically ingenious manipulation of the partnership tax provisions to generate tax benefits bearing little or no relation to the economic reality of the business arrangement between Dow and the banks. Like many other tax shelters, the

[30]The tax and cash flows for 1999-2003 are summarized as follows:

Year	Dow's rental payments (millions)	Bank's priority return (millions)	CPI II loans to Dow (millions)	Dow's taxable income (or loss) (millions)
1999	$69.0	$12.75	$57.4	(59.0)
2000	77.5	12.75	69.3	(1.9)
2001	77.5	12.75	69.6	21.6
2002	77.5	12.75	67.8	25.1
2003	77.5	10.60	69.3	44.1
Total	$379.0	$61.60	$333.4	$29.9

Chemtech I, 2013-1 U.S.T.C. at 83,505-07, 111 A.F.T.R.2d at 961-64. In June 2003, a Dow subsidiary exercised its option to purchase the bank's partnership interest, but *Chemtech II* continued to operate.

[31] *Chemtech II*, 766 F.3d at 458 n.16.

[32] *See Chemtech I*, 2013-1 U.S.T.C. at 83,504, 111 A.F.T.R.2d at 960.

[33]The banks received payments totaling $71 million in the original transaction ($61 million fixed return plus $10 million buyout premium) and $68 million in *Chemtech II*. See Government's Combined Answering and Opening Brief, *supra* note 28, at 57.

[34]In 1999, Congress responded to this ploy by enacting section 732(f), which requires a step-down in the controlled subsidiary's basis in its assets but leaves intact the partnership's increased basis in its assets. *See* I.R.C. §§ 732(f), 755(c); *see also* GEORGE K. YIN & KAREN C. BURKE, PARTNERSHIP TAXATION 236-37 (2d ed. 2013) (explaining the background of these provisions).

Chemtech transactions purported to generate enormous tax benefits based on an aggressively literal reading of the partnership tax rules. However, their shelf life was severely limited because they were almost certain to be shut down once they came to the attention of the Service.[35] Indeed, the key provisions at the core of the *Chemtech* transactions were amended shortly after Dow implemented those transactions.[36]

Apart from the deft technical manipulation of the partnership rules, Dow's tax planners faced a more serious and fundamental challenge. As they well understood, the desired tax benefits could be achieved only if the partnership between Dow and the banks was respected for tax purposes.[37] If the partnership was disregarded as a sham, the *Chemtech* transactions would be recharacterized as if no partnership existed. The contributions of the patents (*Chemtech I*) and the chemical plant (*Chemtech II*) would be ignored, and Dow would be treated as owning the assets directly. Dow's royalty and rental payments would be ignored, and the deductions for those payments would be disallowed, as would Dow's deductions for the costs it incurred in creating, operating, and winding up the partnership. Dow's basis in the chemical plant would not be stepped up, and the inflated depreciation deductions would be disallowed.

Even if the partnership was respected, the nature of the banks' investment in the partnership was open to question. Because the banks were virtually certain to recover their capital investment with a fixed return and without exposure to any significant upside or downside risk, the banks might be viewed essentially as lenders rather than as partners.[38] In that event, the banks' invest-

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[35] *See* Bankman, *supra* note 1, at 1777 (describing a tax shelter as "a product whose useful life is apt to end soon after it is discovered by the Treasury"). Dow signed a confidentiality agreement and paid over $12 million in fees to form *Chemtech I*, including a $5.3 million fee to Goldman Sachs and $1.5 million to King & Spalding. *See* United States' Proposed Findings of Facts and Conclusions of Law at 38, *Chemtech I*, 2013-1 U.S.T.C. ¶ 50,204, 111 A.F.T.R.2d 953 (No. 3:05-cv-00944), ECF No. 89.

[36] The section 704(c) regulations were amended to eliminate the ceiling-rule abuse underlying the *Chemtech I* transaction for contributions of property after December 21, 1993. *See* Reg. §1.704-3(a)(10); T.D. 8500, 1994-1 C.B. 183. Congress addressed the tax-free distribution of stock of a corporate partner's controlled subsidiary underlying the *Chemtech II* transaction by enacting section 732(f), effective for distributions after July 14, 1999. *See* I.R.C. §§ 732(f), 755(c).

[37] The Andrews & Kurth opinion discussed whether the partnership (or the underlying transaction) would be disregarded as a sham under various judicial doctrines and whether the banks' interest would be treated as debt rather than equity. *See Chemtech I*, 2013-1 U.S.T.C. at 83,499, 111 A.F.T.R.2d at 953.

[38] The transactions were structured to ensure that the banks received a fixed return, regardless of the success of the venture. For example, in *Chemtech I*, the foreign banks were entitled to 99% of partnership profits until they received their annual priority return, but were entitled to only 1% of any residual profits (including appreciation in the value of the patents). As a result of Dow's guarantees, the banks were entitled to 97% of their priority return, regardless of whether the partnership had any profits, and additional financial covenants protected the banks from any significant risk of loss. *See Chemtech II*, 766 F.3d at 463-64.

ment would be recharacterized as a loan, and the amounts paid by the partnership to the banks as interest. Moreover, if the banks were not recognized as partners, all of the partnership's taxable income would be allocated to Dow. For Dow, the tax consequences of such a recharacterization would be nearly the same as if the entire partnership was disregarded.[39]

III. *Castle Harbour*

The *Chemtech* transactions were by no means unusual. In 1993, when Dow implemented *Chemtech I* based on a template purchased from Goldman Sachs, General Electric launched its own SLIPs transaction under the name *Castle Harbour*, using a nearly identical structure provided by the investment firm Babcock & Brown.[40] The *Castle Harbour* tax shelter differed from *Chemtech I* in minor respects but involved the same basic sequence of steps: formation of a limited partnership with foreign banks; contribution of corporate assets with high value and low basis; fixed returns on the banks' investment with negligible upside potential or downside risk; disproportionate allocation of taxable income (far in excess of book income) to the banks; and a circular flow of cash. By the time the *Chemtech* transaction reached the courts, the issues concerning the validity of the partnership and the nature of the banks' investment had already generated two appellate decisions in the parallel *Castle Harbour* litigation.[41]

The financing transaction in *Castle Harbour* was undertaken by General Electric Capital Corp. (GECC), acting through its subsidiaries, with the participation of two Dutch banks. GECC's contribution to the partnership consisted of 63 fully-depreciated commercial aircraft valued at $530 million, subject to preexisting leases, together with net cash of $246 million. The Dutch banks contributed $117.5 million cash, which was to be paid back to the banks with a specified 9% annual rate of return in regular installments over an eight-year term. The payments to the banks were nominally tied to

[39]If the foreign banks were disregarded as partners, the Dow partners' outside basis would be increased by the income deflected to the banks, and the chemical plant would not receive a stepped-up basis under section 734(b).

[40]The initial costs of the *Castle Harbour* transaction included a $9 million fee paid to Babcock & Brown. *See* TIFD III-E, Inc. v. United States, 342 F. Supp. 2d 94, 97 (D. Conn. 2004) (*Castle Harbour I*). The tax matters partner of the partnership, TIFD III-E, was a wholly owned subsidiary of General Electric Capital Corp. As used here, the term GECC refers interchangeably to General Electric Capital Corp. and its various subsidiaries involved in the transaction.

[41]*See* TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006) (*Castle Harbour II*), *rev'g Castle Harbour I*, 342 F. Supp. 2d 94; TIFD III-E, Inc. v. United States, 666 F.3d 836 (2d Cir. 2012) (*Castle Harbour IV*), *rev'g* TIFD III-E, Inc. v. United States, 660 F. Supp. 2d 367 (D. Conn. 2009) (*Castle Harbour III*). For discussion and analysis of the issues in *Castle Harbour*, see Karen C. Burke & Grayson M.P. McCouch, *Snookered Again:* Castle Harbour *Revisited*, 128 TAX NOTES (TA) 1143 (Sept. 13, 2010) [hereinafter *Snookered Again*]; Monte A. Jackel & Robert J. Crnkovich, Castle Harbour *Strikes Again*, 125 TAX NOTES (TA) 591 (Nov. 2, 2009); *see also* Karen C. Burke & Grayson M.P. McCouch, *Illusory Partnership Interests and the Anti-Anti-Abuse Rule*, 132 TAX NOTES (TA) 813 (Aug. 22, 2011) [hereinafter *Illusory Partnership Interests*].

the partnership's income and potentially subject to small adjustments, but the partnership agreement provided a separate schedule of shadow accounts and guaranteed payments to ensure that the banks would receive a fixed rate of return on their investment.[42] To protect the banks from any risk of loss, the guaranteed payments were triply secured by a GECC guarantee, a reserve of "core financial assets" (*i.e.*, high-grade commercial paper or cash), and policies of casualty insurance. At the same time, the partnership agreement provided GECC with broad discretionary powers to reclassify the partnership's income-producing assets and to buy out the banks' interest, which severely limited the banks' nominal ability to share in any extraordinary profits.[43]

In sum, the banks made a self-liquidating, fully-secured investment which was to be repaid on a prescribed schedule with a fixed rate of return, while GECC carried on its leasing operations without any discernible shift of entrepreneurial risk or loss of control. The banks contributed 18% of the partnership's total capital and GECC contributed the remaining 82%. For tax purposes, however, the partnership's taxable income, consisting of rental payments for the leased aircraft and investment income, was allocated 98% to the Dutch banks and 2% to GECC.[44] The net result of this allocation was to shift $310 million of taxable income from GECC to the Dutch banks, which were effectively exempt from U.S. income taxation, during the five years of *Castle Harbour's* operation. In effect, GECC sought to redepreciate its fleet of commercial aircraft and thereby to postpone, or perhaps avoid entirely, tax liability of $62 million.[45]

The district court, evidently impressed by the technical sophistication of the *Castle Harbour* shelter, held that the transaction had economic substance,[46]

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[42]*See Snookered Again*, *supra* note 41, at 1146-47 (describing "investment accounts" and guaranteed payment).

[43]The banks' nominal upside potential was limited to $2.85 million plus 1% of any extraordinary partnership profits (which were unlikely to materialize). GECC exercised its option to buy out the banks' interest, at a negligible premium, in 1998, three years before the end of the eight-year term. *See Castle Harbour II*, 459 F.3d at 229 n.8.

[44]This allocation, like the one in *Chemtech*, relied on the ceiling rule under section 704(c) (prior to its amendment in 1993) to exploit the disparity between book and tax depreciation. The Dutch banks' share of book income was largely offset by book depreciation, but their corresponding allocation of tax income could not be reduced by "non-existent" tax depreciation. *Castle Harbour I*, 342 F. Supp. 2d at 121 n.45.

[45]The district court acknowledged the tax deferral benefit but assumed that GECC would eventually pay tax on the "ultimate disposition of the assets." *Castle Harbour I*, 342 F. Supp. 2d at 107 n.29. Nevertheless, if the tax lawyers who designed the *Castle Harbour* shelter followed the same template they used a few years later in *Chemtech II*, the exit strategy would involve permanent tax forgiveness rather than mere deferral.

[46]*Castle Harbour I*, 342 F. Supp. 2d at 108-11. The district court found that the banks' $117.5 million investment in the leasing business carried on by the partnership had economic effect and that GECC was motivated to enter into the transaction, "at least in part, by a desire to raise capital and a desire to demonstrate its ability to do so." *Id.* at 111.

that the Dutch banks were properly treated as partners,[47] and that the tax allocations had substantial economic effect.[48] On appeal, however, the Second Circuit reversed, explaining that the district court erred as a matter of law in misapplying the *Culbertson* "totality-of-the-circumstances" test to assess the nature of the Dutch banks' interest.[49] Although the district court acknowledged the *Culbertson* test in passing, it failed to apply the test properly to determine whether the banks' interest qualified as a "bona fide equity participation."[50] Moreover, the lower court erred "by accepting at face value the appearances and labels created by the partnership, rather than assessing the underlying economic realities."[51] Looking past the form of the transaction to its substance, the Second Circuit concluded that "the Dutch banks' interest was overwhelmingly in the nature of a secured lender's interest" and that the banks had "no meaningful stake in the success or failure of Castle Harbour."[52] While the interest of the Dutch banks "was not totally devoid of *indicia* of an equity participation in a partnership, those indicia were either illusory or insignificant in the overall context of the banks' investment."[53]

Castle Harbour marks a turning point in the development of the sham partnership doctrine. The Second Circuit's decision is significant primarily because it reaffirms the vitality of the *Culbertson* facts-and-circumstances test in determining whether a purported partnership will be respected for income tax purposes. It is not sufficient that two or more parties join together to conduct business or financial operations; they must do so in good faith and act

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[47] *Id.* at 111-17. The district court held that "there was economic substance in not only the actions, but also the formation, of the partnership." *Id.* at 113. Finding it "actually hard to imagine an alternative," the court concluded that creating a partnership was "one—even if not the only—legitimate way" to allow GECC to raise capital against its fleet of aircraft without incurring additional debt (which would have violated GECC's existing financial covenants). *Id.* at 114. The court believed that its conclusion that the transaction had economic substance was "sufficient to establish that the banks had an economically real *equity* interest in the partnership." *Id.* at 116 n.40 (emphasis in original).

[48] *Id.* at 117-21.

[49] *Castle Harbour II*, 459 F.3d at 230. In *Culbertson*, the Supreme Court held that a partnership is recognized for federal income tax purposes when, considering all the relevant facts, "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

[50] *Castle Harbour II*, 459 F.3d at 232.

[51] *Id.* at 231. This disposition made it "unnecessary . . . to consider whether the district court correctly determined that the characterization of the banks' interest as equity was not a sham." *Id.* at 231 n.11. By framing the *Culbertson* test in terms of substance over form, the Second Circuit also sidestepped the district court's holding that the underlying transaction had economic substance and was not a sham. *See Snookered Again*, *supra* note 41, at 1145 n.14 (discussing Second Circuit's "clear error" standard of review in economic substance cases).

[52] *Castle Harbour II*, 459 F.3d at 231.

[53] *Id.* (emphasis in original).

with a business purpose.[54] Moreover, the *Culbertson* test, as elaborated by the Second Circuit, encourages courts to examine not only the business activities and purposes of the partnership under the economic substance doctrine but also the nature of the partners' participation to see if the form claimed by the parties matches the substance of their interests. The substance-over-form inquiry is analytically distinct from, though sometimes connected to, the question of whether a partnership's activities have economic substance. For example, one or both doctrines may be invoked to disregard a purported partnership that is formed solely for tax avoidance purposes, but a finding that the partnership's transactions have economic substance does not foreclose an inquiry into the nature of the partners' respective interests under *Culbertson*.[55] Finally, in determining whether a partner's interest qualifies as a "bona fide equity participation" under *Culbertson*, the Second Circuit found it "helpful" to consider "whether an interest has the prevailing character of debt or equity."[56] If a partnership interest is so overwhelmingly debt-like that it is "more akin" to a secured loan than to a "meaningful stake in the profits of the venture," the owner may fail to qualify as a bona fide partner under *Culbertson*, regardless of whether the interest is explicitly reclassified as debt.[57] In sum, the Second Circuit interpreted *Culbertson* to authorize a more searching inquiry into the nature of a partner's interest in determining whether the use of the partnership form, with its attendant tax advantages, will be respected.

The Second Circuit's analysis was foreshadowed in a line of cases, beginning with *ASA Investerings*, in which the D.C. Circuit disregarded partnerships

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[54] *Culbertson* provides an essential judicial gloss on the statutory definitions of the terms "partnership" and "partner." *See* I.R.C. § 761 (defining a partnership to include "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on," and defining a partner as "a member of a partnership"); *Castle Harbour II*, 459 F.3d at 231 n.12 (noting that the "broad definition of partnership found in section 761 . . . does not supercede or otherwise alter the analysis necessary under *Culbertson*").

[55] *See Castle Harbour II*, 459 F.3d at 232 ("The [Service]'s challenge to the taxpayer's characterization is not foreclosed merely because the taxpayer can point to the existence of some business purpose or objective reality in addition to its tax-avoidance objective."); *see also* AD Global FX Fund, LLC v. United States, 2014-1 U.S.T.C. ¶ 50,244, at 83,780, 113 A.F.T.R.2d 1582, 1586 (S.D.N.Y. 2014) (noting that partnership must "pass muster under sham entity and related doctrines" in addition to the *Culbertson* test). Of course, if the underlying transaction lacks economic substance, the purported partnership will almost certainly be disregarded. *See Castle Harbour II*, 459 F.3d at 232 n.13 ("While a classification that fails the sham test may be certain also to fail the *Culbertson* analysis, a classification that passes the sham test would not necessarily survive *Culbertson*."). It is also possible that some, but not all, of the participants in a venture may be respected as bona fide partners, with the result that the partnership itself is respected but the interests of some of its members are recharacterized for tax purposes. Unless at least two of the members qualify as bona fide partners, however, the partnership itself will not be respected.

[56] *Castle Harbour II*, 459 F.3d at 232.

[57] *Id.* at 236 (emphasis omitted).

that were formed solely for the purpose of avoiding taxes.[58] The court summarized the "basic inquiry" under *Culbertson* as "whether, all facts considered, the parties intended to join together as partners to conduct business activity for a purpose other than tax avoidance."[59] Under this standard, a Dutch bank failed to qualify as a partner because the bank received an essentially risk-free return on its investment at a specified rate, with no upside potential and only de minimis downside risk.[60] The court saw no need to determine whether the bank's capital contribution constituted a loan, noting that the classification of the investment as debt or equity was "quite peripheral to the central issue of whether the parties entered into a bona fide partnership."[61] Since none of the purported partners intended to form a "real partnership,"[62] the partnership itself was disregarded as a sham; regardless of whether the underlying transaction had economic substance, "the absence of a nontax business purpose is fatal."[63] The court recognized the "hazardous" implications of the business purpose doctrine, given the difficulty of determining when a structured transaction "is deemed to have gotten out of hand, to have been carried to such extreme lengths that the business purpose is no more than a façade"; at the same time, the court also considered the doctrine "essential" because it "reduces the incentive to engage in such essentially wasteful activity" and

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[58] *See* ASA Investerings Partnership v. Commissioner, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000); Boca Investerings Partnership v. United States, 314 F.3d 625 (D.C. Cir. 2003), *cert. denied*, 540 U.S. 826 (2003); Andantech L.L.C. v. Commissioner, 331 F.3d 972 (D.C. Cir. 2003).

[59] *ASA Investerings*, 201 F.3d at 513. The tax shelter in *ASA Investerings* generated artificial tax losses by combining a section 453 contingent-payment sale with partnership basis adjustments; a similar shelter was held to lack economic substance in *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

[60] The *de minimis* risk of loss was properly disregarded because it had no appreciable effect on the bank's interest. *ASA Investerings*, 201 F.3d at 514; *see* Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, J., dissenting) (quoted in Knetsch v. United States, 364 U.S. 361, 366 (1960)) (noting that a transaction may be recharacterized if taxpayer's chosen form "does not appreciably affect his beneficial interest except to reduce his tax"); *see also ASA Investerings*, 201 F.3d at 515 ("A partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership.").

[61] *ASA Investerings*, 201 F.3d at 515.

[62] *Id.* at 516.

[63] *Id.* at 512. Relying on *Moline Properties v. Commissioner*, 319 U.S. 436 (1943)—a pre-*Culbertson* decision rejecting a shareholder's attempt to disregard his wholly-owned corporation—the taxpayer in *ASA Investerings* argued that a partnership must be respected if it merely conducts business activity, even in the absence of a business purpose. The D.C. Circuit rejected the argument and interpreted *Moline Properties* as establishing a "unitary test" requiring a nontax business purpose in conjunction with business activity. *See ASA Investerings*, 201 F.3d at 512 ("This reading treats 'sham entity' cases the same way the law treats 'sham transaction' cases, in which the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive."). The court also observed that a sham partnership might be analyzed as a sham transaction, if the formation of the partnership constituted the relevant transaction. *See id.* at 512 n.4.

"helps achieve reasonable equity among taxpayers who are similarly situated—in every respect except for differing investments in tax avoidance."[64]

In *Castle Harbour*, the Second Circuit provided an explicit and extensive explanation of the link between risk participation and partnership status, which implicitly underpins the D.C. Circuit's analysis in *ASA Investerings*. To be recognized as a bona fide partner under *Culbertson*, a purported partner must have a meaningful stake in the success or failure of the partnership venture. An investor who bears no meaningful risk but is essentially guaranteed a fixed return without regard to the partnership's profits and losses may be viewed either as lacking a "true intent . . . to join together in the present conduct of the enterprise"[65] or, alternatively, as making an investment that does not rise to the level of a "bona fide equity participation."[66] In either case, the lack of any meaningful share in partnership profits or risk of loss is fatal to bona fide partner status for tax purposes. In *Castle Harbour*, the purported partnership interest of the tax-indifferent Dutch banks was carefully structured to create the appearance of a potential upside participation in partnership profits as well as a theoretical risk of loss, while ensuring that the banks would actually recover their original investment with a 9% rate of return and without any meaningful share of additional profit or any real risk of loss.[67] The Second Circuit, following the analysis in *ASA Investerings*, disregarded the remote possibility of *de minimis* profits as mere "window dressing designed to give ostensible support to the characterization of equity participation."[68]

In keeping with its substance-over-form analysis, the Second Circuit rejected the taxpayer's argument that the Dutch banks should be respected as partners because their investment was labeled as a capital interest and had many features commonly found in corporate preferred stock.[69] In assessing the real nature of the banks' interest, the Second Circuit inquired whether "the funds were advanced with reasonable expectations of repayment regard-

[64] *ASA Investerings*, 201 F.3d at 513.

[65] Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

[66] *Castle Harbour II*, 459 F.3d at 231; *see also ASA Investerings*, 201 F.3d at 515 ("A partner whose risks are all insured at the expense of another partner hardly fits within the traditional notion of partnership.").

[67] The Dutch banks had a nominal stake in partnership profits and losses, as reflected in their capital accounts, but their risk of gain or loss was virtually eliminated by "investment accounts," guaranteed payments, and other provisions of the partnership agreement, as discussed in *Snookered Again*, *supra* note 41, at 1145-50. In contrast, the transaction in *ASA Investerings* was structured more crudely to eliminate risk through unreported side transactions.

[68] *Castle Harbour II*, 459 F.3d at 236; *cf. ASA Investerings*, 201 F.3d at 514 (disregarding "de minimis risks").

[69] In reversing the district court's holding concerning penalties, the Second Circuit observed that the cases cited by the taxpayer provided "no support" for treating the Dutch banks' interest as equity participation. *Castle Harbour IV*, 666 F.3d at 849; *see* TIFD III-E, Inc. v. United States, 604 F. App'x 69, 70 (2d Cir. 2015) (*Castle Harbour VI*) (reiterating rejection of analogy to preferred stock as "inapt").

less of the success of the venture or were placed at the risk of the business"[70] and concluded that the interest, with its overwhelmingly debt-like features, was "in the nature of a secured loan, with an insignificant equity kicker" rather than a bona fide equity participation.[71] Given the inevitable murkiness of the distinction between debt and equity, coupled with the significance of the distinction for tax purposes and the ability of financial engineers to design hybrid interests, any bright-line test for classifying interests categorically as debt or as equity for tax purposes is likely to invite abuse. Accordingly, the Second Circuit resisted the taxpayer's attempt to exploit an ostensible binary debt-equity distinction and evaluated the nature of the Dutch banks' interest without attempting to articulate a bright-line definition of a bona fide equity participation.[72]

Other courts have followed the Second Circuit's approach in cases involving historic rehabilitation tax credits. In *Historic Boardwalk*, for example, the Third Circuit relied on *Castle Harbour* in determining whether a taxpayer who advanced funds to a tax-exempt state development authority in connection with a restoration project was entitled to a section 47 rehabilitation credit.[73] Noting that the determination of bona fide equity participation "turns on an assessment of risk participation," the court found that the taxpayer, "like the purported bank partners in *Castle Harbour*, did not have any meaningful downside risk or any meaningful upside potential" [74] and refused to allow "a partnership, with all its tax credit gold, [to] be conjured from a zero-risk

[70] *Castle Harbour II*, 459 F.3d at 233 (quoting *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957)).

[71] *Id.* at 241.

[72] *Id.* ("On different facts a difficult question would arise whether an investor's right to a share of profits was sufficient to make its interest a bona fide equity participation for tax purposes notwithstanding the secured guaranty of the return of its principal plus interest. This is not such a case."). The bona fide equity participation test suggests that courts may be inclined to scrutinize equivocal interests with special care in policing access to the tax advantages of partnership classification. *See Snookered Again, supra* note 41, at 1148. For discussions of the debt-equity distinction in the partnership context, see *id.* at 1148 n.40; *see also* Steven R. Schneider, *Is Debt v. Equity Different in a Partnership?*, 93 TAXES 95 (Mar. 2015).

[73] Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012), *cert. denied*, 133 S. Ct. 2734 (2013). The court found the Second Circuit's analysis in *Castle Harbour* "highly relevant" and noted that "resolving whether a purported partner had a 'meaningful stake in the success of failure of the partnership,' ... goes to the core of the ultimate determination of whether the parties 'intended to join together in the present conduct of the enterprise.'" *Id.* at 454; *see also* Rev. Proc. 2014-12, 2014-3 I.R.B. 415 (providing a safe harbor for a "bona fide equity investment" in a section 47 rehabilitation credit partnership).

[74] *Historic Boardwalk*, 694 F.3d at 454-55, 463 ("because [the taxpayer] lacked a meaningful stake in either the success or failure of [the partnership], it was not a bona fide partner").

investment."[75] The Third Circuit relied exclusively on substance-over-form principles in determining that the taxpayer was not a bona fide partner, just as the Second Circuit did in *Castle Harbour*, and assumed, without deciding, that the underlying transaction had economic substance.[76]

In *Castle Harbour*, after the Second Circuit concluded that the Dutch banks lacked a bona fide equity participation, the taxpayer argued on remand that the banks should be recognized as partners under section 704(e)(1). On its face, section 704(e)(1) declares that the owner of a capital interest in a partnership in which capital is a material income-producing factor must be recognized as a partner for federal income tax purposes, regardless of whether the interest was acquired by purchase or gift.[77] The district court agreed and interpreted section 704(e)(1)—a provision expressly aimed at family partnerships—as either repudiating *Culbertson* altogether or at least providing a separate, objective test of partner status for capital-intensive partnerships without regard to intent.[78] However, nothing in the language or the legislative history of section 704(e)(1) suggests an intent to modify or supplant the *Culbertson* test. Instead, section 704(e)(1) addresses the "altogether different question" of whether the donee of a partnership interest will be recognized

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[75] *Id.* at 462. The court recognized that the issue of "entrepreneurial risk" is relevant both to partner status under *Culbertson* and to disguised sale treatment under section 707. *See id.* at 454 n.54 ("Although we are not suggesting that a disguised-sale determination and a bona fide partner inquiry are interchangeable, the analysis pertinent to each look[s] to whether the putative partner is subject to meaningful risks of partnership operations before the partner receives the benefits which may flow from that enterprise."); Reg. § 1.707-3(b)(1)(i) (transfer to partnership coupled with subsequent transfer "not dependent on the entrepreneurial risks of partnership operations" may be treated as disguised sale); *cf.* Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, 639 F.3d 129 (4th Cir. 2011) (treating transaction as a disguised sale of tax credits under section 707).

[76] *See Historic Boardwalk*, 694 F.3d 448 n.50 ("[E]ven if a transaction has economic substance, the tax treatment of those engaged in the transaction is still subject to a substance-over-form inquiry to determine whether a party was a bona fide partner in the business engaged in the transaction . . . .").

[77] *See* I.R.C. § 704(e)(1) (2014). References in this article to section 704(e)(1) are to the provision as it existed before it was revised and renumbered by the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1102(b), 129 Stat. 584, 639 (applicable to partnership taxable years beginning after December 31, 2015). See Karen C. Burke & Grayson M.P. McCouch, *Codifying* Castle Harbour, 150 TAX NOTES (TA) 109 (Jan. 4, 2016) (discussing 2015 amendment); Staff of Joint Comm. on Tax'n, General Explanation of Tax Legislation Enacted in 2015, at 83-84 (2016).

[78] *Castle Harbour III*, 660 F. Supp. 2d at 395. *See* 1 MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 3.02[3], at 3-23 (4th ed. 2007 & Supp. 2015) ("Congress rejected the intent test established by *Tower* and *Culbertson*, as well as any limits (e.g., the original capital requirement) on the type of capital that qualifies for partnership treatment."); *id.* ¶ 1.05[4][a], at 1-41 ("[I]f a putative partnership conducts a real enterprise in which putative partners share capital ownership, tax avoidance motives for the formation of the partnership or for a person becoming a partner are irrelevant.").

as the true owner.[79] It is hardly surprising, therefore, that the Second Circuit again reversed the district court and held that "for the same reasons that the evidence compels the conclusion that the banks' interest was not a bona fide equity participation, it also compels the conclusion that their interest was not a capital interest within the meaning of section 704(e)(1)."[80] *Castle Harbour* was the first case to address the argument that section 704(e)(1) provides an alternative route to partner status independent of the *Culbertson* intent test, and the Second Circuit's explicit rejection of that argument leaves little or no room for doubt concerning *Culbertson*'s continuing vitality.[81]

Nevertheless, in discussing *Castle Harbour*, a leading treatise on partnership taxation insists that the Second Circuit "did not resolve the [section] 704(e)(1) issue" and suggests that the court's holding concerning the requirement of bona fide equity participation may be mere "dictum."[82] This line of argument seeks to negate the precedential significance of the Second Circuit's decisions analyzing *Culbertson* and section 704(e)(1) by recasting *Castle Harbour* as holding simply that "the banks' interests were in fact debt, not merely an

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[79] *See Castle Harbour IV*, 666 F.3d at 844 ("[Section 704(e)(1)'s] focus is not on the nature of the investment in the partnership, but rather on who should be recognized for tax purposes as the owner of the interest"); *Snookered Again*, *supra* note 41, at 1154 ("Despite the taxpayer's ingenious attempt to rehabilitate the banks as partners under section 704(e)(1), the family partnership rules do not provide a statutory shortcut to partnership status without regard to the general definition of a partnership."); *Illusory Partnership Interests*, *supra* note 41, at 815 ("More fundamentally, the section 704(e)(1) argument rests on a radically revisionist view of the intended scope of section 704(e)(1) . . . . Significantly, the purported contradiction between *Culbertson* and section 704(e)(1) was not discovered until fairly recently.").

[80] *Castle Harbour IV*, 666 F.3d at 847.

[81] *See id.* at 848 n.8 ("[E]ven if the taxpayer is correct that the tests of partner status under *Culbertson* and [section] 704(e)(1) conceivably yield different results in some circumstances, that possibility has no bearing on this case.").

[82] McKEE ET AL., *supra* note 78, ¶ 3.02[2A], at S3-5 ("In *Castle Harbour IV*, the Second Circuit did not resolve the [section] 704(e)(1) issue and, perhaps unwittingly, relegated its disquisition in *Castle Harbour II* on the necessity of participation under *Culbertson* to the status of dictum.").

interest 'in the nature of' debt."[83] Of course, if the court had actually classified the banks' interests as debt rather than equity, it would have been pointless to discuss either the requirement of bona fide equity participation under *Culbertson* or the nature of a capital interest under section 704(e)(1).[84] In fact, the Second Circuit took considerable care to avoid such a simplistic classification and rested its holding on the ground that the banks' interest, which was "in the nature of a secured loan, with an insignificant equity kicker," did not amount to a bona fide equity participation.[85] Perhaps the taxpayers' argument is best understood as part of a "concerted litigation strategy for rolling back *Culbertson* and challenging related anti-abuse rules."[86] In *Chemtech*, for example, the taxpayer advanced an identical argument that *Castle Harbour* stands for the "unremarkable proposition that debt is not a partnership interest."[87]

In *Castle Harbour*, the district court held that the 20% negligence penalty sought by the government did not apply at the partnership level because the partnership had a "reasonable basis" for treating the Dutch banks' interest as equity rather than debt based on an analogy to preferred corporate stock.[88] On appeal, however, the Second Circuit issued a summary reversal, rejecting the preferred stock analogy as "inapt" and noting that none of the authorities cited by the taxpayer involved an overwhelmingly debt-like interest with

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[83] *Id.* Moreover, the treatise accuses the Second Circuit itself of propounding this "revisionist interpretation" of *Castle Harbour II*, *id.*, apparently on the basis of a footnote in which the court summarized *Castle Harbour II* as having "ruled that the objective facts of the structure . . . indicated that the banks' interest was 'overwhelmingly in the nature of a secured lender's interest,' and therefore required that the banks' interest be treated as debt for tax purpose[s], regardless of the parties' desire to have it treated as equity." *Castle Harbour IV*, 666 F.3d at 848 n.8. For GECC, the tax consequences of holding that the Dutch banks were not bona fide partners may have been functionally equivalent to treating the banks as lenders, in accordance with the substance of the transaction. Nevertheless, it seems disingenuous to suggest that the court's "simple statement" "obviated the need for any further discussion of [section] 704(e)(1)" since "if the banks' interests are properly treated as debt, they clearly cannot be partnership interests under [section] 704(e)(1)." McKEE ET AL., *supra* note 78, ¶ 3.02[3], at S3-9. Similarly, the treatise's argument that a purported partnership interest must be upheld if it is classified as equity, even if it does not constitute bona fide equity participation, seems either contrary or nonresponsive to the Second Circuit's ruling in *Castle Harbour*. *See id.* ¶ 3.02[2A], at S3-7 ("[I]f, despite the absence of participation, an investment is equity, and not debt, for tax purposes, then the interest should be recognized as a valid partnership interest. Otherwise, the investment falls into a category to which no established tax regime applies.").

[84] *See* McKEE ET AL., *supra* note 78, ¶ 3.02[2A], at S3-6 (arguing that "the Second Circuit's reliance on *Culbertson* seems entirely misplaced in view of its ultimate determination that the banks' interest were debt" for tax purposes).

[85] TIFD III-E, Inc. v. United States, 459 F.3d 220, 241 (2d Cir. 2006) (*Castle Harbour II*).

[86] *Illusory Partnership Interests*, *supra* note 41, at 813; *see* Schneider, *supra* note 72, at 125 (noting that the authors of the treatise remain "quite adamant that *Culbertson* does not apply to capital partners in capital intensive partnerships").

[87] Petition for Rehearing En Banc at 10-11, Chemtech Royalty Assoc., L.P. v. United States, 766 F.3d 453 (5th Cir. 2014) (No. 13-30887), ECF No. 55 (*Chemtech II*).

[88] TIFD III-E, Inc. v. United States, 8 F. Supp. 3d 142, 148 (D. Conn. 2014), *rev'd*, 604 F. App'x 69 (2d Cir. 2015) (*Castle Harbour V*).

only "illusory or insignificant" indicia of equity.[89] "An attempt to create the appearance of a legitimate tax position is not an attempt to comply with the [Code]."[90]

In *Castle Harbour*, the Second Circuit reached its decision by evaluating the nature of the Dutch banks' interest under substance-over-form principles, without deciding whether the underlying SLIPs transaction had economic substance. The codified economic substance doctrine enacted in 2010, however, might require a different analysis.[91] Under section 7701(o), Castle Harbour's ostensible business purpose of raising capital by "monetizing" its fleet of aircraft would no longer be sufficient by itself to establish a valid business purpose.[92] Castle Harbour would also be required to demonstrate that its reasonably expected pre-tax profit from the transaction was substantial in relation to the expected net tax benefits.[93]

In economic substance cases, the lack of any meaningful change in the control and use of assets bears directly on the likelihood that a transaction will be "efficiency enhancing absent its tax consequences" and thus whether the transaction was undertaken for any purpose other than tax avoidance.[94] In *Castle Harbour*, the Dutch banks provided 18% of the partnership's capital but lacked any effective rights of management or control, which constitute "the defining feature of ownership when viewed in terms of economic substance."[95] As GECC's management well understood, the tax-efficient arrangement with the foreign banks required GECC to forego the ability to actively manage the airplanes or modify the existing leases until the banks'

[89] *Castle Harbour VI*, 604 F. App'x at 70 ("[W]e previously rejected such an analogy to preferred stock as inapt . . . . But we did not merely reject the analogy on balance; rather, we concluded that the preferred-stock authorities invoked by [the taxpayer] provided '*no support* for [its] treatment of the banks' interest as equity.") (emphasis in original).

[90] *Id.*

[91] See I.R.C. § 7701(o) (added by the Health Care and Education Reconciliation Act of 2010, Pub. L. 111-152, 124 Stat. 1029).

[92] In *Castle Harbour*, the district court found that creating a partnership was a "legitimate way of achieving the non-tax purpose of raising capital." *Castle Harbour I*, 342 F. Supp. 2d at 114; *cf. Chemtech I*, 2013-1 U.S.T.C. at 83,515, 111 A.F.T.R.2d at 972 (noting that "cheaper and less complex" alternatives to the SLIPs transaction were available to achieve the goal of obtaining off-balance-sheet financing).

[93] *See* Salem Financial, Inc. v. United States, 786 F.3d 932, 949 (Fed. Cir. 2015), *cert. denied*, 84 U.S.L.W. 3180 (U.S. Mar. 7, 2016) (No. 15-380) ("Even if there is some prospect of profit, that is not enough to give a transaction economic substance if the prospect of a [nontax] return is grossly disproportionate to the tax benefits that are expected to flow from the transaction.").

[94] T. Christopher Borek et al., *Tax Shelters or Efficient Tax Planning? A Theory of the Firm Perspective on the Economic Substance Doctrine*, 57 J.L. & ECON. 975, 978 (2014); *see id.* at 996 (suggesting "that courts need not undertake" the "difficult endeavor" of articulating a "bright-line distinction between debt and equity . . . because, from an economic substance perspective, control is the defining characteristic of ownership, and control rights are often much easier to identify").

[95] *Id.* at 996.

interests were bought out.[96] If the purported equity financing were disaggregated from the operation of GECC's leasing business, it is clear that the Dutch banks did not "join together in the present conduct of the enterprise" with GECC.[97]

IV. *Southgate* and *Chemtech*

The bona fide equity participation requirement, articulated by the Second Circuit in *Castle Harbour* as an application of *Culbertson*, has gained wide judicial acceptance as a test for determining the validity of a purported partnership interest for tax purposes. In *Southgate*,[98] for example, the Fifth Circuit followed the Second Circuit's lead and struck down a shelter that purported to avoid tax on about $200 million of taxable income by shifting built-in losses from a tax-indifferent party to a U.S. taxpayer.[99] Although the underlying transaction—the acquisition of a portfolio of high-basis, low-value nonperforming Chinese loans—had economic substance,[100] the court found that the partnership itself was a sham.[101] Neither the U.S. taxpayers nor the tax-indifferent party intended to join together in the business of collecting the loans, or to share in potential gains or losses; instead, the purported partnership was a "redundancy," an entity which "served no function whose accomplishment was not already assured by other means or could not have

[96] To preserve the banks' immunity from U.S. taxes, all operations related to aircraft management had to be taken outside the United States. *See* Appendix B to the United States Initial Brief on Remand at B17-20, TIFD III-E Inc. v. United States, No. 3:01-cv-01839 (D. Conn. Jan. 31, 2007) ("pitch document" summarizing costs and benefits of transaction), ECF No. 112.

[97] *Culbertson*, 337 U.S. at 742; *see also* Bank of New York Mellon Corp. v. Commissioner, 801 F.3d 104, 121-123 (2d Cir. 2015), *cert. denied*, 84 U.S.L.W. 3264 (U.S. Mar. 7, 2016) (No. 15-572) (analyzing economically substantial loan separately from transaction that generated disputed tax benefits, and allowing deduction for interest on loan).

[98] Southgate Master Fund, L.L.C. v. United States, 659 F.3d 466 (5th Cir. 2011).

[99] *See Southgate*, 659 F.3d 466. In form, the tax-indifferent party (Cinda) contributed high-basis, low-value assets (nonperforming loans) to a partnership, and the U.S. taxpayer (Beal) subsequently purchased most of Cinda's partnership interest and thereby acquired the built-in losses; to take advantage of the losses, Beal also engaged in a "basis build" by contributing securities which remained subject to his control. *Id.* at 473-78. The transaction—a mirror image of the high-value, low-basis ploy involved in *Castle Harbour* and *Chemtech*—exploited the ability to shift unlimited built-in losses to a new partner under Regulation section 1.704-3(a)(7), prior to the enactment of section 704(c)(1)(C) in 2004. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 833, 118 Stat. 1418 (amending sections 704, 734, and 743, generally effective for transactions occurring after October 22, 2004); *see also* Prop. Reg. § 1.704-3(f)(3)(iii)(A), (C), Exs. (1)-(2), 79 Fed. Reg. 304 (2014) (eliminating transferor's excess basis on subsequent transfer of the section 704(c)(1)(C) partner's interest).

[100] *See Southgate*, 659 F.3d at 480-83 (summarizing the economic substance test as requiring that "the transaction must exhibit objective economic reality, a subjectively genuine business purpose, and some motivation other than tax avoidance"). Beal, a billionaire Texas banker, invested actively in distressed debt; Cinda was a Chinese state-owned asset management company that acquired nonperforming loans at a fraction of face value. *See id.* at 469.

[101] *See id.* at 491.

been equally well assured by alternative, less tax-beneficial means."[102] Finally, applying substance-over-form principles, the court disregarded the partnership and recharacterized the U.S. taxpayer's acquisition of the nonperforming loans as a direct sale.[103]

In conducting the sham partnership analysis, the Fifth Circuit examined not only the purported partners' actions, which belied any intent to join together in conducting a business venture for profit, but also the nature of their respective interests, which were structured to insulate the partners from any substantial downside risk or upside potential.[104] Relying on *Castle Harbour*, the Fifth Circuit emphasized the distinction between the economic substance of the underlying transaction and the characterization of the partners for tax purposes:

> The fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny. The parties' selection of the partnership form must have been driven by a genuine business purpose. This is not to say that tax considerations cannot play *any* role in the decision to operate as a partnership. It is only to say that tax considerations cannot be the *only* reason for a partnership's formation. If there was not a legitimate, profit-motivated reason to operate as a partnership, then the partnership will be disregarded for tax purposes even if it engaged in transactions that had economic substance.[105]

Significantly, the court also noted that it applied "especially stringent" scrutiny to the taxpayer's choice of the partnership form "[b]ecause so many abusive tax-avoidance schemes are designed to exploit the Code's partnership provisions."[106] Critics of the Fifth Circuit's sham partnership analysis may be inclined to dismiss *Southgate* as merely applying "careful scrutiny of the bona

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[102] *Id.* at 489.

[103] *See id.* at 491-92. Treating the transaction as a direct sale of the nonperforming loans (rather than a sale of a partnership interest) prevented Beal from acquiring Cinda's built-in losses. *Id.* at 492. Because the issues arose in a partnership-level proceeding, the court did not address the tax consequences to the U.S. partners. *See id.* at 469 n.4.

[104] Cinda viewed its interest in the partnership as "purely symbolic," since it had no real stake in the success or failure of the partnership, and its actions evinced "an intent to sabotage and undermine Southgate's efforts to make a profitable business out of servicing and collecting on its portfolio of [nonperforming loans]." *Id.* at 486. When faced with a choice to "preserve the business but risk the tax benefit" or to "sacrifice the business and preserve the tax benefit," the U.S. taxpayers unhesitatingly chose the latter course and manifested "an unmistakable intent to forgo the joint conduct of a profit-seeking venture." *Id.* at 485. As for Beal, his retained "vise grip" on the securities he contributed was inconsistent with an intent to share potential gains or losses with the other partners and rendered the basis build "economically insubstantial." *Id.* at 488.

[105] *Id.* at 484 (emphasis in original); *see id.* at 492 ("the acquisition of the [nonperforming loans] had economic substance, but . . . the formal partnership structure through which [the] acquisition took place was a sham"); *id.* at 483 ("The fact that an economically substantial transaction comes wrapped in a dubious form is not a reason to disregard the transaction; it is a reason to disregard the form.").

[106] *Id.* at 483-84 (citing *Castle Harbour II*).

fides of the underlying business activity (or the participation of a purported member in that activity) whenever the claimed tax consequences of the transaction are unusual or extraordinary."[107] However, this interpretation seems inconsistent with the court's focus on "whether there was a nontax business purpose that necessitated the partnership's existence."[108] In arguing that a partnership should be recognized for tax purposes if it merely conducts substantial business activity, regardless of any nontax business purpose for creating the partnership,[109] the critics rely on a misreading of *Moline Properties* that was squarely rejected by the Fifth Circuit when it explained that an entity may be ignored, notwithstanding its business activity, if it lacks a nontax business purpose.[110] Whether the requirement is framed in terms of a business need or a profit-seeking motive for forming the partnership, it is clear that a partnership is not exempt from scrutiny under *Culbertson* merely because it engages in substantial business activity.

Expanding on the discredited reading of *Moline Properties*, some commentators argue that a business purpose requirement is also inconsistent with the check-the-box regulations,[111] promulgated in 1996, which allow an unincorporated business entity with more than one member to elect to be classified as either a corporation or a partnership for tax purposes.[112] By "eliminat[ing] any substantive distinction between the terms 'partner' and 'shareholder,'" the argument runs, the regulations implicitly impose a single, uniform standard for determining whether the members of an unincorporated business entity will be treated as partners or as shareholders.[113] A further extension of the same reasoning asserts that an entity's freedom to elect partnership or

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[107] McKEE ET AL., *supra* note 78, ¶ 3.03[2], at S3-15 (suggesting a "better reading" of *Southgate*).

[108] *Southgate*, 659 F.3d at 491.

[109] *See* McKEE ET AL., *supra* note 78, ¶ 3.03[1][b], at 3-32 ("Under the traditional *Moline Properties* analysis, a finding of business purpose is unnecessary for entity recognition if the entity conducts business activity."); *id.* ¶ 3.03[2], at 3-37 to 3-38 (criticizing as "wrong" and "dangerous" the notion that "even though an entity actually engages in tax-recognized, profit-oriented activities, it will be disregarded for tax purposes unless a business need for its existence can be demonstrated").

[110] *See Southgate*, 659 F.3d at 484 n.64 ("[I]t is *Southgate* who misreads *Moline Properties*.")

[111] Reg. § 301.7701-3(a). The regulations were promulgated in late 1996 and became generally effective as of January 1, 1997. *See* Reg. § 301.7701-3(h).

[112] *See* McKEE ET AL., *supra* note 78, ¶ 3.09[7][b], at 3-116 ("The check-a-box Regulations establish a regime under which the base requirements for corporate or partnership status are identical. Under this regime, every business entity that could elect to be classified as a corporation is now entitled to be classified as a partnership, assuming only that it is not a *per se* corporation and that it has more than one member.").

[113] *Id.* ("Therefore, any person who would be treated as a shareholder if the entity elects to be treated as a corporation should also be considered a "member"—and thus, potentially, a partner—under the check-a-box Regulations regardless of the entity's actual classification."); *id.* ¶ 3.03[1][b], at 3-39 (arguing that "imposing a business need requirement for entity recognition would create a large 'twilight zone' of substantive, income and loss-producing activities that would not be regulated and taxed either as corporations or partnerships" and that "no such twilight zone exists").

corporate status implies the existence of a uniform standard for distinguishing debt from equity in the partnership and corporate contexts, and concludes that if the entity elects partnership status, the owner of any equity interest in the entity must be respected as a partner.[114] This line of argument was advanced by the taxpayer in *Superior Trading*—involving a distressed-debt tax shelter similar to the *Southgate* transaction—and soundly rejected by the Seventh Circuit.[115] In response to the argument that the *Culbertson* test has been "superseded" by the check-the-box regulations, the court observed that the purpose of the regulations is "merely to determine whether the default tax treatment of the entity shall be under the corporate or partnership provisions of federal tax law, not whether [the entity] shall be entitled to the benefits . . . created by those provisions should they be found inapplicable for other reasons."[116] Since the partnership was a sham, it was "entitled to none of the benefits that the Internal Revenue Code bestows on partnerships," including the ability to transfer section 704(c) built-in losses.[117]

While the argument that the check-the-box regulations provide an end-run around the *Culbertson* test may seem "compelling" or even "infallible" to its proponents,[118] *Southgate* and *Superior Trading* suggest that it is unlikely to withstand judicial scrutiny. While a taxpayer may be estopped to repudiate its own choice of form, the government can always disregard a transaction that lacks economic substance and recharacterize the form of a transaction to match its substance. Any transaction involving a purported partnership will also be subject to the partnership anti-abuse regulation, which draws upon

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[114] *See id.* ¶ 3.02[2A], at S3-7 ("[I]f, despite the absence of participation, an investment is equity, and not debt, for tax purposes, then the investment should be recognized as a valid partnership interest. Otherwise, the investment falls into a category to which no established tax regime applies."); *id.* ¶ 3.05[3], at 3-54 (arguing that "the shareholder-partner parity created by the check-a-box Regulations appears to solidify" the concept of the "direct applicability" of "corporate debt-equity principles . . . to the question of whether a relationship [is] a lender-borrower relationship or a true partnership").

[115] *See* Superior Trading, LLC v. Commissioner, 728 F.3d 676, 680 (7th Cir. 2013). Applying a sham partnership analysis, the court found that "[n]o joint business goal" motivated the formation of the partnership in which one partner sought to extract value from worthless receivables while the other partner aimed to convert the built-in losses into a "tax bonanza." *Id.* ("A transaction that would make no commercial sense were it not for the opportunity it created to beat taxes doesn't beat them. Substance prevails over form.").

[116] *Id.* at 681.

[117] *Id.*; *see also* Markell Co. v. Commissioner, 107 T.C.M. (CCH) 1447 (2014) (rejecting identical argument in a Son-of-BOSS "intermediary" tax shelter); Kenna Trading, LLC v. Commissioner, 143 T.C. 322, 352 (2014) ("[the] check-the-box regulations do not supersede *Culbertson* insofar as the putative members must still come together to form an entity").

[118] McKEE ET AL., *supra* note 78, ¶ 3.09[7][b], at 3-116 (conceding that the logic of the argument, "compelling as it seems," is "hard to square with substantial case law"); *id.* ¶ 3.03, at S3-12 n.101.2 (suggesting that the "infallible logic" of the argument "may have fallen prey to the inartful drafting of a transaction's promoter" in *Superior Trading*, and arguing that the Seventh Circuit "misse[d] the inference of the check-a-box regulations").

Culbertson and related common law doctrines.[119] It would be strange indeed if the check-the-box regulations promulgated in 1996 were intended *sub silentio* to override the *Culbertson* test embodied in the anti-abuse regulation promulgated less than three years earlier. While the check-the-box regulations may have some unanticipated repercussions, there is no indication that they were intended to undermine or displace the *Culbertson* test for partnership validity.[120]

Against the backdrop of *Castle Harbour* and *Southgate*, it is hardly surprising that the SLIPs transaction in *Chemtech* failed to withstand judicial scrutiny. The district court struck down the shelter on three separate grounds: (1) the transactions lacked economic substance; (2) the partnerships were shams; and (3) the Dutch banks were lenders rather than partners.[121] On appeal, the Fifth Circuit upheld the sham partnership determination without reaching the two alternative grounds.[122]

The Fifth Circuit reaffirmed its earlier formulation in *Southgate* of the *Culbertson* intent test, which requires that the parties intend both "to act in good faith for some genuine business purpose" and "to be partners, demonstrated by an intent to share 'the profits and losses.' If the parties lack either intent, then no valid tax partnership has been formed."[123] The Fifth Circuit affirmed the district court's finding that "Dow lacked the intent to share the profits and losses of the Chemtech transactions with the foreign banks," which was amply supported by the evidence.[124] The transactions were structured to ensure that the banks received "a fixed annual return on their investment," without regard to the success or failure of the partnership venture.[125] The banks "faced effectively no risk to their initial capital investment or to their priority return;" indeed, had they been required to bear any significant

[119] Reg. § 1.701-2(b) (authorizing the Service to recast a transaction "to achieve tax results that are consistent with the intent of subchapter K"). The anti-abuse regulation is generally effective for transactions occurring on or after May 12, 1994. *See* Reg. § 1.701-2(g).

[120] Indeed, the Treasury continues to recognize the continuing vitality of *Culbertson* in determining "whether a partnership will be respected for Federal tax purposes." Series LLCs and Cell Companies, 75 Fed. Reg. 55699 (Sept. 14, 2010) (also citing *Moline Properties* for the proposition that recognition of an entity separate from its owners for tax purposes is a question of federal tax law rather than local law).

[121] *See* Chemtech Royalty Assoc., L.P. v. United States, 2013-1 U.S.T.C. ¶ 50,204, at 83,498, 111 A.F.T.R.2d 953, 954 (M.D. La. 2013) (*Chemtech I*).

[122] Chemtech Royalty Assoc., L.P. v. United States, 766 F.3d 453, 459 n.18 (5th Cir. 2014) (*Chemtech II*).

[123] *Id.* at 461 (citing *Tower*, *Culbertson*, and *Southgate*); *see id.* at 460 n.20 (citing *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438 (1943) for the proposition that a sham partnership may be disregarded, since "[i]n such situations the form is a bald and mischievous fiction").

[124] *Chemtech II*, 766 F.3d at 465.

[125] *Id.* at 463 (noting the similarity to the *Castle Harbour* transaction).

risk of loss, they would not have participated in the transaction.[126] Finally, the banks "did not meaningfully share in any potential upside."[127]

Dow argued unsuccessfully that the Dutch banks must be recognized as partners for tax purposes if their interests were classified as equity rather than debt, regardless of other circumstances bearing on the parties' intent. This argument represented a transparent end-run around *Culbertson* in the form of an alternative, mechanical test for partner status that turned solely on whether the banks had "a legal right to demand repayment of their principal investment on [a] fixed future date," echoing the binary debt-equity test unsuccessfully advanced by the taxpayer in *Castle Harbour*.[128] The Fifth Circuit flatly rejected the argument, noting that such a test "would run afoul of *Culbertson* and *Southgate*" and "elevate the transaction's form over its substance, contrary to long-standing doctrine."[129] Furthermore, the court observed that, while the Second Circuit in *Castle Harbour* had found it "*helpful* first to address whether the [banks'] interest ha[d] 'the prevailing character of debt or equity,'" Dow was unable to point to any authority for the proposition that a court "*must* first determine whether an interest qualifies as debt or equity before [it] can address whether there is a sham partnership under *Culbertson*."[130]

At trial, the district court struck down the *Chemtech* shelter not only because the partnership was a sham but also on the alternative ground that the SLIPs transaction lacked economic substance. The district court found that the transaction had no effect on Dow's financial position: the contribution of the patents and the chemical plant resulted in no change in Dow's control or use of the contributed assets; the formation of the partnership did not generate any income; and the cash flows were circular.[131] Furthermore, the district court found that the transaction was motivated purely by tax benefits and that Dow could have achieved its purported business purpose of off-balance-sheet financing through "cheaper and less complex alternatives to SLIPs."[132] On appeal, Dow's core argument was that the SLIPs transaction was merely a

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[126] *Id.* at 464 (noting that "Dow agreed to bear all of the non-insignificant risks" arising from the transaction).

[127] *Id.* Just as in *Castle Harbour*, the banks were potentially entitled to a one percent share of residual profits from patent portfolio appreciation, but neither Dow nor the banks expected such appreciation to occur. The court dismissed the banks' upside potential as *de minimis*, noting that Dow had the ability to control residual profits by removing profitable patents. *Id.*

[128] *Id.* at 462.

[129] *Id.* at 463.

[130] *Id.* at 462; *see id.* at 462 n.26 ("We do not express any opinion as to what the proper test is for determining whether an interest constitutes debt or equity.").

[131] *See* Chemtech Royalty Assoc., L.P. v. United States, 2013-1 U.S.T.C. ¶ 50,204, at 83,514, 111 A.F.T.R.2d 953, 968-69 (M.D. La. 2013) (*Chemtech I*) (noting that the transfer of assets to the partnership "did not result in any economic advantage to Dow," the SLIPs transaction "did not change Dow's financial position," and "none of the cash flows had any economic substance whatsoever").

[132] *Id.*, 2013-1 U.S.T.C. at 83,515, 111 A.F.T.R.2d at 972 ("A prudent business owner would not have chosen SLIPs . . . unless his business was seeking only the tax benefits derived from [the] transaction.").

complicated way to raise capital, which concededly offered large potential tax benefits but also had sufficient business purpose and profit potential because the proceeds of the financing were to be used in Dow's business operations.[133] Because the Fifth Circuit rested its decision solely on the sham partnership finding, however, it did not need to review the district court's application of the economic substance doctrine. Nevertheless, it remanded the case to the district court to reconsider the applicability of valuation misstatement penalties, which the district court had initially refused to impose based on a line of Fifth Circuit case law that was subsequently overruled by the Supreme Court.[134]

On remand, the district court imposed a 40% gross valuation misstatement penalty with respect to the *Chemtech II* transaction, noting the Supreme Court's holding that the penalty "encompasses misstatements that rest on legal as well as factual errors, and is therefore applicable to misstatements that rest on the use of a sham partnership."[135] On appeal, Dow challenged the imposition of substantial-understatement and negligence penalties, arguing that it had substantial authority and a reasonable basis for concluding that the Dutch banks had equity interests in a valid partnership.[136] Dow's argument is essentially a reiteration of the penalty defense raised by the taxpayer—and summarily rejected by the Second Circuit—in *Castle Harbour*.

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[133] *See* Response and Reply Brief of Appellants/Cross-Appellees at 5, *Chemtech II*, 766 F.3d 463 (5th Cir. 2014) (No. 13-30887), ECF No. 39 ("[Dow] engaged in a bona fide asset-backed equity financing that could only be effected through a legal entity that must be classified as a partnership, and the investors were partners because they owned equity and not debt in Chemtech"); *id.* at 20 ("Dow's contributions of assets to the partnership and the license-back (or lease-back) of those assets to Dow . . . were as necessary to the asset-backed equity financing as the investors' contributions of money."). *But see* Salem Financial, Inc. v. United States, 786 F.3d 932, 953 (Fed. Cir. 2015), *cert. denied*, 84 U.S.L.W. 3180 (U.S. Mar. 7, 2016) (No. 15-380) (distinguishing *Northern Indiana Public Service Co. v. Commissioner*, 115 F.3d 506 (7th Cir. 1997)).

[134] *See Chemtech II*, 766 F.3d at 465. The district court initially imposed a 20% penalty for negligence and substantial understatement but concluded that valuation misstatement penalties were inapplicable, following *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990) (holding penalties inapplicable to transactions lacking economic substance). In *United States v. Woods*, 134 S. Ct. 557 (2013), however, the Supreme Court overruled *Heasley* and held valuation misstatement penalties applicable to a transaction lacking economic substance. *See* Karen C. Burke & Grayson M.P. McCouch, *Woods: A Path Through the Penalty Maze*, 142 TAX NOTES (TA) 829 (Feb. 24, 2014).

[135] Chemtech Royalty Assoc., L.P. v. United States, 2015-1 U.S.T.C. ¶ 50,301, at 83,948, 115 A.F.T.R.2d 1807, at 1809 (M.D. La. 2015), *aff'd*, 2016 BL (5th Cir. May 17, 2016) (*Chemtech III*).

[136] *See* Brief of Appellants at 19, *Chemtech III*, *appeal docketed*, No. 15-30577 (5th Cir. July 6, 2015), ECF No. 17 (arguing that "there was substantial authority and a reasonable basis at the time Chemtech filed its 1997–1998 returns for the determination that the partnership was valid" and also "for the position that the banks had sufficient participation in profits and losses to prevent *Chemtech I* from being disregarded as a 'sham partnership'"); *id.* (arguing that "substantial authority and a reasonable basis likewise support Chemtech's position that the disputed transactions had economic substance and involved equity rather than debt").

Given the structural resemblance between the SLIPs transactions in *Chemtech* and *Castle Harbour*, and the similar legal analysis and conclusions of the Fifth Circuit and the Second Circuit concerning the nature of the banks' purported partnership interests, it seems highly unlikely that the Fifth Circuit will reach a different conclusion on the penalty issue.

Indeed, despite some differences of emphasis and terminology, the Fifth Circuit's analysis in *Chemtech* seems virtually identical to the approach elaborated by the Second Circuit in *Castle Harbour* in determining whether the members of a purported partnership will be treated as partners for tax purposes. The Fifth Circuit's sham partnership test, like the Second Circuit's bona fide equity participation test, focuses on whether there was a legitimate, nontax reason for using the partnership form and whether the purported partner had a substantial stake in the success or failure of the partnership venture. Both tests can be understood as applications of the basic *Culbertson* intent test that constitutes a judicial gloss on the statutory definitions of the terms "partnership" and "partner." Moreover, while the issue of whether a purported partnership interest passes muster under *Culbertson* is analytically distinct from the issue of whether the underlying transaction has economic substance, the lack of a business purpose or of a real prospect of profit or loss—in connection with the formation of the partnership or the conduct of business activity, as the case may be—may be fatal to the taxpayer's position. Thus, in striking down the SLIPs transactions, the Fifth Circuit in *Chemtech* and the Second Circuit in *Castle Harbour* rested their respective decisions on the illusory nature of the banks' purported partnership interests without addressing the economic substance of the underlying transactions.

Some commentators have applauded the Fifth Circuit for focusing narrowly on the sham partnership determination to the exclusion of economic substance in *Chemtech*.[137] Any inference concerning the vitality of the economic substance doctrine, however, may be unwarranted. For reasons of judicial economy, the Fifth Circuit may have viewed the sham partnership finding as the simplest and most direct avenue to affirm the district court's

[137] Some commentators have applauded the narrow focus of the Fifth Circuit's opinion. *See, e.g.*, Richard M. Lipton & Samuel Pollack, *The Fifth Circuit Reins in But Upholds the District Court*, 122 J. TAX'N 100, 100-01, 105 (Mar. 2015) (applauding the Fifth Circuit for focusing on sham partnership doctrine, and criticizing the district court for treating separate doctrines as "fungible or interchangeable"); Andy Howlett & Lisandra Ortiz, *Chemtech: A Showcase for Common Law Partnership Doctrines*, 147 TAX NOTES (TA) 1285, 1295 (June 15, 2015) ("[T]he Fifth Circuit accomplished with a scalpel what the district court did with a sledge hammer . . . ."); Jasper L. Cummings, Jr., *The Fifth Circuit and Tax Shelters: Chemtech*, 145 TAX NOTES (TA) 835, 840 (Nov. 17, 2014) ("The fact that the Fifth Circuit did not choose to adopt the trial court's economic substance doctrine ground implies that it liked that approach less than *Southgate's* gloss on *Culbertson*.").

findings of fact.[138] By the same token, in reversing the district court's judgment in *Castle Harbour*, the Second Circuit may have found it preferable as a matter of judicial technique to focus on the district court's errors of law concerning the nature of the banks' interest rather than its exhaustive findings of fact concerning the economic substance of the underlying transaction. In the wake of *Castle Harbour* and *Chemtech*, it seems clear that SLIPs transactions are vulnerable to challenge under the *Culbertson* intent test as well as the economic substance doctrine; the two approaches are cumulative and not mutually exclusive.

V. The Partnership Anti-Abuse Rule

In 1998, at the time of the transition from *Chemtech I* to *Chemtech II*, Dow had sheltered five years of royalty income, totaling more than $380 million, from tax, and the partnership's subsidiary, CPI, held $460 million in demand notes issued by Dow in exchange for cash that it had received through circular cash flows. Had the partnership simply distributed its assets, including the CPI stock, back to Dow in liquidation after redeeming the Dutch banks' interest, Dow would have realized $381 million of gain, equal to the difference between the $460 million of distributed assets and the redeemed Dow partner's $79 million outside basis in its partnership interest. Furthermore, the gain would have been taxable under section 731 if the Dow demand notes were treated as marketable securities.[139]

To avoid this unwelcome result, Dow developed a plan which it hoped would completely eliminate the built-in tax liability.[140] First, Dow exchanged its demand notes for a deeply-subordinated 33-year note that would no longer constitute a marketable security, and the partnership distributed CPI stock and patents to an existing Dow partner in redemption of its interest. Next, the partnership made a section 754 election, triggering a $381 million basis step-up under section 734(b) in the newly-contributed chemical plant

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[138]Alternatively, the Fifth Circuit may have been reluctant to revisit its controversial economic substance decision holding that a foreign tax credit arbitrage transaction had pre-tax profit potential. *See* Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001); Bank of New York Mellon Corp. v. Commissioner, 801 F.3d 104, 124 (2d Cir. 2015), *cert. denied*, 84 U.S.L.W. 3264 (U.S. Mar. 7, 2016) (No. 15-572) (disagreeing with *Compaq* and agreeing with *Salem*); Charlene D. Luke, *The Relevance Games: Congress's Choices for Economic Substance Gamemakers*, 66 TAX LAW. 551, 575-76 (2013) [hereinafter *The Relevance Games*] (noting that section 7701(o) was intended to overturn *Compaq*); Charlene D. Luke, *Risk, Return, and Objective Economic Substance*, 27 VA. TAX REV. 783, 816-25 (2008) (discussing *Compaq* and pre-tax profit test).

[139]*See* I.R.C. § 731(a), (c).

[140]As a Dow internal memorandum revealed, Dow expected to receive CPI's "unremitted earnings" tax-free because "[t]he receipt of earnings will not occur until a future date when the subsidiary has ceased operations, converted its net assets into cash and liquidated." United States' Proposed Findings of Facts and Conclusions of Law, *supra* note 35, at 161.

which constituted the partnership's principal remaining asset.[141] The final step of the plan called for the former Dow partner to purchase enough additional CPI stock to gain control of CPI and then distribute CPI's assets to Dow in a tax-free liquidation under section 332, leaving Dow with $381 million of tax-free income and the partnership with a stepped-up basis in a chemical plant poised for a new round of depreciation and circular cash flows. In theory, the process could be repeated indefinitely.

Each step of Dow's plan was vulnerable to attack. Dow's substitution of its subordinated long-term note for its demand notes arguably had no business purpose and lacked economic substance, as the district court found.[142] Even if the distribution of CPI stock escaped tax under section 731, however, the remaining steps could be challenged under the partnership anti-abuse rule, which requires that (1) the partnership must be bona fide and each partnership transaction must have a substantial business purpose, (2) the form of each partnership transaction must be respected under substance-over-form principles, and (3) the tax consequences must accurately reflect the partners' economic agreement and clearly reflect the partners' income.[143] A basic premise of Subchapter K, implicit in the basis provisions, is that any realized gain deferred through basis adjustments and tax-free distributions will be preserved and will ultimately be accounted for by the partners. Dow's plan to inflate the partnership's basis in the chemical plant by means of a section 754 election, while permanently eliminating Dow's tax liability on the built-in gain in the CPI stock, appears fundamentally inconsistent with this understanding of the intent of Subchapter K.

In arguing that the partnership anti-abuse rule did not alter the tax consequences under section 731, Dow relied on a memorandum decision in which the Tax Court refused to apply the anti-abuse rule to a distribution of nonmarketable securities in redemption of a limited partner's interest, based on its finding that the redemption, viewed in isolation, had economic

[141] *See* I.R.C. § 734(b). The partnership's $381 million inside basis step-up mirrored the equivalent step-down (from $460 million to $79 million) in the assets distributed to the Dow partner in redemption of its partnership interest. *See* I.R.C. § 732(b). The shift of the partnership's inside basis from the CPI stock to the chemical plant set the stage for redepreciating the chemical plant in *Chemtech II*.

[142] *See* Chemtech Royalty Assoc., L.P. v. United States, 2013-1 U.S.T.C. ¶ 50,204, at 83,514-15, 111 A.F.T.R.2d 953, 971-73 (*Chemtech I*). The Fifth Circuit found it unnecessary to review this finding on appeal because it affirmed on the alternative ground that the partnership itself was a sham. *Chemtech II*, 766 F.3d at 465.

[143] Reg. § 1.701-2(a) (listing requirements "[i]mplicit in the intent of subchapter K"). The anti-abuse rule authorizes the government to recast a transaction if a principal purpose of the transaction is "to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K." Reg. § 1.701-2(c).

substance and did not violate substance-over-form principles.[144] The court warned, however, that the "totality of the actions" taken by the partnership might "present grounds for concluding that there was not a proper reflection of income" as required under the anti-abuse rule,[145] and ultimately invoked the anti-abuse rule and section 743 to require a step-down in the basis of the distributed securities and prevent indefinite gain deferral.[146]

Dow's reliance on the decision for the sweeping proposition that "[t]he partnership anti-abuse rule cannot validly be applied to a transaction that ha[s] economic substance and that satisfie[s] all applicable statutory requirements" is misplaced.[147] While the economic substance issue might be resolved differently after the enactment of section 7701(o),[148] the Tax Court's willingness to apply the anti-abuse rule based on the "totality of the [taxpayer's] actions" indicates the continuing vitality of the clear-reflection rule, even for transactions that have economic substance. Of course, the clear-reflection rule, like the codified economic substance rule, is an anti-abuse rule which is appropriately limited to transactions falling outside the intended scope of provisions that "promote administrative convenience and other policy objectives."[149] Accordingly, a transaction that does not clearly reflect the partners' income may withstand scrutiny, but only if the taxpayer can demonstrate that the ultimate tax results are "clearly contemplated" by specific provisions of the statute or the regulations.[150]

Dow argued that its plan did not violate the intent of Subchapter K because the statute expressly allows elective basis adjustments which can be used to obtain noneconomic tax benefits, including the shifting of basis from depreciable to nondepreciable assets. Under this argument, the upward section 734(b) basis adjustment is intended to preserve parity between the partnership's inside basis and the continuing partners' outside bases,

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[144] *See* Countryside Limited Partnership v. Commissioner, 95 T.C.M. (CCH) 1006 (2008) (granting taxpayer's motion for partial summary judgment). The court rejected the government's attempt to recast the distribution as a taxable distribution of cash pursuant to the anti-abuse rule, and also held that section 731(c) did not apply. *See id.* at 1022; Reg. § 1.731-2(h). For further discussion, see Karen C. Burke, *Tax Avoidance as a Legitimate Business Purpose*, 118 TAX NOTES (TA) 1393 (Mar. 31, 2008).

[145] *Countryside*, 95 T.C.M. (CCH) at 1022 n.29.

[146] *See* Decision, Countryside Limited Partnership v. Commissioner (No. 22023-05 and 3162-05) (May 26, 2011) (stipulated decision); *see also* Decision, CLP Promisee LLC v. Commissioner (No. 2176-08) (May 26, 2011); Decision, Manchester Promisee LLC v. Commissioner (No. 2178-08) (May 26, 2011).

[147] Plaintiff's Pre-Trial Brief at 110, *Chemtech I*, 2013-1 U.S.T.C. ¶ 50,204, 111 A.F.T.R.2d 953 (No. 3:05-cv-00944), ECF No. 107.

[148] *See* Karen C. Burke, *Reframing Economic Substance*, 31 VA. TAX REV. 271, 287-88 (2011).

[149] Reg. § 1.701-2(a)(3) (noting the possibility that certain provisions intended "to promote administrative convenience and other policy objectives" may "produce tax results that do not properly reflect income").

[150] Reg. § 1.701-2(a)(3); *cf. The Relevance Games*, *supra* note 138, at 567 (noting that "a clear showing of consistency with a deliberately provided tax benefit is required" to rebut application of section 7701(o)).

regardless of whether the distributee partner ever recognizes the built-in gain in the distributed assets.[151] Accordingly, Dow argued, the consequences of the elective basis adjustments can be curtailed only by statutory amendment, not by application of the anti-abuse rule. Indeed, the statute was amended in 2004 to require mandatory basis reductions and prevent the occurrence of duplicated tax losses in the absence of a section 754 election.[152] Had the 2004 amendments applied to the *Chemtech* transaction, the partnership would have been required to reduce its basis in the CPI stock to reflect the Dutch banks' built-in loss when they withdrew from the partnership, and the subsequent distribution of the CPI stock to the redeemed Dow partner would not have triggered an upward adjustment to the partnership's basis in the chemical plant under section 734(b). The 2004 amendments, while not applicable to the *Chemtech* transaction, may nevertheless be relevant in determining whether Dow's use of elective basis adjustments as part of its overall plan violated the intent of Subchapter K under the anti-abuse rule.

Critics of the partnership anti-abuse rule have long lamented the lack of an objective baseline standard for applying the clear-reflection requirement, noting the hybrid blend of entity and aggregate treatment reflected in Subchapter K.[153] Nevertheless, the clear-reflection standard represents an attempt to address abusive transactions that exploit complex interactions of technical provisions, coupled with a hyperliteral interpretive method, to achieve tax results that are clearly at odds with the statutory scheme and do not reflect the partners' economic arrangement. Under the anti-abuse rule, a tax-avoidance purpose for forming a partnership may be relevant in determining whether the partnership itself will be respected and whether the mechanical provisions of Subchapter K can be used to achieve unintended results.[154] In *Chemtech*, the sole purpose for forming *Chemtech II* was to implement the basis-strip transaction that effectively transferred the partnership's high basis in the CPI stock to the chemical plant contributed by Dow. The section 754 election

[151] *See* Plaintiff's Pre-Trial Brief, *supra* note 147, at 106-10. Dow argued "the partnership anti-abuse rule is little more than a Rorschach test that enables the [Service] to adopt whatever interpretation of the 'intent of Subchapter K' happens to suit its litigating position." *Id.* at 108. Alternatively, Dow argued that the government's interpretation of the anti-abuse rule would render it invalid. *See id.* at 110-12.

[152] *See* I.R.C. §§ 734(a), 743(a) (mandatory basis adjustments in the case of a "substantial basis reduction" or a "substantial built-in loss").

[153] *See* William F. Nelson, *The Limits of Literalism: The Effect of Substance Over Form, Clear Reflection and Business Purpose Considerations on the Proper Interpretation of Subchapter K*, 73 TAXES 641, 642 (Dec. 1995) ("[T]here is no basis for asserting that a literal application of the partnership provisions should recede to such an overarching standard. . . . [I]n fact, there is no single 'proper reflection' theory of Subchapter K that could support such a standard."); *cf.* Sowell, *supra* note 4, at 107 n.62 (noting that while the clear-reflection standard is not necessarily well understood, existing authority "does imply that the Treasury and [Service] were not undertaking an unprecedented step by incorporating this standard into [Regulation section] 1.701-2").

[154] *See* Reg. § 1.701-2(d), Ex. (8) (illustrating plan to duplicate losses in absence of section 754 election).

and the consequent upward section 734(b) basis adjustment were simply the mechanisms by which Dow sought to duplicate tax losses by transmuting the banks' built-in loss from *Chemtech I* into depreciation deductions for the continuing Dow partners in *Chemtech II*.

Dow's purpose in making the section 754 election and adjusting the basis of the chemical plant was not merely to generate artificial depreciation deductions, in violation of the clear-reflection requirement of the partnership anti-abuse rule. As part of its larger plan, Dow sought to avoid tax permanently on the income recycled through the partnership. The final steps in the plan involved a distribution to a Dow partner of CPI stock, followed by the partner's acquisition of control and the tax-free liquidation of CPI under section 332. These final steps exploited a loophole that was finally closed by the enactment of section 732(f) in 1999, several months after the Dow partner received a distribution of CPI stock.[155] While the statutory amendment did not apply to Dow's transaction, it also had no bearing on the government's authority to recast the transaction under the partnership anti-abuse rule. In recasting an abusive transaction to reflect the partners' income in accordance with the intent of Subchapter K, the government is not constrained by the form or the sequence of steps chosen by the taxpayer. If a purported partnership lacks a non-tax business purpose, the government is entitled to disregard it as a sham and thereby prevent the partners from manipulating the provisions of Subchapter K.

If Dow raises a penalty defense in a partner-level refund proceeding, it may be relevant to consider the advice that Dow received concerning the partnership anti-abuse rule.[156] Some commentators have downplayed the significance of the rule, noting that it is rarely invoked by courts and inferring

[155] *See* I.R.C. § 732(f). Had section 732(f) applied to the distribution, CPI's basis in the Dow note would have been reduced by $381 million and Dow would have received the note with a correspondingly reduced basis upon a subsequent liquidation of CPI. Dow argued that section 732(f), even if it applied, would not have prevented the partnership from claiming a stepped-up basis in the chemical plant. *See* Plaintiff's Pre-Trial Brief, *supra* note 147, at 109 ("The legislative solution enacted by Congress . . . is irrelevant to the application of sections 734(b) and 754.").

[156] The district court determined that the *Chemtech* partnerships were tax shelters whose principal purpose was tax avoidance. Chemtech Royalty Assoc., L.P. v. United States, 2013-1 U.S.T.C. ¶ 50,204, at 83,521, 111 A.F.T.R.2d 953, 978 (*Chemtech I*). Prior to 2004, the substantial authority exception was generally available for tax shelters only if the taxpayer reasonably believed that its reporting position was more likely than not proper; Dow did not raise any "reasonable cause" defense in the partnership-level proceeding. *See id.*, 2013-1 U.S.T.C. at 83,522, 111 A.F.T.R.2d at 980; *see also* I.R.C. § 6662(d)(2)(B), (C). It is not clear that any opinion provided by the King & Spalding tax lawyers who helped to structure both the *Castle Harbour* and *Chemtech* transactions would be considered "independent" for purposes of Dow's penalty defense. *See* Tigers Eye Trading, LLC v. Commissioner, 97 T.C.M. (CCH) 1622, 1634 (2009) (defense may be completely vitiated if the professional adviser acted as a promoter, defined as one who "participated in structuring the transaction or is otherwise related to, has an interest in, or profits from the transaction").

that its validity may be open to question.[157] In fact, courts rarely discuss the anti-abuse rule, not because of any doubts about its validity, but rather because the rule largely overlaps the longstanding judicial doctrines on which courts routinely rely in striking down abusive partnership transactions.[158] The anti-abuse rule, including the requirements that a partnership must be bona fide and must not violate substance-over-form principles, may be viewed as reinforcing the judicial doctrines applied in *Castle Harbour*, *Southgate*, and *Chemtech*.[159] Accordingly, critics miss the mark in arguing that the anti-abuse rule contradicts a "firmly established" principle "that a partnership can exist for tax purposes and that the rules of Subchapter K apply *even if the partnership was formed or availed of for the primary purpose of reducing tax*."[160] This argument rests on the same expansive reading of section 704(e)(1) that was squarely rejected by the Second Circuit in *Castle Harbour*.[161] Properly understood, there is no conflict between the partnership anti-abuse rule, *Culbertson*, and section 704(e). Instead, the statute, the regulations and the case law are all premised on the existence of a bona fide partnership with partners who have joined together to carry on a business venture for a purpose other than mere tax avoidance. They do not support recognizing a partnership that lacks a non-tax business purpose or granting partner status to members who lack a bona fide equity participation, nor do they prevent a court from looking behind the form of a partnership to the substance of the parties' underlying economic arrangement.

Nevertheless, the partnership anti-abuse rule should not be dismissed as superfluous or redundant. In 1994, when the rule was initially promulgated, the tax shelters involved in *Castle Harbour*, *Southgate*, and *Chemtech* were still being aggressively marketed and widely used, and they had not yet been subjected to judicial scrutiny under the doctrines of economic substance,

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[157] Indeed, one treatise characterizes the anti-abuse rule as a "scarecrow" and suggests that the government has strategically sought to avoid a judicial determination concerning its validity. *See* McKEE ET AL., *supra* note 78, ¶ 1.05[1][c], at 1-21 ("If the Service is so concerned with the validity of the anti-abuse rule that it will not put it to the test in a court, taxpayers will eventually recognize the rule for the scarecrow that it is.").

[158] *See* Sowell, *supra* note 4, at 92-93. It may be difficult to demonstrate invalidity under the prevailing standard of review for administrative regulations. *See* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 55 (2011) (according same degree of deference under *Chevron* to Treasury regulations as regulations of other agencies).

[159] *But cf.* McKEE ET AL., *supra* note 78, ¶ 1.05[1][a], at 1-16 (referring to the anti-abuse rule as "a stunning departure from existing law").

[160] *Id.* ¶ 1.05[4][a], at 1-40 (emphasis in original); *see also id.* at 1-43 (describing the anti-abuse rule as "an attempt to simultaneously reopen and preempt a debate that the Service lost in the courts and in Congress more than forty years ago"). The same commentators also argue that the partnership anti-abuse rule exceeds the scope of the Treasury's regulatory authority and is therefore invalid. *See id.* ¶ 1.05[5], at 1-62 to 1-76.

[161] *See Illusory Partnership Interests*, *supra* note 41, at 821; *see also* Burke & McCouch, *supra* note 77, at 109 ("On their face, the 2015 amendments merely codify the Second Circuit's 2012 *Castle Harbour* decision, but in the absence of contrary authority such a clarification hardly seems necessary.").

business purpose, sham partnership, and substance over form. Despite the substantial overlap with those doctrines, the anti-abuse rule continues to provide useful guidance for identifying abusive partnership transactions and preventing manipulation of Subchapter K for wholesale tax avoidance. Similarly, despite the suggestion of some commentators to the contrary,[162] the codification of the economic substance doctrine does not appear to have rendered the anti-abuse rule obsolete or irrelevant, to the extent that the clear-reflection and principal-purpose requirements of the rule, as well as its substance-over-form principles, are viewed as distinct from the "rule of law" underlying section 7701(o).[163]

VI. Conclusion

When Dow, General Electric, and other U.S. corporations implemented SLIPs transactions and similar tax shelters in the 1990s, they undertook a calculated risk. Relying on professional advice, corporate taxpayers concluded that strict compliance with the literal terms of the Code and regulations would allow them to avoid hundreds of millions of dollars of federal income tax liability. Even if the expected tax benefits failed to materialize, reliance on professional advice might allow them to escape penalties. The transactions were carefully orchestrated to exploit the extraordinarily flexible provisions of Subchapter K, based on a hyperliteral interpretation of the statute and the regulations. Too often, corporate taxpayers and their advisers either demonstrated little regard for business purpose, economic substance, or related anti-abuse doctrines, or viewed those doctrines as obstacles to be circumvented rather than as real constraints on abusive tax shelters.

Despite the technical ingenuity of their design, however, the shelters in *Castle Harbour*, *Chemtech*, and *Southgate* were vulnerable from the outset. The advisers who reviewed (and in some cases designed) them failed to acknowledge the variety and adaptability of doctrines developed by courts to disregard or recharacterize equivocal transactions. To some extent, this may reflect a failure on the advisers' part to foresee how courts would respond to tax avoidance schemes that used hyperliteral interpretation to subvert the purposes of the statute and regulations.[164] Ultimately, when presented with

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[162] *See, e.g.*, Monte A. Jackel, *Subchapter K and the Codified Economic Substance Doctrine*, 128 TAX NOTES (TA) 321, 322 (July 19, 2010).

[163] The distinction may be significant in imposing a strict-liability penalty for transactions lacking economic substance. *See* I.R.C. § 6662(b)(6) (imposing strict-liability penalty for transaction lacking economic substance under section 7701(o) or failing to meet requirements of "any similar rule of law"); Notice 2014-58, 2014-44 I.R.B. 746 (distinguishing substance-over-form doctrine from codified economic substance doctrine for purpose of strict-liability penalty under section 6662(b)(6)); Sowell, *supra* note 4, at 104 (suggesting the anti-abuse rule may allow the government to challenge abusive transactions without triggering strict-liability penalty under section 6662(b)(6)).

[164] *See COBRA Strikes Back*, *supra* note 2, at 66 (noting that "in the late 1990s, it was not clear whether [judicial anti-abuse] doctrines would prove sufficiently robust to withstand the proclivity of some courts for hyper-literalism in interpreting tax statutes").

an opportunity to scrutinize the shelters, the courts overwhelmingly rejected taxpayers' formalistic arguments in favor of a more searching inquiry into the nature and purposes of the transactions. In particular, the courts gave new life to the longstanding *Culbertson* intent test, requiring that the members of a purported partnership must not only join together in good faith to conduct a business venture but also have a real stake in the success or failure of the venture. This expansive view of *Culbertson* allowed courts to disregard illusory partnership interests without having to determine whether the underlying transaction also lacked economic substance. The rejuvenation of *Culbertson* offers a salutary warning that literal compliance with the Code and regulations cannot insulate abusive transactions from challenge and that the flexible rules of Subchapter K should not be taken as an open-ended invitation to tax avoidance. The emerging sham partnership doctrine demonstrates the resourcefulness and versatility of courts in adapting longstanding doctrines to address new forms of abuse. Inevitably, anti-abuse doctrines, whether announced by courts or embodied in statutes or regulations, will be criticized as unpredictable and uncertain in application.[165] Nevertheless, some degree of uncertainty may be unavoidable in curbing overly aggressive tax planning. Indeed, taxpayers and their advisers may eventually come to perceive the sham partnership doctrine as a less onerous alternative to the codified economic substance doctrine. If an equivocal transaction fails for lack of economic substance, the taxpayer will incur a strict-liability penalty in addition to the loss of expected tax benefits. In contrast, if the transaction fails because a partnership is disregarded as a sham under *Culbertson*, courts may finally have an opportunity to determine whether the professional advice relied on by the taxpayer provides an effective penalty shield.

[165]As Randolph Paul observed, "the trouble with dependence upon free or liberal statutory interpretation of a taxing statute, is that no one can be sure when it will be employed." Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440, 473 (1968) (quoting RANDOLPH PAUL, STUDIES IN FEDERAL TAXATION 265 (1937)).

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Federal Regulations

Reg § 1.751-1. Unrealized receivables and inventory items.

Caution: The Treasury has not yet amended Reg § 1.751-1 to reflect changes made by P.L. 105-34, P.L. 103-66, P.L. 98-369, P.L. 97-448, P.L. 95-618, P.L. 95-600, P.L. 94-455, P.L. 91-172, P.L. 89-570

Effective: July 16, 2004. These regulations apply to transactions on or after May 15, 2002.

(a) Sale or exchange of interest in a partnership.

(1) Character of amount realized. To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of "unrealized receivables" and "inventory items which have appreciated substantially in value", see section 751(c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". See paragraph (e) of this section.

(2) Determination of gain or loss. The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under §1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest. See §1.460-4(k)(2)(iv)(E) for rules relating to the amount of ordinary income or loss attributable to a contract accounted for under a long-term contract method of accounting.

(3) Statement required. A partner selling or exchanging any part of an interest in a partnership that has any section 751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information--

(i) The date of the sale or exchange;

(ii) The amount of any gain or loss attributable to the section 751 property; and

(iii) The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

(b) Certain distributions treated as sales or exchanges.

(1) In general.

(i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of $100,000 in which partner A has an interest of 30 percent, or $30,000. If A receives $20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the $80,000 of section 751 property remaining in the partnership after the distribution, only $6,000 ($30,000 minus $24,000 (30 percent of $80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining $14,000 ($20,000 minus $6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).

(i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the

section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) Distribution of partnership property other than section 751 property.

(i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).

(4) Exceptions.

(i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and §1.736-1.

(5) Statement required. A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) Unrealized receivables.

(1) The term "unrealized receivables," as used in subchapter K, chapter 1 of the Code, means any rights (contractual or otherwise) to payment for—

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able.to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(4)

(i) With respect to any taxable year of a partnership ending after September 12, 1966 (but only in respect of expenditures paid or incurred after that date), the term *unrealized receivables* , for purposes of this section and sections 731, 736,

741, and 751, also includes potential gain from mining property defined in section 617(f)(2). With respect to each item of partnership mining property so defined, the potential gain is the amount that would be treated as gain to which section 617(d)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(ii) With respect to sales, exchanges, or other dispositions after December 31, 1975, in any taxable year of a partnership ending after that date, the term *unrealized receivables* , for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in a DISC as described in section 992(a). With respect to stock in such a DISC, the potential gain is the amount that would be treated as gain to which section 995(c) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(iii) With respect to any taxable year of a partnership beginning after December 31, 1962, the term *unrealized receivables* , for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1245 property. With respect to each item of partnership section 1245 property (as defined in section 1245(a)(3)), potential gain from section 1245 property is the amount that would be treated as gain to which section 1245(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1245 property were sold by the partnership at its fair market value. See §1.1245-1(e)(1). For example, if a partnership would recognize under section 1245(a)(1) gain of $600 upon a sale of one item of section 1245 property and gain of $300 upon a sale of its only other item of such property, the potential section 1245 income of the partnership would be $900.

(iv) With respect to transfers after October 9, 1975, and to sales, exchanges, and distributions taking place after that date, the term *unrealized receivables* , for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in certain foreign corporations as described in section 1248. With respect to stock in such a foreign corporation, the potential gain is the amount that would be treated as gain to which section 1248(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(v) With respect to any taxable year of a partnership ending after December 31, 1963, the term *unrealized receivables* , for purposes of this section and sections

731, 736, 741, and 751, also includes potential gain from section 1250 property. With respect to each item of partnership section 1250 property (as defined in section 1250(c)), potential gain from section 1250 property is the amount that would be treated as gain to which section 1250(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1250 property were sold by the partnership at its fair market value. See §1.1250-1(f)(1).

(vi) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables* , for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm recapture property as defined in section 1251(e)(1) (as in effect before enactment of the Tax Reform Act of 1984). With respect to each item of partnership farm recapture property so defined, the potential gain is the amount which would be treated as gain to which section 1251(c) (as in effect before enactment of the Tax Reform Act of 1984) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(vii) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables* , for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm land as defined in section 1252(a)(2). With respect to each item of partnership farm land so defined, the potential gain is the amount that would be treated as gain to which section 1252(a) (1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(viii) With respect to transactions which occur after December 31, 1976, in any taxable year of a partnership ending after that date, the term *unrealized receivables* , for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from franchises, trademarks, or trade names referred to in section 1253(a). With respect to each such item so referred to in section 1253(a), the potential gain is the amount that would be treated as gain to which section 1253(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the items were sold by the partnership at its fair market value.

(ix) With respect to any taxable year of a partnership ending after December 31, 1975, the term *unrealized receivables* , for purposes of this section and sections

731, 736, 741, and 751, also includes potential gain under section 1254(a) from natural resource recapture property as defined in §1.1254-1(b)(2). With respect to each separate partnership natural resource recapture property so described, the potential gain is the amount that would be treated as gain to which section 1254(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the property were sold by the partnership at its fair market value.

(5) For purposes of subtitle A of the Internal Revenue Code, the basis of any potential gain described in paragraph (c)(4) of this section is zero.

(6)

(i) If (at the time of any transaction referred to in paragraph (c)(4) of this section) a partnership holds property described in paragraph (c)(4) of this section and if—

(A) A partner had a special basis adjustment under section 743(b) in respect of the property;

(B) The basis under section 732 of the property if distributed to the partner would reflect a special basis adjustment under section 732(d); or

(C) On the date a partner acquired a partnership interest by way of a sale or exchange (or upon the death of another partner) the partnership owned the property and an election under section 754 was in effect with respect to the partnership, the partner's share of any potential gain described in paragraph (c)(4) of this section is determined under paragraph (c)(6)(ii) of this section.

(ii) The partner's share of the potential gain described in paragraph (c)(4) of this section in respect of the property to which this paragraph (c)(6)(ii) applies is that amount of gain that the partner would recognize under section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1251(c) (as in effect before the Tax Reform Act of 1984), 1252(a), 1253(a), or 1254(a) (as the case may be) upon a sale of the property by the partnership, except that, for purposes of this paragraph (c)(6) the partner's share of such gain is determined in a manner that is consistent with the manner in which the partner's share of partnership property is determined; and the amount of a potential special basis adjustment under section 732(d) is treated as if it were the amount of a special basis adjustment under section 743(b). For example, in determining, for purposes of this paragraph (c) (6), the amount of gain that a partner would recognize under section 1245 upon a sale of partnership property, the items allocated under §1245-1(e)(3)(ii) are allocated to

the partner in the same manner as the partner's share of partnership property is determined. See §1.1250-1(f) for rules similar to those contained in §1.1245-1(e)(3)(ii).

(d) Inventory items which have substantially appreciated in value.

(1) Substantial appreciation. Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms "inventory items which have appreciated substantially in value" or "substantially appreciated inventory items" refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the "fair market value" of inventory items has the same meaning as "market" value in the regulations under section 471, relating to general rule for inventories.

(2) Inventory items. The term "inventory items" as used in subchapter K, chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(1).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivisions (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) Section 751 property and other property. For the purposes of this section, "section 751 property means unrealized receivables or substantially appreciated inventory items, and "other property" means all property (including money) except section 751 property.

(f) Effective date. Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of subchapter K, chapter 1 of the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of §1.771-1. See also section 771(c) and paragraph (c) of §1.771-1. The rules contained in paragraphs (a)(2) and (a)(3) of this section apply to transfers of partnership interests that occur on or after December 15, 1999.

(g) Examples. Application of the provisions of section 751 may be illustrated by the following examples:

Example (1).

(i)

(A) A and B are equal partners in personal service partnership PRS. B transfers its interest in PRS to T for $15,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	Assets	
	Adjusted basis	**Fair Market value**
Cash	$3,000	$3,000
Loans Receivable	10,000	10,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	20,000	32,000

Liabilities and Capital	Adjusted per books	Fair Market value
Liabilities	$2,000	$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

(B) None of the assets owned by PRS is section 704(c) property, and the capital assets are nondepreciable. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by T. See section 752. B's undivided half-interest in the partnership property includes a half-interest in the partnership's unrealized receivables items. B's basis for its partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). If section 751(a) did not apply to the sale, B would recognize $6,000 of capital gain from the sale of the interest in PRS. However, section 751(a) does apply to the sale.

(ii) If PRS sold all of its section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($6,000) and the amount of ordinary income or loss determined under paragraph (a)(2) of this section ($7,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $1,000 capital loss.

Example (2).

(a) Facts. Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

Assets	Adjusted basis per books	Market value
Cash	$15,000	$15,000
Accounts receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable property	42,000	48,000
Land	9,000	9,000

	Assets	
	Adjusted basis per books	Market value
Total	96,000	111,000

	Liabilities and Capital	
	Per books	Value
Current liabilities	$15,000	$15,000
Mortgage payable	$21,000	$21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	20,000	25,000
Total	96,000	111,000

The distribution received by C consists of $10,000 cash and depreciable property with a fair market value of $15,000 and an adjusted basis to the partnership of $15,000.

(b) Presence of section 751 property. The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, $39,000 (inventory $30,000, and accounts receivable $9,000), exceeds 120 percent of the $30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, $39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of $96,000 or $9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash ($5,000) and $15,000 in depreciable property ($1,000 less than his $16,000 share). In addition, he received other partnership property ($5,000 cash and $12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable ($3,000), inventory ($10,000), land ($3,000), and the balance of his interest in depreciable

property ($1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of $13,000 ($3,000 in accounts receivable and $10,000 in inventory). Thus, $13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) Distributee partner's tax consequences. C's tax consequences on the distribution are as follows:

(1) The section 751(b) sale or exchange. C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is $10,000 ($7,000 for inventory and $3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for $13,000. Thus, on the sale of his share of inventory items, C realizes $3,000 of ordinary income.

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of $22,000 for the remainder of his partnership interest. The total distribution to C was $37,000 ($22,000 in cash and liabilities assumed, and $15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and $9,000 in money ($22,000 less $13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732(b), C's basis for the depreciable property is $13,000 (the remaining basis of his partnership interest, $22,000, reduced by $9,000, the money received in the distribution).

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the $22,000 money distributed (in cash and the assumption of C's share of liabilities) $13,000 was paid to acquire C's interest in inventory ($10,000 fair market value) and in accounts receivable ($3,000). Since under section 751(b) the

partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is $13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable ($30,000) by $10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by $13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from $21,000 to $24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See paragraph (e) of §1.732-1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: $15,000 in depreciable property (with a basis to the partnership of $15,000) and $9,000 in money ($22,000 less $13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property before the distribution, $42,000, is reduced by the basis of the depreciable property distributed, $15,000, leaving a basis for the depreciable property in the partnership of $27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been $15,000, and is only $13,000 in C's hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by $2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be $38,000 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities each assumed).

(f) Partnership trial balance. A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below.

Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

	I Sec. 754, Election in effect		II Sec. 754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	$5,000	$5,000	$5,000	$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
	76,000	86,000	74,000	86,000
Current liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
A	20,000	25,000	20,000	25,000
B	20,000	25,000	20,000	25,000
	76,000	86,000	76,000	86,000

Example (3).

(a) Facts. Assume that the distribution to partner C in example (2) of this paragraph in liquidation of his entire interest in partnership ABC consists of $5,000 in cash and $20,000 worth of partnership inventory with a basis of $14,000.

(b) Presence of section 751 property. For the same reason as stated in paragraph (b) of example (2), the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. In the distribution, C received his share of cash ($5,000) and his share of appreciated inventory items ($13,000). In addition, he received appreciated inventory with a fair market value of $7,000 (and with an adjusted basis to the partnership of $4,900) and $12,000 in money (liabilities assumed). C has relinquished his interest in $16,000 of depreciable property and $3,000 of land. Although C relinquished his interest in $3,000 of accounts receivable, such accounts receivable are inventory items and, therefore,

that exchange was not an exchange of section 751 property for other property. Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., depreciable property or land for inventory items). Assume that the partners agree that the $7,000 of inventory in excess of C's share was received by him in exchange for $7,000 of depreciable property.

(d) Distributee partner's tax consequences. C's tax consequence on the distributions are as follows:

(1) The section 751(b) sale or exchange. C is treated as if he had received his 7/16 ths share of the depreciable property in a current distribution. His basis for that share is $6,125 (42,000/48,000 of $7,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16 ths share of depreciable property to the partnership for $7,000, realizing a gain of $875.

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was $32,000 ($20,000, plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of $25,875 for the remainder of his partnership interest. Of the $37,000 total distribution to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of $13,000 (which had an adjusted basis to the partnership of $9,100) is limited to $8,875, the amount of the remaining basis for his partnership interest, $25,875, reduced by $17,000, the money received. Thus, C's total aggregate basis for the inventory received is $15,875 ($7,000 plus $8,875), and not its $14,000 basis in the hands of the partnership.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of the $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/16 ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is $42,875 ($42,000 less $6,125, the basis of the 7/16 ths share considered as distributed to C, plus $7,000, the partnership purchase price for this share).

(2) The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 7/16 ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100, and C's basis for such inventory after distribution is only $8,875. The basis of the inventory remaining in the partnership must be increased by $225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution, plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities now assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example (4).

(a) Facts. Assume the same facts as in example (3) of this paragraph except that the partners did not identify the property which C relinquished in exchange for the $7,000 of inventory which he received in excess of his share.

(b) Presence of section 751 property. For the same reasons stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. The analysis stated in paragraph (c) of example (3) of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received $7,000 of inventory in exchange for his release of 7/19 ths of the depreciable property and 7/19 ths of the land. ($7,000, fair market value of property released, over $19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.

(d) Distributee partner's tax consequences. C's tax consequences on the distribution are as follows:

(1) The section 751(b) sale or exchange. C is treated as if he had received his 7/19 ths shares of the depreciable property and land in a current distribution. His basis for those shares is $6,263 (51,000/57,000 of $7,000, their fair market value), as determined under

paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19 ths shares of depreciable property and land to the partnership for $7,000, realizing a gain of $737.

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was $32,000 ($20,000 plus $12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by $6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of $25,737 for the remainder of his partnership interest. Of the total $37,000 distributed to C, $30,000 ($17,000 in money, including liabilities assumed, and $13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory (with a fair market value of $13,000 and an adjusted basis to the partnership of $9,100) is limited to $8,737, the amount of the remaining basis for his partnership interest ($25,737 less $17,000, money received). Thus, C's total aggregate basis for the inventory he received is $15,737 ($7,000 plus $8,737), and not the $14,000 basis it had in the hands of the partnership.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership consisting of the remaining members has $2,100 of ordinary income on the sale of $7,000 of inventory which had a basis to the partnership of $4,900 (21,000/30,000 of $7,000). This $7,000 of inventory was paid to acquire 7/19 ths of C's interest in the depreciable property and land. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. The bases of the depreciable property and land would be $42,737 and $9,000, respectively. The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $5,158 basis (42,000/48,000 of $5,895) for C's 7/19 ths interest constructively distributed and increased by $5,895 (16,000/19,000 of $7,000), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $1,105 basis ($9,000/9,000 of $1,105) of land constructively distributed to C, and increased by $1,105 (3,000/19,000 of $7,000), the portion of the purchase price allocated to the land.

(2) The part of the distribution not under section 751(b). In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 12/19 ths interests in depreciable property and land which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under

section 734(b) since the adjusted basis to the partnership of the inventory distributed had been $9,100 and C's basis for such inventory after the distribution is only $8,737. The basis of the inventory remaining in the partnership must be increased by the difference of $363. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be $39,050 ($20,000 original contribution plus $12,000, each partner's original share of the liabilities, plus $6,000, the share of C's liabilities assumed, plus $1,050, each partner's share of ordinary income realized by the partnership upon the part of the distribution treated as a sale or exchange).

Example (5).

(a) Facts. Assume that partner C in example (2) of this paragraph agrees to reduce his interest in capital and profits from one-third to one-fifth for a current distribution consisting of $5,000 in cash, and $7,500 of accounts receivable with a basis to the partnership of $7,500. At the same time, the total liabilities of the partnership are not reduced. Therefore, after the distribution, C's share of the partnership liabilities has been reduced by $4,800 from $12,000 (⅓ of $36,000) to $7,200 (⅕ of $36,000).

(b) Presence of section 751 property. For the same reasons as stated in paragraph (b) of example (2) of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) The properties exchanged. C's interest in the fair market value of the partnership properties before and after the distribution can be illustrated by the following table:

	C's interest Fair Market Value		C received		
Item	**One-third before**	**One-fifth after**	**Distribution of share**	**In excess of share**	**C relinquished**
Cash	$5,000	$2,000	$3,000	$2,000	
Liabilities assumed	(12,000)	(7,200)		4,800	
Inventory items:					
Accounts receivable	3,000	300	2,700	4,800	
Inventory	10,000	6,000			$4,000
Depreciable property	16,000	9,600			6,400
Land	3,000	1,800			1,200
Total	25,000	12,500	5,700	11,600	11,600

Although C relinquished his interest in $4,000 of inventory and received $4,800 of accounts receivable, both items constitute section 751 property and C has received only $800 of accounts receivable for $800 worth of depreciable property or for an $800 undivided interest in land. In the absence of an agreement identifying the properties exchanged, it is presumed C received $800 for proportionate shares of his interests in both depreciable property and land. To the extent that inventory was exchanged for accounts receivable, or to the extent cash was distributed for the release of C's interest in the balance of the depreciable property and land, the transaction does not fall within section 751(b) and is a current distribution under section 732(a). Thus, the remaining $6,700 of accounts receivable are received in a current distribution.

(d) Distributee partner's tax consequences. C's tax consequences on the distribution are as follows:

(1) The section 751(b) sale or exchange. Assuming that the partners paid $800 worth of accounts receivable for $800 worth of depreciable property, C is treated as if he received the depreciable property in a current distribution, and his basis for the $800 worth of depreciable property is $700 (42,000/48,000 of $800, its fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his $800 share of depreciable property to the partnership for $800. On the sale of the depreciable property, C realizes a gain of $100. If, on the other hand, the partners had agreed that C exchanged an $800 interest in the land for $800 worth of accounts receivable, C would realize no gain or loss, because under paragraph (b)(2)(iii) of this section his basis for the land sold would be $800. In the absence of an agreement, the basis for the depreciable property and land (which C is considered as having received in a current distribution and then sold back to the partnership) would be $716 (51,000/57,000 of $800). In that case, on the sale of the balance of the $800 share of depreciable property and land, C would realize $84 of gain ($800 less $716).

(2) The part of the distribution not under section 751(b). Section 751(b) does not apply to the balance of the distribution. Under section 731, C does not realize either gain or loss on the balance of the distribution. The adjustments to the basis of C's interest are illustrated in the following table:

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Original basis for C's interest	$32,000	$32,000	$32,000

	If accounts receivable received for depreciable property	If accounts receivable received for land	If there is no agreement
Less basis of property distributed prior to sec. 751 (b) sale or exchange	−700	−800	−716
	31,300	31,200	31,284
Less money received in distribution	−9,800	−9,800	−9,800
	21,500	21,400	21,484
Less basis of property received in a current distribution under sec. 732	−6,700	−6,700	−6,700
Resulting basis for C's interest	14,800	14,700	14,784

C's basis for the $7,500 worth of accounts receivable which he received in the distribution will be $7,500, composed of $800 for the portion purchased in the section 751(b) exchange, plus $6,700, the basis carried over under section 732(a) for the portion received in the current distribution.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. The partnership realizes no gain or loss in the section 751 sale or exchange because it had a basis of $800 for the accounts receivable for which it received $800 worth of other property. If the partnership agreed to purchase $800 worth of depreciable property, the partnership basis of depreciable property becomes $42,100 ($42,000 less $700 basis of property constructively distributed to C, plus $800, price of property purchased). If the partnership purchased land with the accounts receivable, there would be no change in the basis of the land to the partnership because the basis of land distributed was equal to its purchase price. If there were no agreement, the basis of the depreciable property and land would be $51,084 (depreciable property, $42,084 and land $9,000). The basis for the depreciable property is computed as follows: The common partnership basis of $42,000 is reduced by the $590 basis (42,000/48,000 of $674) for C's $674 interest constructively distributed, and increased by $674 (6,400/7,600 of $800), the part of the purchase price allocated to the depreciable property. The basis of the land would be computed in the same way. The $9,000 original partnership basis is reduced by $126 basis (9,000/9,000 of $126) of the land constructively distributed to C, and increased by $126 (1,200/7,600 of $800), the portion of the purchase price allocated to the land.

(2) The part of the distribution not under section 751(b). The partnership will realize no gain or loss in the balance of the distribution under section 731. Since the property in C's hands

after the distribution will have the same basis it had in the partnership, the basis of partnership property remaining in the partnership after the distribution will not be adjusted (whether or not an election under 754 is in effect).

Example (6).

(a) Facts. Partnership ABC distributes to partner C, in liquidation of his entire one-third interest in the partnership, a machine which is section 1245 property with a recomputed basis (as defined in section 1245(a)(2)) of $18,000. At the time of the distribution, the balance sheet of the partnership is as follows:

	Assets	
	Adjusted basis per books	**Market value**
Cash	$3,000	$3,000
Machine (section 1245 property)	9,000	15,000
Land	18,000	27,000
Total	30,000	45,000

	Liabilities and Capital	
	Per books	**Value**
Liabilities	$0	$0
Capital:		
A	10,000	15,000
B	10,000	15,000
C	10,000	15,000
Total	30,000	45,000

(b) Presence of section 751 property. The section 1245 property is an unrealized receivable of the partnership to the extent of the potential section 1245 income in respect of the property. Since the fair market value of the property ($15,000) is lower than its recomputed basis ($18,000), the excess of the fair market value over its adjusted basis ($9,000), or $6,000, is the potential section 1245 income of the partnership in respect of the property. The partnership has no other section 751 property.

(c) The properties exchanged. In the distribution C received his share of section 751 property (potential section 1245 income of $2,000, i.e., ⅓ of $6,000) and his share of section 1245 property (other than potential section 1245 income) with a fair market value of $3,000, i.e., ⅓ of ($15,000 minus $6,000), and an adjusted basis of $3,000, i.e., ⅓ of $9,000. In addition he

received $4,000 of section 751 property (consisting of $4,000 ($6,000 minus $2,000) of potential section 1245 income) and section 1245 property (other than potential section 1245 income) with a fair market value of $6,000 ($9,000 minus $3,000). C relinquished his interest in $1,000 of cash and $9,000 of land. Assume that the partners agree that the $4,000 of section 751 property in excess of C's share was received by him in exchange for $4,000 of land.

(d) Distributee partner's tax consequences. C's tax consequences on the distributions are as follows:

(1) The section 751(b) sale or exchange. C is treated as if he received in a current distribution 4/9 ths of his share of the land with a basis of $2,667 (18,000/27,000 × $4,000). Then C is considered as having sold his 4/9 ths share of the land to the partnership for $4,000, realizing a gain of $1,333. C's basis for the remainder of his partnership interest after the current distribution is $7,333, i.e., the basis of his partnership interest before the current distribution ($10,000) minus the basis of the land treated as distributed to him ($2,667).

(2) The part of the distribution not under section 751(b). Of the $15,000 total distribution to C, $11,000 ($2,000 of potential section 1245 income and $9,000 section 1245 property other than potential section 1245 income) is not within section 751(b). Under section 732(b) and (c), C's basis for his share of potential section 1245 income is zero (see paragraph (c)(5) of this section) and his basis for $9,000 of section 1245 property (other than potential section 1245 income) is $7,333, i.e., the amount of the remaining basis for his partnership interest ($7,333) reduced by the basis for his share of potential section 1245 income (zero). Thus C's total aggregate basis for the section 1245 property (fair market value of $15,000) distributed to him is $11,333 ($4,000 plus $7,333). For an illustration of the computation of his recomputed basis for the section 1245 property immediately after the distribution, see example (2) of paragraph (f)(3) of §1.1245-4.

(e) Partnership's tax consequences. The tax consequences to the partnership on the distribution are as follows:

(1) The section 751(b) sale or exchange. Upon the sale of $4,000 potential section 1245 income, with a basis of zero, for 4/9 ths of C's interest in the land, the partnership consisting of the remaining members has $4,000 ordinary income under sections 751(b) and 1245(a)(1). See section 1245(b)(3) and (6)(A). The partnership's new basis for the land is $19,333, i.e., $18,000, less the basis of the 4/9 ths share considered as distributed to C ($2,667), plus the partnership purchase price for this share ($4,000).

(2) The part of the distribution not under section 751(b). The analysis under this subparagraph should be made in accordance with the principles illustrated in paragraph (e)

(2) of examples (3), (4), and (5) of this paragraph.

T.D. 6175 , 5/23/56 , amend T.D. 6832 , 7/6/65 , T.D. 7084 , 1/7/71 , T.D. 8586 , 1/9/95 , T.D. 8847 , 12/14/99 , T.D. 9137 , 7/15/2004 .

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Integrating Subchapters K and S—Just Do It

WALTER D. SCHWIDETZKY*

I. Introduction

The Code contains two "pass-through" tax regimes for business entities. One is contained in Subchapter K, which applies to partnerships, the other in Subchapter S, which, unsurprisingly, applies to S corporations. In the main, both Subchapters tax the owners of the entities rather than the entities themselves. Having two pass-through tax regimes creates obvious administrative and other inefficiencies. There was a time when S corporations served a valuable purpose, particularly when taxpayers needed a fairly simple and foolproof pass-through entity that provided a liability shield. But limited liability companies (LLCs), which are usually taxed as partnerships,[1] in most contexts make S corporations obsolete. LLCs too can be fairly simple and foolproof, while providing the superior tax benefits of the partnership provisions of Subchapter K.[2] The advent and popularity of LLCs means that the inefficiency created by two separate pass-through tax regimes can no longer be justified. I propose that a new pass-through regime be created that retains Subchapter K and incorporates the best parts of Subchapter S, with the balance of Subchapter S repealed. Integrating these two pass-through regimes requires that some changes be made to the C corporation provisions of Subchapter C as well. I also make Subchapter K available to most nonpublic C corporations, putting most closely held businesses on a level playing field.

It has been difficult to justify Subchapter S for some time. In 1996, I published an article recommending the repeal of Subchapter S.[3] In a rather novel experience for a law professor, in 2004 there was a bill in the House of

*Professor of Law, University of Baltimore, School of Law; I would like to thank Professor William Lyons of the University of Nebraska College of Law, Professor Fred Brown of the University of Baltimore School of Law, Professor Sean M. O'Connor of the University of Washington School of Law, the participants at the 2008 Washburn University School of Law Partnership Tax Symposium, and the participants in the tax meetings of the 2008 Law and Society Conference (organized by Professor Neil Buchanan of George Washington University School of Law) for their decidedly helpful comments. This Article was written with the benefit of a research stipend from the University of Baltimore School of Law, for which I am grateful.

[1] *See infra* text accompanying notes 10–18.

[2] *See infra* text accompanying notes 62–104.

[3] Walter D. Schwidetzky, *Is It Time To Give The S Corporation A Proper Burial?*, 15 VA. TAX REV. 591 (1996) [hereinafter S Corp. Burial]. I draw freely from that article in writing this one.

Representatives that would have, among other things, enacted my proposal.[4] The bill, however, never became law and the tax system remains saddled with both tax partnerships and S corporations.

The tax universe today is very different from that of 1996. I continue to believe that Subchapter S should be repealed. It remains inefficient to have two pass-through tax regimes, and the repeal of Subchapter S is much more politically realistic than the repeal of Subchapter K, and indeed, perhaps more realistic today than it was in 1996. But there is also much additional grist for the mill, and, with a little prodding from some colleagues, I am reexamining the area. I am encouraged in my efforts by the fact that business entity tax reform is receiving heightened attention in Congress.[5]

S corporations offer a number of legitimate benefits not currently available to tax partnerships and those benefits should be incorporated into Subchapter K. Many of these benefits have come to the fore since my 1996 article. Some derive from the simple fact that the S corporation is a corporation. For example, parties who anticipate a public offering often use an S corporation, as it is a simple matter to convert it to a C corporation prior to the public offering. Employee Stock Option Plans, which by definition can only own corporate stock, often own stock in S corporations. S corporations are often preferred by the venture capital industry. The hope is that the S corporation will be able to make a public offering of its stock, or that the S corporation will become the target of a friendly takeover by a public corporation. Those takeovers are much easier to structure on a tax-friendly basis if the target is a corporation. How can the needs of the parties making these and similar uses of S corporations be met in a world without Subchapter S? The solution I propose is to make it easier for partnerships to incorporate than is currently the case.

Another benefit of S corporations is the so-called "capital gain freeze" where taxpayers sell real property to an S corporation to "freeze" existing long-term capital gains before developing the property. I recommend that a comparable benefit be made available in Subchapter K.

The changed tax and business environment cause me to recommend a bolder, more comprehensive approach than that which I recommended in my 1996 article. As noted above, I now recommend that almost all nonpublicly traded corporations be allowed to elect to be taxed under Subchapter K. Closely held businesses should at least have the option of playing on the same field.

S corporations are also often used to improperly reduce or eliminate Social Security and Medicare taxes. The elimination of S corporations will, of course, end this abuse.

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[4]Small Business Modernization Act of 2004, H.R. 4137, 108th Cong. (2004) [hereinafter H.R. 4137].

[5]*See* J. COMM. ON TAX'N, 110TH CONG., TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF BUSINESS, (Comm. Print 2008), *available at* http://www.house.gov/jct/x-48-08.pdf [hereinafter JCX-48-08].

But the repeal of Subchapter S will make more acute a problem that currently exists with the Social Security and Medicare tax provisions. These taxes are meant to apply to income from services, but the current rules may over- or understate the applicable tax liability. In conjunction with any business entity tax reform, Congress must more clearly address when income is from services (and thus subject to these taxes) and when income is from capital (and thus not so subject). I recommend that, aside from portfolio income, all income of partnerships that are primarily engaged in the performance of services be subject to Social Security and Medicare taxes. For capital intensive partnerships, on the other hand, I recommend that partners be required to be paid reasonable compensation for their services, and that only this compensation be subject to Social Security and Medicare taxes.

Part II of the Article discusses the tax entity selection process generally, as well as the basics of the taxation of C corporations, S corporations, and partnerships. Part III explores the tax advantages and disadvantages of partnerships and S corporations. Part IV looks at the data on the relative popularity of the major business entities and provides a possible explanation for the continued popularity of S corporations. Part V discusses H.R. 4137, a bill that was ahead of its time (and not unflawed). Part VI asks whether we should repeal Subchapter K instead. Part VII recommends that nonpublic corporations also be allowed to elect Subchapter K. Part VIII proposes taxpayer-friendly methods for getting to my version of the promised land, and Part IX gives a brief conclusion.

II. Context

A. *Tax Entity Pigeon-Holing*[6]

As a general principle, for federal tax purposes, businesses have three entities from which to choose: The C corporation, the S corporation, and the tax partnership. State law corporations are always classified as corporations for federal tax purposes (C or S).[7] State law unincorporated business entities, on the other hand, might be classified as any of these three entities for federal tax purposes (or if they have a single owner, simply be disregarded for federal tax purposes).[8] Thus, a partnership for federal tax purposes may be something very different for state law purposes. The ubiquitous example is the LLC,[9] which is not a partnership for state law purposes, but typically is a partner-

[6]For those with tax expertise, what follows belabors the obvious. Think of it as outreach to rookies and foreign cross-trainers.

[7]Reg. § 301.7701-2(b)(1).

[8]*See* Reg. § 301.7701-3. Of course, an individual doing business alone, and not through an entity, conducts business as a sole proprietorship, but that is not normally thought of as a separate entity. Since it lacks any type of liability shield, it is also usually an unintelligent choice. Further, there are what might be called special-use entities that operate outside this universe. Examples include regulated investment companies, better known as RICs or mutual funds, and real estate investment trusts, better known as REITs. *See* I.R.C. §§ 851, 856.

[9]A less ubiquitous example is the business trust.

ship for federal tax purposes. These differences between state law classification of business entities and federal tax law classification of those entities prompt use of the somewhat awkward term "tax partnership." To the extent possible, I will avoid this awkward term. In general, when I refer to a partnership, I mean an entity treated as a partnership for federal tax purposes.

Tax classification of entities has a long, at times combative, and often tedious history.[10] The Service finally grew weary of the effort it had to expend on tax classification issues, and quite sensibly came out with the "Check the Box Regulations" in 1996, which dramatically simplified things.[11] An eligible, unincorporated state law entity generally may choose its status for federal tax purposes.[12] If the "eligible entity"[13] makes no election, it is disregarded for federal tax purposes if it has a single member (making it thus a "disregarded entity"),[14] and it is taxed as a partnership if it has two or more members.[15] Alternatively, the entity may "check the box," that is, elect to be taxed as a C corporation or, if it meets the qualifications, an S corporation.[16] It would be out of the ordinary for an entity to check the box to be taxed as a C corporation,[17] and somewhat unusual to check the box to be taxed as an S corporation, inducing some to say it makes more sense to call them the "Don't Check the Box" Regulations.[18]

[10] *See* Boris Bittker & James Eustice, Federal Income Taxation of Corporations and Shareholders, § 2.01-2.04 (2000) [hereinafter Bittker & Eustice].

[11] Simplification of Entity Classification Rules, 61 Fed. Reg. 66584 (Dec. 18, 1996) (to be codified at 26 C.F.R. pt. 1); Reg. § 301.7701-1 to -3.

[12] Reg. § 301.7701-3(a),-3(b)(1). There are a number of exceptions. Insurance companies, banks, entities owned by a state or a political subdivision of a state, and entities taxable as corporations under provisions of the Code other than section 7701(a)(3) are taxed as C corporations. *See* Reg. § 301.7701-2(b). My focus here is on state law, *i.e.* domestic entities. The rules are different for foreign entities. *See* Reg. §§ 301.7701-2(b)(8), -3(b)(2).

[13] An eligible entity is an entity that is *not* classified under the Regulations as a corporation. *See* Reg. 301.7701-3(a). Actual state law corporations are classified as corporations for federal income tax purposes. Other per se tax corporations include insurance companies and certain banks (though they typically also operate using a state law corporation). *See* Reg. § 301.7701-2(b).

[14] If the sole owner of the eligible entity is an individual, for tax purposes the entity is treated as a sole proprietorship. If the sole owner is a corporation, the entity is treated as a division or branch of the corporation. *See* Reg. § 301.7701-3(b).

[15] *Id.*

[16] Reg. § 301.7701-3(c).

[17] But it is not unheard of. Indeed, if one prefers to be a C corporation, it can make sense to form a state law LLC rather that a state law corporation and check the box. LLCs commonly have more modern "statutory architecture," meaning they are more flexible and have a lesser reporting burden than corporations. *See* Carter Bishop & Daniel Kleinberger, Limited Liability Companies: Tax and Business Law ¶ 1.02 [hereinafter Bishop & Kleinberger].

[18] *See, e.g.*, Limited Liability Company Handbook § 3 (Mark Sargent & Walter Schwidetzky eds., 2008).

B. *C Corporations*

C corporations are not beloved because they are subject to two levels of tax. The C corporation is subject to a tax on its income at the corporate level,[19] and when the C corporation pays dividends, the shareholders who receive them are taxed again, typically at a 15% rate.[20] A distribution is only a dividend to the extent of a C corporation's "earnings and profits."[21] Earnings and profits, to put it very roughly, are undistributed net earnings of a C corporation.[22] A contribution of property to the C corporation in exchange for stock is not taxable to the corporation under section 1032, but is a fully taxable exchange to the contributing shareholders unless the shareholders transferring the property have control of the corporation immediately after the transfer, defined, to oversimplify a bit, as 80% of the stock.[23] If a C corporation makes a nonliquidating distribution of assets to its shareholders, it must recognize any gain inherent in those assets at the corporate level, but is denied any such loss.[24] If it is a liquidating distribution, gains are recognized and losses may be recognized by the C corporation.[25] On liquidation, shareholders generally recognize a capital gain or loss based on the difference between the money and fair market value of what is received and the basis in their stock, again assuring two levels of tax. In either a nonliquidating or liquidating distribution, the recipient shareholder takes a fair market value basis in the distributed property.[26]

One might think that no one in his right mind would ever use a C corporation and indeed, most right-minded people do not. But there are exceptions, three of which deserve to be highlighted. Publicly traded entities normally are taxed as C corporations, so a business planning a public offering, especially

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[19] *See* I.R.C. § 11.

[20] *See* I.R.C. § 1(h)(11). If you want more detail, see BITTKER & EUSTICE, *supra* note 10, ¶ 8.01-8.05. A dividend received deduction is available to corporate shareholders under section 243.

[21] *See* I.R.C. §§ 301(c)(1), 316. Distributions in excess of earnings and profits generally recover basis and then are treated as gain from the sale of the underlying stock. *See* I.R.C. § 301(c)(1)-(2).

[22] Numerous special calculations apply. *See* BITTKER & EUSTICE, *supra* note 10, ¶ 8.03-9.04.

[23] I.R.C. §§ 351(a), 368(c). Specifically, the owners must own stock (previously held or received on the exchange) possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. I.R.C. § 368(c).

[24] I.R.C. §§ 301(d), 311. The gains increase earnings and profits. Reg. § 1.312-7(b)(1).

[25] *See* I.R.C. § 336(a). Losses inherent in distributed corporate assets may only be recognized on a liquidating distribution, and then there are limits. *See* I.R.C. § 336(d). The recipient shareholder takes a fair market value basis in the property received. I.R.C. § 334(a). Gain or loss is generally not recognized on the liquidation of a corporate subsidiary and the corporate shareholder takes a carryover basis in the assets. *See* I.R.C. §§ 332, 334(b).

[26] I.R.C. §§ 301(d), 334(a).

an immediate one, might form a C corporation from the outset.[27] It might also select an S corporation and then switch to C corporation status, as I discuss below. C corporations often are preferred in international transactions. Foreign countries may find it difficult to classify, and indeed may be completely flummoxed by, U.S. tax partnerships such as LLCs.[28] Further, and more importantly, many tax treaties that the U.S. has with foreign countries give preferential treatment to dividend payments, making the C corporation (the only entity capable of paying a dividend) a rational choice for a U.S. business's foreign activities.[29] The sometimes awkward operation of the U.S. branch profits tax also can make U.S. C corporation subsidiaries preferable for the U.S. business activities of many foreign corporations.[30] Finally, one might select a C corporation for an extra "run up" the tax brackets. Under section 11, the rates of tax on C corporation taxable income range from 15% on the first $50,000 and 25% on the next $25,000 up to 35% on income over $10 million.[31] The maximum individual income tax rate is 35% under section 1(i). A taxpayer whose marginal tax rate is 35% might be tempted to collect additional income in a C corporation to take advantage of the lower corporate rates, especially on taxable income up to $75,000. There are Code sections that would get in the way of serious abuse in this regard, including a flat tax rate of 35% for personal service corporations in section 11(b)(2), the accumulated earnings tax of section 531, and the personal holding company tax of section 541. But minor game playing, which in the aggregate may cost

[27]A publicly traded partnership is normally taxed as a C corporation, though there is an exception for publicly traded partnerships 90% or more of whose income is from certain passive sources. *See* I.R.C. § 7704.

[28]For the German take on limited liability companies, see generally Helmut Krabbe, *Steuerliche Einordnung der nach dem Recht der Bundesstaaten der USA gegründeten Limited Liability Company*, 10 INTERNATIONALE STEUERRECHT [ISTR] 351 (2004); Christiana Djanani, et al., *Die Einordnung der LLC nach innerstaatlichem deutschen und US-amerikanischen Steuerrecht*, 14 INTERNATIONALE STEUERRECHT [ISTR] 481 (2004).

[29]*See, e.g.*, Convention Between the United States and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, U.S.-F.R.G. art. 10(2), Aug. 29, 1989, 5 U.S.T. 2768. An outbound transaction is one in which a U.S. taxpayer invests outside the United States.

[30]The U.S. corporate subsidiaries are always C corporations as corporations and nonresident aliens cannot be shareholders of an S corporation. *See* I.R.C. § 1361(b). For a discussion of why a foreign corporation would prefer to operate with a U.S. corporate subsidiary rather than a branch, see generally Fred Brown, *Reforming the Branch Profits Tax to Advance Neutrality*, 25 VA. TAX REV. 1219 (2006).

[31]The rate goes to 34% for taxable income above $75,000 but not exceeding $10 million, and 35% for taxable income over $10 million. The benefit of the graduated rates below 34% are phased out for corporations with taxable income between $100,000 and $335,000, and the 34% rate is phased out for corporations with taxable income over $15 million. *See* I.R.C. § 11. Note that the application of section 199 can result in a lower effective tax rate. The tax rate on dividends paid to individuals is generally 15%. *See* I.R.C. § 1(h)(11).

the fisc dearly, is possible and is reported to take place.[32]

Lest I leave the novice reader with the impression that all C corporation users are stuck with a double tax, let me quickly add that this is far from necessarily the case. C corporations often seek to "zero out" their income by, among other things, paying deductible salaries to shareholder-employees, paying deductible interest to shareholder-creditors, and paying deductible rent to shareholder-landlords. Many a lawyer has become enriched doing battle in court over what counts as a reasonable salary, a reasonable amount of debt, or a reasonable amount of rent.[33] Further, the deductibility of interest when contrasted with the nondeductibility of dividends can encourage a C corporation to have an excessively debt-heavy financial structure.[34]

The relatively new tax rate on dividends of 15%[35] sometimes stands the corporate tax world on its head. Salary, interest income, and rents are all taxed at ordinary income rates of up to 35%. It can make more sense to pay a non-deductible dividend than, for example, a deductible salary to a shareholder-employee, especially for C corporations with low marginal income tax rates that have shareholders with high marginal rates. This change of pace is utterly counterintuitive to battle-hardened tax veterans.

C. *S Corporations*

S corporations were in many respects designed with the smaller business in mind, though there is no dollar limit on their size, and many are quite sizeable with numerous employees.[36] An S corporation is a pass-through entity. Generally, there is no corporate level tax. Instead, to recite the statutory litany, income, gain, loss, deduction, and credit of the S corporation flow through to, and are taken into account by, the shareholders, retaining the character they had at the corporate level.[37] Allocations of these items to the shareholders are based on shareholders' percentage of stock holdings.[38] An S corporation is subject to the Subchapter C rules for property contributions and distributions. Thus, a contribution of property to the S corporation in

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[32] *See* John W. Lee, *A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie But the Numbers Never Do,"* 78 TEX. L. REV. 995 (1999).

[33] *See* BITTKER & EUSTICE, *supra* note 10, ¶ 8.05.

[34] *See* I.R.C. § 163(a); *see generally*, U.S. DEPARTMENT OF TREASURY, OFFICE OF TAX POLICY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY (Dec. 20, 2007). In one of the more hilarious chapters of tax history (yes, it is possible for tax to be funny), Congress in 1969 enacted section 385, authorizing the Service to issue regulations defining debt and equity. The Service tried early on, got shot down, and has not worked up the nerve to try again since. Some 40 years have gone by since the enactment of section 385, and we are still waiting for the regulations (not that many tax advisors want the Service to work up that nerve). *See* James Eustice, *'Debt-Like' Equity & 'Equity-Like' Debt: Treasury's Anti-Hybrid Proposals*, 71 TAX NOTES (TA) 1657, 1657 (June 17, 1996).

[35] *See* Jobs and Growth Tax Relief Act of 2003, Pub. L. No. 08-27, 117 Stat. 752 (2003).

[36] *See* BITTKER & EUSTICE, *supra* note 10, ¶ 6.01.

[37] *See* I.R.C. § 1366.

[38] I.R.C. § 1377(a).

exchange for stock only goes untaxed if the contributors meet the 80% control test of section 351(a) immediately after the contribution.[39] Further, the S corporation recognizes gain (which normally goes untaxed at the corporate level and flows through to shareholders along with other corporate income) when it distributes appreciated property to shareholders.[40] Losses inherent in distributed property may only be recognized in a liquidating distribution, and then limitations apply.[41]

Generally, a shareholder's share of the S corporation's income increases her basis in her stock, and losses and distributions reduce that basis.[42] Losses may only be deducted to the extent of the stock basis and any basis in debt the corporation owes the shareholder.[43] Unused losses may be carried forward indefinitely.[44] Distributions generally are not taxable to the shareholder unless the amount of money and fair market value of property distributed exceed the shareholder's stock basis. The excess is viewed as gain from the sale of the stock.[45]

This rather pleasant state of affairs changes if the S corporation has previously been a C corporation or been combined on a tax favored basis (*i.e.* without being fully taxed) with a C corporation. As long as it meets the qualification requirements, there are no restrictions on a C corporation becoming an S corporation. Further, the reorganization rules of section 368 apply to S corporations. Thus, for example, it is possible for a C corporation to merge tax free into an S corporation.[46]

An S corporation does not ordinarily pay dividends. That is the province of C corporations. Only a C corporation can generate earnings and profits.[47] An S corporation can, however, inherit the earnings and profits of a C corporation if it was once a C corporation or if a C corporation merged into it.[48] If an S corporation has earnings and profits, it is possible for the S corporation to distribute a dividend which, like any dividend, is income to the recipient shareholder (and that thus does not fall under the distribution rules described above). To simplify a bit, an S corporation generally is considered to first make distribution of its own net earnings. Distributions in excess of its own net earnings generally come out of the earnings and profits, and thus constitute dividends and income to the shareholders, until the earnings and profits are eliminated.[49] Dividends do not affect shareholders' stock bases.[50]

[39] I.R.C. §§ 351(a), 368(c); *see supra* text accompanying notes 22–25.
[40] I.R.C. § 311(b).
[41] *See* I.R.C. § 336.
[42] I.R.C. § 1367.
[43] I.R.C. § 1366(d)(1).
[44] I.R.C. § 1366(d)(2).
[45] I.R.C. § 1368.
[46] *See* I.R.C. § 368(a)(1)(A).
[47] *See supra* text accompanying notes 19–22.
[48] *See* I.R.C. § 381(a).
[49] *See* I.R.C. § 1368(c).
[50] *See* I.R.C. § 301(c).

Section 1374 applies a corporate level tax on the S corporation at the highest C corporation tax rate when the gains from certain assets are recognized. Covered assets are those held by the C corporation at the time it makes an S election or those that find their way from a C corporation into an S corporation on a tax favored basis, such as through a merger.[51] Section 1374 ceases to apply ten years after the C corporation makes the S election or after an asset finds its tax favored way into S corporation solution.[52] Additionally, section 1375 applies a corporate level tax at the highest C corporation tax rate to "excess net passive income"[53] if the S corporation has earnings and profits.[54] Passive income is income from sources such as dividends and royalties.[55] Generally, net passive income is gross passive income minus expenses to earn it and excess net passive income is net passive income in excess of 25% of gross receipts. In sections 1374 and 1375, Congress is clearly trying to preserve the double taxation attributable to the erstwhile C corporation.

The rules governing qualification as an S corporation also can present problems. These rules have been dramatically liberalized over the years, in part to make the S corporation more competitive with partnerships, but still provide very real limits on the use of S corporations. An S corporation may not have more than 100 shareholders[56] (as recently as 1995 it was 35 shareholders,[57] and in the early days it was ten shareholders[58]), and may not have more than

[51] *See* I.R.C. §§ 368(a)(1)(A), 1374(a), and 381(a); *see also* Reg. § 1.1374-1(e).

[52] Further, the maximum gain subject to the section 1374 tax cannot exceed the net gain inherent in the C corporation assets at the time of the S election or at the time of the tax-favored transfer to the S corporation. The gain recognized under section 1374 on any individual asset cannot exceed the net gain inherent in it at either of those times.

[53] Essentially, passive investment income less the expenses to earn that income. *See* I.R.C. § 1375(b)(2).

[54] Distributions deemed to come out of earnings and profits are taxable dividends to the recipient shareholders. I.R.C. § 1368(c)(2).

[55] *See* I.R.C. §§ 1375(b)(3), 1362(d)(3).

[56] Actually, as members of a family can be treated as one shareholder, an S corporation can have thousands of shareholders, albeit ones that are related. *See* I.R.C. § 1361(c)(1)(A)(ii).

[57] I.R.C. § 1361(b)(1)(A) (1995).

[58] See I.R.C. § 1371(a) (1958).

one class of stock (though differences in voting rights are allowed).[59] There are rules for who may and who may not be S corporation shareholders. The "may not" group includes nonresident aliens, financial institutions that use the reserve method of accounting contained in section 585 (applies to many banks), insurance companies, corporations electing under section 936 (which allows credits for certain income from Puerto Rico), and Domestic International Sale Corporations (now something of an antique, as they have been held to violate the General Agreement on Tariffs and Trade).[60] The "may" group is limited to individuals, their estates, certain trusts (in general, voting trusts and trusts which are family oriented), qualified pension trusts, and section 510(c)(3) charitable organizations. Note that corporations (C or S) are not on the allowed list of shareholders, so generally a corporation may not own stock in an S corporation. There is one limited exception: an S corporation may own a qualified Subchapter S corporate subsidiary (QSSS), have the benefit of the subsidiary's liability shield for state law purposes, but have the subsidiary ignored for tax purposes, with all income and expenses flowing through to the parent.[61] It often makes more sense, though, for the S corporation to use a wholly owned LLC, as there are fewer qualification requirements. There is no restriction the other way around, and an S corporation may own stock in a C corporation.

S corporations that once tangoed with C corporations have to be watch-

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[59] I.R.C. § 1361(b)(1), (2). A husband and wife and family members can be treated as one shareholder. *See* I.R.C. § 1361(c)(1)(A), (B). Often it is not clear why certain of the limitations on the use of S corporations were chosen. With regard to the one class of stock rule, however, there is a hint in the legislative history in this regard. The original drafters of subchapter S may have been concerned that the issuance of a class of preferred stock might have made it difficult to tax current earnings to shareholders. They may also have questioned how to tax dividends on preferred stock. See S. Rep. No. 83-1622, at 4667 (1954), which briefly discusses the complexities of having dividends on preferred stock in the context of a proposed bill that foreshadowed subchapter S. As the use of the S corporation accumulated adjustment account and the proposed S Corporation Reform Act of 1995 demonstrate, these problems are solvable. *See* I.R.C. § 1368(c)(1), (e)(1); *see also* James Eustice & Joel Kuntz, Federal Income Taxation of S Corporations ¶ 7.06 [hereinafter Eustice & Kuntz]; Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 Tax L. Rev. 105, 141–43 (1991).

As with all corporations that borrow funds from their shareholders, there is a risk that this debt could be classified as equity, and thereby perhaps constitute the prohibited second class of stock. *See* Bittker & Eustice, *supra* note 10, ¶ 4.02. Section 1361(c)(5) provides some relief in this regard, providing that irrespective of the debt to equity ratio, "straight debt" will not be reclassified as equity. To qualify as straight debt, the debt must be payable on demand or at a date certain, generally the interest rate must not be contingent, the debt must not be convertible, and the creditor must be an individual, an estate, a trust that qualifies as an S corporation shareholder, or a commercial lender. *See* I.R.C. § 1651(c)(5)(B).

[60] I.R.C. § 1361(b)(1)(C), (b)(2); *see also* Tax Understanding, Dec. 7–8, 1981, GATT B.I.S.D. 28S/114.

[61] I.R.C. § 1361(b)(3). Note that since an S corporation can own stock in other corporations, it can be part of an "affiliated group" (though outside of the QSSS rules, a corporation may still not be a shareholder). This was once prohibited. *See* Eustice & Kuntz, *supra* note 59, ¶ 3.06.

ful, but otherwise life is pretty good, or at least so it seems until the taxpayer learns of the advantages of Subchapter K. The grass is always greener. As I will discuss next, generally partnerships offer a still better tax deal than S corporations, but there are situations when S corporations have the upper hand. I will address these advantages after the partnership discussion.

D. *Partnerships*

Partnerships are also not subject to an entity level tax. Items of income, gain, loss, deduction, and credit flow through to, and are taken into account by, the partners, retaining the character they have at the partnership level.[62] Taxable income increases a partner's basis in his partnership interest; deductible loss reduces that basis.[63] A partner may not deduct losses in excess of this "outside basis," though unused losses may be carried forward indefinitely.[64] Other pertinent details of partnership taxation follow.

Complexity is a large problem in the partnership tax arena. The partnership tax regime need not make the life of a given taxpayer complex, but it often does. As is not uncommon with tax law, there is tension between complexity and precision on the one hand, and administerability and taxpayer compliance on the other hand. Further, in a preview of things to come, that complexity can lead to abuses, in which case there can be complexity and imprecision, not the best of both worlds.[65]

III. Advantages and Disadvantages of Partnerships and S Corporations

A. *Advantages of Partnerships over S Corporations*

Most tax professionals will affirm that on balance a partnership is, from a federal income tax perspective, superior to an S corporation. I now review the advantages. I intersperse a few S corporation advantages in this discussion when they are directly related to the partnership advantage for easier and more efficient understanding. These interspersed S corporation advantages are rarely, if ever, important enough to cause one to prefer an S corporation to a partnership. Those S corporation advantages that can make it the preferable vehicle I discuss separately below.

1. *Contributions and Distributions*

Tax-free contributions of property are more readily achieved using the partnership form. Normally, no gain or loss is recognized on a contribution of property to a partnership in exchange for a partnership interest.[66] There is no 80% threshold as there is with corporations, in fact there is no threshold at all.

[62] I.R.C. § 702.
[63] I.R.C. § 705.
[64] I.R.C. § 704(d).
[65] For an example of an abuse in this context, see Regulation section 1.701-2(d), ex. 9.
[66] I.R.C. § 721(a).

If a partner makes a contribution of property to a partnership, under section 704(c)(1)(A), any gain or loss inherent in the property on contribution is taxed to the contributing partner when the partnership disposes of the property.[67] There is no analogy to section 704(c)(1)(A) in Subchapter S. Though a shareholder may make a tax-free contribution of property to an S corporation under section 351(a), upon disposition of that property, any inherent gain or loss is allocated to all of the shareholders based on their stock holdings.[68] Thus, a shareholder contributing appreciated property could, on a disposition of the property by the S corporation, effectively shift a portion of the gain to other shareholders.[69] As a consequence of that gain, the other shareholders could see their stock bases increase to an amount in excess of the fair market value of their stock. The other shareholders might not be able to take advantage of the loss inherent in the stock until the stock is sold, which could be well into the future. Further, the shareholders' recognized loss on the stock normally is a capital loss whereas the gain on the sale of the contributed property may be ordinary income, resulting in a character distortion in addition to a timing distortion. Finally, adding insult to injury, if a shareholder with a loss in his stock dies before disposing of the stock, he takes his loss with him.[70] The loss disappears because his heirs take a fair market value basis in the stock under section 1014.

The lack of an S corporation equivalent to section 704(c)(1)(A) can work to the benefit of shareholders who contribute appreciated property because the pre-acquisition gain is shifted to others, and to the disadvantage of shareholders who contribute money. The converse is the case if depreciated property is contributed. However, well-informed parties dealing at arm's length factor this issue into the allocations of stock to the shareholders. In a family context, where the parties are not dealing at arm's length, the lack of a section 704(c)(1)(A) analog may permit some income shifting amongst the shareholders. This can happen in a nonfamily context as well, where the shareholders to whom the gain is shifted have offsetting net operating loss carryforwards or are tax exempt. It seems unlikely, however, that given the other advantages of Subchapter K, that the lack of a section 704(c)(1)(A) analog drives many, if any, choice of entity decisions.[71]

In contrast to an S corporation, generally no gain or loss is recognized

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[67] There is a whole lot more to it than that. For example, tax depreciation generated by the property is allocated to the other partners to the extent of their shares of "book depreciation." Further, because section 704(c)(1)(A) by its terms can work imperfectly, Regulation section 1.704-3 provides three methods for applying it, the traditional method, the traditional method with curative allocations, and the remedial method.

[68] I.R.C. § 1366(a).

[69] The converse is the case if the property has an inherent, recognizable loss, but in that event the shareholder is more likely to sell the property and contribute the resulting cash.

[70] As the heirs generally take a fair market value basis as of the date of death under section 1014, the loss is effectively eliminated. *See* I.R.C. § 1014.

[71] Section 1366(e) limits some abuse in the S corporation context. The partnership rule has a sounder tax and economic foundation.

when a partnership distributes property to its partners.[72] Normally the recipient partner takes a carryover basis in the distributed property.[73] Obviously, the partnership rules are normally more favorable to taxpayers than the S corporation rules. Further, the tax cost of withdrawing property from an S corporation is often too high to justify the distribution. Current law prevents many S corporations from liquidating and converting to other forms of business enterprise, even if they would otherwise prefer to.

Sections 707(a)(2)(b), 704(c)(1)(B) and 737 contain complex rules designed to prevent taxpayers from using the tax-free contribution and distribution rules for partnerships to disguise what is in substance a taxable sale or exchange.[74] There is no analog in the S corporation provisions. Of course, in an S corporation it is more difficult to make a tax-free contribution, and any gain inherent in distributed property is recognized on distribution.[75] These disadvantages make a comparable anti-abuse rule for S corporations less necessary.

2. *Allocations*

A partnership is allowed to make "special allocations" to its partners. For example, someone who is otherwise a 50% partner can be allocated 90% of

[72]I.R.C. § 731(a).

[73]I.R.C. § 732(a)(1). However, that basis can never exceed the recipient partner's basis in his or her partnership interest. I.R.C. § 732(a)(2).

[74]Section 707(a)(2)(B) was Congress's first pass at this area. It addresses the situation in which there is a direct or indirect transfer of money or property by a partner to a partnership and a related direct or indirect transfer of money or other property by the partnership to the partner. If the facts indicate that the transfers are in substance a sale or exchange, that is how they are treated (and not as a nontaxable contribution and distribution under sections 721 and 731). The Regulations provide a presumption that if the exchanges take place within two years of one another, there is a rebuttable presumption that they are related, subject to some exceptions. Reg. § 1.707-3(c)(1).

Section 704(c)(1)(B) of the Code provides that if a partner contributed property to a partnership and that property is distributed to another partner within seven years of the contribution, the contributing partner recognizes any gain or loss from the sale of the property. The gain or loss recognized is the amount that would have been recognized under section 704(c)(1)(A) if the property had been sold at its fair market value at the time of the distribution.

Section 737 of the Code provides that if a partner contributes appreciated property to a partnership, and other property is distributed to the contributing partner within seven years, the contributing partner recognizes gain to the extent of the lesser of the amount by which the fair market value of the distributed property exceeds the partner's basis in his or her partnership interest or the net precontribution gain. The net precontribution gain is defined as the gain that would have been recognized under section 704(c)(1)(B) if the contributed property had been distributed to another partner within seven years of the contribution.

Note that section 707(a)(2)(B) does not automatically apply, whereas sections 704(c)(1)(B) and 737 do. If it does apply, section 707(a)(2)(B) makes the transaction fully taxable. That is not necessarily the case with the other two code sections.

[75]*See supra* text accompanying notes 38–40.

the depreciation deductions.[76] In an S corporation, all allocations of income, loss or deductions, must be based on the shareholders' stock holdings.[77] Under certain circumstances, an S corporation can effectively vary that allocation. It can pay a shareholder-employee a larger salary in a given year. A deserving shareholder-employee can be given an option to buy stock that can be exercised to increase corporate ownership, and thereby increase income and loss allocations.[78] While these substitute methods can be helpful, they are just that, substitute methods, and do not offer the flexibility of the special allocations rules available to the partnership form.

3. *Entity Debt*

Under section 752, an increase in a partner's share of partnership liabilities is treated as though the partner contributed money to the partnership to the extent of her share of partnership liabilities.[79] Like any other contribution, these amounts increase the partner's basis in her partnership interest.[80] It is difficult to overstate the value of being able to increase outside basis with partnership debt. A partner is allowed to deduct her share of partnership losses to the extent of that basis.[81]

In all but one of the circuits that have examined the issue, debt incurred by an S corporation does not increase the shareholders' stock bases, even if the shareholders' guarantee the debt and the creditors view the shareholders

[76]In order for a special allocation to be allowed, under the safe harbor it must have "substantial economic effect." I.R.C. § 704(b). The substantial economic effect test has two parts, the "economic effect test" and the "substantiality test." Reg. § 1.704-1(b)(vii)(2).

In order for the economic effect test to be met, partners' capital accounts must be maintained in accordance with certain rules. The capital accounts must be increased for the fair market value of contributed property (net of associated debt), money contributed, and allocable partnership income. The capital accounts must be decreased for the fair market value of distributed property, money distributed, and partnership losses. Reg. § 1.704-1(b)(2)(iv)(b). The other requirements of the economic effect test are that a partner must be paid the balance of her capital account on liquidation of her interest, and if a partner has a deficit capital account, she must restore it on liquidation of that interest. Reg. § 1.704-1(b)(2)(ii). Under an alternative safe harbor, an allocation is allowed even if a partner does not have a deficit restoration obligation, provided, inter alia, the allocation does not cause or increase a deficit account balance. These are sometimes known as the qualified income offset or "QIO" rules. *See* Reg. § 1.704-1(b)(2)(ii)(d).

The substantiality test requires that the economic effect of an allocation of a partner be "real." For example, if a partner is allocated a loss, on a present value, after tax basis, his position must be diminished and that of the other partners must be enhanced. If this does not occur, the economic effect of the allocation is not substantial. Reg. § 1.704-1(b)(2)(iii).

[77]I.R.C. § 1366(a).

[78]This option should not violate the one-class-of-stock rule. Reg. § 1.1361-1(l)(4)(iii)(B)(2).

[79]Similarly, a decrease in a partner's share of partnership liabilities is treated as a distribution of money. I.R.C. § 752(b).

[80]I.R.C. § 705(a)(1).

[81]Subject to the loss limitation provisions of Code sections 465 and 469.

as the primary payors.[82] A shareholder of an S corporation can only deduct losses to the extent of the basis in the stock plus the basis of any loans by the shareholder to the corporation.[83] A shareholder's inability to include an appropriate share of corporate debt in stock basis can thus be troublesome. To avoid the impact of this rule, a shareholder can borrow the funds directly and then loan or contribute the funds to the corporation, thereby receiving an increased stock or debt basis, against which losses can be deducted. Not all shareholders are well enough advised to know to borrow the funds directly. Further, when the debt is secured, loaning the funds via a shareholder is often awkward. Who would own the secured property, the corporation or the shareholder? If the corporation, why would the corporation provide security for a loan to a shareholder? Is the provision of security a distribution to the shareholder? If the shareholder owns the security, is it property the corporation needs? Would it have to be rented to the corporation? Is adequate liability insurance available to protect the corporation and the shareholder against mishaps while the corporation uses the property? What if an S corporation (especially one with numerous shareholders) wants to buy a property subject to debt? Is it practical to have the shareholders buy the property, contribute it to the corporation, but stay primarily liable on the debt? What if the debt secured by the property is nonrecourse and therefore it is not possible for the shareholders contributing the property to remain liable on the debt? Finally, lenders often prefer to have the primary obligor be the primary debtor. These types of considerations often mean that the parties cannot avoid a loan being made directly to the corporation.

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[82]Grojean v. Commissioner, 248 F.3d 572 (7th Cir. 2001); Uri v. Commissioner, 949 F.2d 371 (10th Cir. 1991); Harris v. United States, 902 F.2d 439 (5th Cir. 1990); Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); Estate of Leavitt v. Commissioner, 90 T.C. 206 (1988), *aff'd*, 875 F.2d 420 (4th Cir. 1989). *Contra* Selfe v. United States, 778 F.2d 769 (11th Cir. 1985). The court in *Selfe* held that debt-equity principles developed under subchapter C of the Code could be used in determining whether a corporate debt guaranteed by a shareholder could be characterized as a capital contribution. The case involved somewhat unusual facts in that the loan was originally made to the taxpayer and then converted to corporate loans when the taxpayer incorporated her business. The Eleventh Circuit ruled against the taxpayer in *Sleiman v. Commissioner*, 187 F.3d 1352 (11th Cir. 1999), which involved more traditional facts (original loan to corporation, guaranteed by shareholders). The *Sleiman* court did not overrule *Selfe*, however, and indeed seem to confirm its holding.

For an example of how sloppy paperwork can be fatal see *Bolding v. Commissioner*, 70 T.C.M. (CCH) 110, 1995 T.C.M. (RIA) ¶ 95,326 (A shareholder obtained a line of credit from a bank. Funds were disbursed from the line of credit directly to the S corporation at the shareholder's direction. The Court held that the funds did not constitute a contribution to the equity of the corporation because, based on the taxpayer's testimony, the funds were included on the corporation's balance sheet as "Loans from Shareholders." The Tax Court, however, did not treat the funds as an indebtedness of the corporation to the shareholder either, because the court could not determine that the funds borrowed from the bank constituted part of the balance of the "Loans from Shareholders." The loans from the shareholder were not evidenced by promissory notes or clear book entries.).

[83]I.R.C. § 1366(d).

4. *Section 754 Election*

Another substantial advantage of the partnership over the S corporation is the availability of the "section 754 election." Among the times a section 754 election can be useful is when a partnership interest is purchased or inherited. If an election is made, the "inside basis" of the purchasing or inheriting partner's share of partnership assets is increased or decreased to equal the outside basis of that partner's partnership interest.[84] If the inside basis of a partner's share of partnership assets is "stepped up" as a result of the election, when the relevant assets of the partnership are sold, the purchasing or inheriting partner does not recognize gain to the extent of pre-acquisition appreciation. The partner also is able to use the higher inside basis for computing depreciation and other relevant deductions.[85] What is good for the goose is good for the gander, and a section 754 election can result in a downward adjustment if, at the time the purchasing or inheriting partner acquires an interest, the assets of the partnership have a fair market value that is less than their bases.[86] If a partnership has partners regularly coming and going, section 754 elections can become a major accounting headache, though the computer age has reduced the pain.

Generally, a section 754 election is just that, an election. Logically, one would make the election if it means an upward adjustment and not make it if it means a downward adjustment. Life is sometimes that good, but often is not. Once an election is made, it cannot be undone without the consent of the Service.[87] If the partnership makes the election when a partnership interest is purchased when the good times are rolling, it is most likely stuck with it if a partnership interest is again purchased when the good times are no longer rolling. The Service will not permit an election to be revoked merely to avoid a downward adjustment.[88] Further, a downward adjustment is mandatory if, at the time of the transfer of the partnership interest, the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property.[89]

Comparable adjustments to inside partnership bases are also possible when a partner recognizes a gain or loss on a partnership distribution to him. Again, a downward adjustment can be required in some cases where a loss is recognized.[90]

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[84] I am putting in very simple terms rules that are highly complex. *See* I.R.C. §§ 743, 754, 755; Reg. §§ 1.743-1(b)-(d), 1.755-1.

[85] Reg. § 1.743-1(b)-(d), (j).

[86] *See id.*

[87] Reg. § 1.754-1(c).

[88] Permission may be given if there has been a substantial change in the nature of the partnerships business, a substantial increase in the assets of the partnership, a change in the character of the partnership assets, or an increased frequency of retirements or shifts of partnership interests. *See* Reg. § 1.754-1(c).

[89] I.R.C. § 743(d).

[90] I.R.C. §§ 734(b), 754, 755; Reg. § 1.743(b), (c).

A section 754 election in many respects permits greater accuracy. When a taxpayer purchases an interest in an entity, he is ultimately looking at the value of the assets in that entity to determine what he should pay. Especially for a pass-through entity, being able to harmonize inside and outside basis ensures that the tax consequences of the investment mostly closely match the economics of the investment. For example, if the partner buys the partnership interest when a given partnership asset is worth $100, and the partnership sells the asset for $100, the partner has no economic gain or loss. Without a section 754 election, however, the partner may be allocated *tax* gain or loss if the partnership's basis in that asset is other than $100. For this reason, among others, there have been suggestions that section 754 elections be made mandatory across the board.[91] Mandatory elections have been resisted in part because of the greater complexity they add to the system, but may gain new momentum if Subchapter S is repealed, permitting greater attention to be focused on Subchapter K.

For all of its complexity, most tax advisors agree that the existence of the section 754 election is a good thing, at least for their clients. No analog to the section 754 election exists for an S corporation. Thus, upon buying or inheriting stock in an S corporation, the stockholder takes a basis in the stock equal to its fair market value as of the date of purchase or the decedent's date of death.[92] He cannot adjust the inside basis of the S corporation's assets to equal the possibly higher outside basis of the corporate stock. Upon a sale of appreciated corporate assets, the shareholder is taxed on a proportionate share of the income, notwithstanding the fact that this income might increase the basis of his stock in excess of its fair market value. The shareholder might not be able to take advantage of the loss inherent in the stock until the stock is sold, which could be well into the future. Further, the shareholder's recognized loss on the stock normally is a capital loss whereas the gain on the sale of the relevant property may be ordinary income, resulting in a character distortion in addition to a timing distortion. Finally, if a shareholder dies before disposing of the stock, he takes his losses with him. The loss disappears because his heirs take a fair market value basis in the stock under section 1014.

5. *Compensation for Services*

Often some owners contribute the capital necessary to start the business, while others perform the services that will hopefully make the business successful. How should the service owners be compensated? Partners can hold two different types of partnership interests: A capital interest, entitling the recipient to an interest in the underlying capital of the partnership, or a profits interest,

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[91] *See* GEORGE K. YIN & DAVID J. SHAKOW, TAXATION OF PRIVATE BUSINESS ENTERPRISES 371–77 (1999) [hereinafter ALI Report]; Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2003, S. 1072, 108th Cong. § 5683 (2003); Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 469 (2004).

[92] I.R.C. §§ 1012, 1014(a). In the case of inherited stock, the valuation date can sometimes be later than the date of death. *See* I.R.C. § 1014(a).

entitling the recipient to share only in future profits of the partnership. The two types of interest are typically taxed differently. The fair market value of a capital interest given in exchange for services is taxable to the recipient.[93] Rarely, however, is a capital interest exchanged for services, because, in effect, the "money partners" would be giving a share of their contributions to the service partner. It is more common for a service provider to receive a profits interest. Currently, in most circumstances, a profits interest is not taxable on receipt.[94] I say currently, because the Service has proposed, and may soon finalize, regulations that at least technically will change this result.[95] These Proposed Regulations provide that any partnership interest, profits or capital, is property.[96] Outside the partnership context, it is long established law that the fair market value of property received in exchange for services is ordinary income, and the Proposed Regulations seek to implement this rule fully in the partnership context.[97] Under most circumstances, however, the Proposed Regulations allow a partnership interest to be valued at its liquidation value.[98] If a true future profits interest is involved, its liquidation value is commonly zero as the future profits have not yet been earned and cannot reliably be predicted. Thus, while there is a lot of smoke, there is often not going to be much fire. A service partner usually incurs no income on receipt of a profits interest now, and will also usually incur no income if the Proposed Regulations are finalized. Of course, when the partnership earns profits, the partner holding a profits interest includes his distributive share of those partnership profits in

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[93] I.R.C. § 83(a); Reg. § 1.721-1(b)(1). Under section 83(a), the incidence of income is deferred if the partnership interest is subject to a substantial risk of forfeiture.

[94] Rev. Proc. 1993-27, 1993-2 C.B. 343. If a person, acting as a partner or in anticipation of becoming a partner, provides services to or for the benefit of the partnership and receives a profit interest in return, the Service will not treat this transaction as taxable provided:

1. the interest does not relate to a predictable stream of income;
2. the partner does not dispose of the interest within two years; or
3. the interest is not of a "publicly traded" limited partnership.

[95] *See* Prop. Reg. § 1.83-3(l), 70 Fed. Reg. 29,675 (2005).

[96] *See id.*

[97] *See* I.R.C. § 83(a); Prop. Reg. § 1.83-3(e), 70 Fed. Reg. 29,675 (2005) (explicitly providing that "property" includes a partnership interest); Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955); Int'l Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943); *see also* New York State Bar Association Tax Section, *Proposed Regs and Rev. Proc. on Partnership Equity Transferred in Connection with the Performance of Services*, 109 TAX NOTES (TA) 1311 (2005); Marty McMahon, *Recognition of Gain by a Partnership Issuing an Equity Interest for Services: The Proposed Regulations Get it Wrong*, 109 TAX NOTES (TA) 1161 (2005).

[98] See Proposed Regulation section 1.83-3(l), 70 Fed. Reg. 29,675 (2005), which provides for a safe harbor for when liquidation value may be used, and the related Proposed Revenue Procedure in Notice 2005-43, 2005-24 I.R.B. 1221. The Proposed Revenue Procedure provides that the safe harbor may be used when the partnership interest (including a profits interest) received is *not* (1) related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (2) transferred in anticipation of a subsequent disposition, or (3) an interest in a publicly traded partnership within the meaning of section 7704(b). *See* Notice 2005-43, 2005-24 I.R.B. 1221. These are very similar to the rules of Revenue Procedure 1993-27, 1993-24 I.R.B. 63.

income under section 702.

While this Article is not the place to engage fully the "carried interest debate," it should be noted that this advantage of partnerships has at times engendered controversy. The service provider usually has the same ordinary income tax consequence in the partnership context that she has outside the partnership context.[99] The service provider receiving nonpartnership property for services has ordinary income equal to the fair market value of the property received. The profits earned and allocated to the service provider-partner are also ordinary income—well there is the rub; that is usually the case, but not always. If the service provider is running a private equity fund, and the profits generated by the fund are from the sale of, say, capital assets held for over one year, the fund's profits consist of long term capital gains taxed at a 15% rate rather than ordinary income taxed at (maximally) a 35% rate.[100] The fact that fund managers may be compensated for their services with 15% rather than 35% dollars has caused more than a little consternation in Congress, and the House passed a bill that would have changed this outcome, though it was never ultimately enacted.[101] Whatever the result of the carried interest debate, the underlying rule for profits interest is unlikely to be changed dramatically outside the private equity fund arena, and indeed it is not readily changeable. The uncertainty of future profits usually means a future profits interest is valued at zero.[102] Thus, overall, this advantage for partnerships likely has a bright future.

In the S corporation universe, on the other hand, there is only one type of ownership interest that can be given a service provider: stock.[103] The fair market value of an unrestricted stock interest is income to the recipient, no

[99] The timing of when the ordinary income is recognized can, however, be very different.

[100] *See* I.R.C. § 1.

[101] To Amend the Internal Revenue Code of 1986 to Extend Certain Expiring Provisions, and for other Purposes, H.R. 3996, 110th Cong. (2007); *see* Chris Sanchirico, *Taxing Carry: The Problematic Analogy to "Sweat Equity,"* 117 TAX NOTES (TA) 239 (2007); Michael L. Schler, *Taxing Partnership Profits Interests as Compensation Income*, 119 TAX NOTES (TA) 829 (2008); Michael S. Knoll, *The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income*, 50 WM. & MARY L. REV. 115, 117–18 (2008); Henry Ordower, *Demystifying Hedge Funds: A Design Primer*, 7 U.C. DAVIS BUS. L.J. 323 (2007); David A. Weisbach, *Professor Says Carried Interest Legislation Is Misguided*, 2007 TAX NOTES TODAY 505 (2007).

For earlier but still relevant articles see Mark P. Gergen, *Reforming Subchapter K: Compensating Service Partners*, 48 TAX L. REV. 69 (1992) (in which Professor Gergen recommends treating the compensatory allocations to a partner as ordinary salary income). For a trio of related articles discussing this issue (the latter two commenting on the first and adding their perspective) see Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247 (1992); W. Lesse Castleberry, *Commentary:* Campbell–*A Simpler Solution*, 47 TAX L. REV. 277 (1992); and Leo L. Schmolka, *Commentary Taxing Partnership Interests Exchanged for Services: Let* Diamond/Campbell *Quietly Die*, 47 TAX L. REV. 287 (1992).

[102] *See* St. John v. United States, 84-1 U.S.T.C ¶ 9158, 53 A.F.T.R.2d 84-718, 84-721 (C.D. Ill. 1983).

[103] *See* I.R.C. § 1361(b)(1); *see also* Reg. § 1361-1.

ifs, ands, or buts about it.[104] Note that the S corporation service provider is given the equivalent of a partnership capital interest. If the S corporation is liquidated the day after the service provider is given an unrestricted stock interest, she receives a share of the S corporation's assets, even if they were contributed by others. Thus, the unrestricted stock received always has current value, something that is not necessarily the case for a partnership profits interest.

B. *Advantages of S Corporations over Partnerships*

1. *Background*

Before beginning this discussion, I should mention an advantage that S corporations once had, but no longer do. Indeed, this advantage was so significant, it might have alone justified keeping Subchapter S alive. Before the advent of LLCs, S corporations were a good solution for the "Mom and Pop" business. Pre-LLCs, the only way to give the business a liability shield and the benefits of partnership taxation was to form a limited partnership with a corporate general partner. Mom and Pop could have been the limited partners as well as the officers and directors of the corporate general partners. But, this meant that Mom and Pop had to manage two entities, and be careful not to engage in management activities when they had their limited partner hat on; doing otherwise could lead to personal liability.[105] Mom and Pop usually could not be trusted to keep things straight so many advisors put them in an S corporation. It was a second best, but safer choice.[106] But now Mom and Pop can use an LLC and have the benefits of partnership taxation, while operating out of a single entity that in most states is less burdensome to keep straight than a corporation.[107] Further, in these closely held entities, the complexities of Subchapter K are mostly held in abeyance, so that the LLC also is a fairly simple entity for tax purposes.[108]

Numerous changes have been made to Subchapter S to make it more appealing. As I noted above, it may now have up to 100 shareholders. Section 501(c)(3) organizations, pension plans, and family trusts may now be shareholders. An S corporation can own a QSSS and own stock in C corporations.[109] But few are benefitted by these changes. Over 88% of S corporations

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[104] I.R.C. § 83(a) (stating that the incidence of income is deferred in the stock interest subject to a substantial risk of forfeiture).

[105] In the interim, the rules for limited partner participation have been liberalized in many states. *See* Unif. Ltd. P'ship Act § 303 (2001).

[106] *See* BISHOP & KLEINBERGER, *supra* note 17, ¶ 1.01.

[107] See BISHOP & KLEINBERGER, *supra* note 17 , ¶ 3.08.

[108] For example, special allocations may not be needed and section 754 elections are likely rare. *See supra* text accompanying notes 73–78, 84–92.

[109] *See supra* text accompanying notes 56–61.

have two or fewer shareholders, almost always individuals.[110] These changes thus benefit a small number of S corporations. The 100 shareholder rule is primarily valuable in S corporations where trusts own stock and an extended family is the beneficiary of the trusts.[111]

The advantages of partnerships, in contrast, benefit the "everyday" LLC as well as the sophisticated model. Members of everyday LLCs make contributions of property to the LLC and receive distributions from it. These transactions are normally tax free under sections 721 and 731. While perhaps not a majority, a large number of LLCs make special allocations of income and loss to its members. Most entities, including everyday LLCs, have debt. Only in a partnership-type vehicle, such as an LLC, is section 752(a) available to permit owner-level bases to be increased by entity-level debt. Sales of ownership interests are common for all types of businesses, and owners of even the smallest business cannot avoid the grim reaper. Yet only a person buying or inheriting a partnership interest can receive an inside basis adjustment if an election under section 754 is in effect. Further, these considerations tend to drive the choice of entity decision.

But all that said there are a few circumstances when S corporations have the upper hand, though of relatively less importance and relatively few in number. As I discuss in detail below, these advantages do not provide adequate justification for the entire S corporation edifice. Those advantages that are legitimate should be incorporated into Subchapter K, those that are not should be abandoned.

2. *Corporate Pathways*

Some of the advantages that an S corporation has over a partnership have to do not with the S corporation taxation regime as such, but with the fact that an S corporation is just that, a corporation. Sometimes it is good to be a corporation. Some examples follow.

a. *Going Public.* While publicly traded partnerships and even publicly traded LLCs exist, the overwhelming majority of publicly traded entities are C corporations.[112] Thus, a business that wants to make a public offering usually needs to find its way into a C corporation. This process is quite a straightforward matter for an S corporation. An S corporation may terminate its S election with a majority vote of its shareholders.[113] Thereafter, it is a C

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[110] As of 2004. *See* INTERNAL REVENUE SERVICE, SOI TAX STATS – S CORPORATIONS, at tbl. 6 (2004) [hereinafter SOI TAX STATS], *available at* http://www.irs.gov/pub/irs-soi/04co1120s06.xls (last visited Apr. 2, 2009).

[111] I.R.C. § 1361(c)(2)(B)(iii), (iv) (stating that family members can be treated as one shareholder, making the effective number of permitted shareholders theoretically vast); *see* I.R.C. § 1361(c)(1)(A), (B); *see also* EUSTICE & KUNTZ, *supra* note 59, ¶ 3.04; Schiff Harden, LLP, TAX UPDATE (Oct. 22, 2004), http://www.schiffhardin.com/binary/tax_102204.pdf.

[112] BISHOP & KLEINBERGER, *supra* note 17, ¶ 16.01.

[113] I.R.C. § 1362(d)(1)(b) (stating that a final S corporation return must be filed).

corporation and the public offering of the stock can proceed.[114]

For a partnership, matters are more complex. There are two main options.[115] In "Option One," the partnership contributes its assets to the corporation in exchange for stock. The partnership then liquidates and distributes the stock to its partners. In "Option Two," the partners contribute their partnership interests to the corporation in exchange for stock, liquidating the partnership as a matter of law, because a single owner—to wit, the corporation—remains.[116]

The potential problem lies not with the liquidation of the partnership, but with the incorporation. The liquidation of the partnership is typically, and usually straight forwardly, tax free under sections 731. The incorporation will be tax free to the corporation under section 1032, but for it to be tax free to the contributing shareholders, it must fall within section 351(a). As I discussed above, section 351(a) provides that a contribution of property to a corporation is tax free if the contributing parties receive only stock in the exchange and are in 80% control of the corporation "immediately after the transfer."[117]

Does section 351(a) apply to Options One and Two? The critical issue is whether the contributing shareholders have 80% control "immediately after" the property is contributed in exchange for stock. In Option Two, the answer is clearly yes as the stock goes directly to the partners. In Option One, where the stock first goes to the partnership and then to the partners, the concern is whether the partnership's ownership of the stock is so transitory that it prevents the section 351(a) requirements from being met. In Revenue Ruling

[114]Corporations do not recognize gain or loss on the receipt of property in exchange for stock. I.R.C. § 1032. If the purchasers buying the stock pay with cash, as is typical, there is no gain or loss to them either. Thus, section 351 is not needed. *See* Benjamin G. Wells, *Planning for the Special Tax Problems That Arise in Taking an S Corporation Public*, 80 J. TAX'N 164 (1994); *see also* Victor Fleischer, *Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137 (2003); Daniel S. Goldberg, *Choice of Entity for a Venture Capital Start-Up: The Myth of Incorporation*, 55 TAX LAW. 923 (2002); Joseph Bankman, *Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737 (1994).

[115]A third approach is for the partnership to liquidate and distribute its assets to the partners, who could then contribute them to the corporation. The mechanics of this approach are more problematic. Two sets of state transfer taxes could apply, for example, one on the partnership's distribution to the shareholders and another on the partners' contribution to the corporation. Further, if there is an actual or deemed distribution of money to a partner in excess of his basis in his partnership interest, he would have to recognize gain under section 731(a)(1) to the extent of the excess. In addition, if the transfers to the corporation were not done contemporaneously with the liquidation of the partnership (admittedly quite unlikely), there would be the risk that a given partner might not be willing to contribute a particular property, or might have sold it, etc. Even if these problems did not exist, it is hard so see why one would not prefer Options One or Two.

[116]Unif. P'Ship Act § 101(6) (1997) (defining a partnership as an association of two or more persons).

[117]Section 368(c) defines control to mean ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

1984-111, however, the Service ruled that where, as in Option One, there is a contribution of property by the partnership to the corporation followed by a liquidation of the partnership, the requirements of section 351(a) are met.[118] In effect, the Ruling ignores the fact that the partnership's ownership of the stock is brief.

Does the answer change if a public offering follows the incorporation? Revenue Ruling 1984-111 does not address this question. The issue is whether the shareholders obtaining stock from the public offering have to be counted for purposes of the 80% control test, and if so, when they are counted. If the contribution to the corporation by the partners or the partnership is treated as fully separate from the public offering, there is no problem because there is 100% control immediately after the original formation of the corporation. If the contributions to the corporation by the partners or the partnership and the contributions by the participants in the public offering are treated as a single transaction, there is still no problem because the contributors also have 100% control immediately after the contribution. However, if section 351 defines the control group as *both* the partners or the partnership *and* the public purchasers, and if the partners or partnership are considered to make their contributions at different times, section 351 does not apply to *any* contributor.[119]

To complicate this complex situation further, there are two possible scenarios. One is where, prior to incorporation, the partners and the partnership have no agreement with an underwriter to make a public offering of the stock. The other scenario is just the opposite, where the partners do have that agreement. Typically, the partners will prefer the latter scenario. Once incorporated as a C corporation, the corporation and the owners may have to incur two levels of taxation to get back to a partnership.[120] Thus, if the primary reason for incorporating is to go public, the partners want to be sure the public offering is going to happen before tripping the incorporation domino.

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[118] *See* Rev. Rul. 1984-111, 1984-2 C.B. 88 (revoking Rev. Rul. 1970-239, 1970 C.B. 74, which came to the same conclusion with regard to the section 351(a) issue). Revenue Ruling 1970-239 held that the tax consequences of all three scenarios were the same. Revenue Ruling 1984-111 revokes that holding, concluding that the tax consequences of the different options can vary. Assuming § 351(a) applies, then in the case of Option One, the partnership takes the same basis in the stock that it had in the contributed property under § 358(a). Then the partnership liquidation rules kick in. Generally, the distributee partners will allocate their bases in the partnership interest to the stock. *See* I.R.C. § 732. In the case of Option Two, under § 358(a), the erstwhile partners take as their bases in the stock, the bases they had in the contributed partnership interests. I should perhaps note that there is no question here that the parties are contributing "property" to the corporation, one of the requirements of § 351(a). Contributions of services will not generally count. See BITTKER & EUSTICE, *supra* note 10, ¶ 3.02[2].

[119] It would be highly unusual for less than 20% of the stock to be sold in a public offering. Normally, participants in a public offering are contributing cash to the corporation, so for them no gain recognition exists. Under section 1032, there is also no income to the corporation.

[120] *See supra* text accompanying notes 25–26.

If the agreement is reached with the underwriter after incorporation, the control test of section 351(a) is most likely met. The contribution by the partners or partnership is most likely seen as wholly separate from the public offering. Current case law generally looks to whether there is a binding obligation made *before* incorporation by the shareholders to dispose of the stock.[121] If so, the stock that is the subject of that agreement cannot be counted toward the 80% control test. If there is no such agreement, all of the stock that is received can be counted toward the 80% test. The Tax Court summarizes the law as follows:

> A determination of "ownership," as that term is used in section 368(c) and for purposes of control under section 351, depends upon the obligations and freedom of action of the transferee with respect to the stock when he acquired it from the corporation. Such traditional ownership attributes as legal title, voting rights, and possession of stock certificates are not conclusive. If the transferee, as part of the transaction by which the shares were acquired, has irrevocably foregone or relinquished at that time the legal right to determine whether to keep the shares, ownership in such shares is lacking for purposes of section 351. By contrast, if there are no restrictions upon freedom of action at the time he acquired the shares, *it is immaterial* how soon thereafter the transferee elects to dispose of his stock or whether such disposition is in accord with a preconceived plan not amounting to a binding obligation.[122]

[121] *See, e.g.*, Intermountain Lumber v. Commissioner, 65 T.C. 1025, 1031–32 (1976).

[122] *Id.* at 1031–32 (emphasis supplied); *see* BITTKER & EUSTICE, *supra* note 10, ¶ 3.09[2] (also containing this quote). It is sometimes also said that even without a binding obligation, the taxpayer fails to comply with section 351 if the loss of control is both part of a preconceived plan and a sine qua not thereof. BITTKER & EUSTICE, *supra* note 10, ¶ 3.09[2]. The anti-taxpayer authority for this, however, is rather thin. There is one case, *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966), in which an exchange of the shares received in the incorporation in a purported B reorganization was imminent, but no binding agreement to make the exchange was in effect. The Tax Court held that section 351(a) did not apply to the incorporation, notwithstanding the lack of a binding agreement to exchange the shares, in part because the incorporation lacked a business purpose. *Id.* at 40. *West Coast* is inconsistent with the Tax Court's later holding in *Intermountain*. As both are Tax Court cases, the later holding of *Intermountain* should be controlling. The other contrary authority is the hoary Revenue Ruling 1954-96, 1954-1 C.B. 111, which, of course, is not binding on the judiciary. Further, the trend of the Service's rulings is pro-taxpayer. Recently, the Service ruled that the section 351(a) requirements were met even where there was a binding obligation to transfer the stock received in the section 351 transaction, where there was an alternative tax free, section 351(a) way of structuring the transaction. *See* Rev. Rul. 2003-51, 2003-21 I.R.B. 938. Finally, there is some support in the Regulations for the Tax Court's holding in *Intermountain*. Reg. § 1.351-1(a)(1) ("[I]*mmediately after the exchange* does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation *where the rights of the parties have been previously defined* and the execution of the agreement proceeds with an expedition consistent with orderly procedure.") (emphasis supplied). The language about the rights of the parties having been "previously defined" is consistent with the binding agreement approach. I found no circuit court decisions inconsistent with the binding agreement test in the section 351 context. Indeed, the Tax Court cites a number of circuit courts in support of its decision in *Intermountain*. *See Intermountain Lumber*, 65 T.C. at 1032. That said, a given appellate court

An obligation to dispose of stock could be interpreted to include new stock to be issued by the corporation. But there is no such binding obligation to issue additional stock if the agreement with the underwriter is made *after* incorporation. Thus on incorporation of the partnership the requirements of section 351(a) should be met. It is conceivable a court could disagree with the Tax Court's analysis, but that has not happened since the case came out in 1976, over 30 years ago.

And if there is such a binding obligation with the underwriter before incorporation? The Service historically has taken a pro-taxpayer approach.[123] The Treasury and the Service solidified their views (if perhaps not the clarity with which they were expressed) in Treasury Regulation section 1.351-1(a)(3) in 1996. It provides that if a person acquires stock from an underwriter in exchange for cash in a qualified underwriting transaction, that person is treated as transferring the cash directly to the corporation in exchange for stock.[124] Further, the Regulations also provide that in determining whether the 80% test is met, simultaneity is not required, "but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure."[125] Finally, the preamble to Treasury Regulation section 1.351-1(a)(3) provides:

> [A]lthough the regulations specifically concern underwriting, it is intended that its principles could apply equally in *factually analogous situations*. For example, if the ownership by other intermediaries in the distribution of stock . . . , such as broker-dealers, is transitory, that ownership should also be disregarded.[126]

Reading these provisions together along with Revenue Ruling 1984-111, it seems clear that the incorporation of the partnership under either Option One or Two, coupled with a public offering of the underlying stock, falls within section 351(a), even if there is a binding obligation to make the public offering prior to incorporation. To summarize: (1) the transfers by the partners or the partnership to the corporation and the transfers of the moneys to the corporation from the public offering do not need to be simultaneous, (2) in Option One, the transience of the partnership's ownership is effectively ignored, and (3) the transfers from the public offering are deemed to go directly to the corporation, even if the underwriter is a way station. Thus,

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could apply the step transaction doctrine in a way that prevents section 351(a) from applying if there was a preconceived plan as suggested in BITTKER & EUSTICE, supra note 10, even if there was no binding agreement. *See also* Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349 (1991).

[123] *See* Rev. Rul. 1978-294, 1978-2 C.B. 141, *superseded by* Reg. § 1.351-1(a)(3).

[124] Reg. § 1.351-1(a)(3). A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock in transitory.

[125] Reg. § 1.351-1(a)(1).

[126] T.D. 8665, 1996-1 C.B. 35 (emphasis supplied).

assuming the public offering occurs promptly after incorporation, both the partner contributors and the public offering contributors should be seen as part of one group, and, of course, that group has control of the corporation once the smoke clears.[127] Thus, the taxpayers will not be denied the benefits of section 351(a).[128]

While there are few federal income tax hurdles to a partnership incorporating and making a public offering of the stock, there may be state law hurdles. State and local transfer taxes as well as transfer consents from mortgagors, landlords, etc. could be issues for an incorporating partnership.[129] Typically, they are not issues on the conversion of an S corporation into a C corporation, because from a nontax perspective there has been no change. The same state law entity, to wit, the corporation, exists both before and after its conversion, subject to a different type of federal income tax treatment.

The public offering arena is one in which the S corporation has some advantages, though if there are few or no state law hurdles, the disadvantages of the partnership form are likely not substantial. Getting to the public offering from a partnership form may involve more hassle than getting to it from an S corporation form, but often the hassle is worth it. Much may depend on how soon the public offering is planned (recalling that more businesses plan to go public than actually go public). If many years may go by between the

[127]If there is a dramatic delay in the public offering, and there was a pre-incorporation binding obligation to do the public offering, it could prove awkward. On the one hand, the binding agreement makes it hard to ignore the public shareholders, on the other hand, a long delay makes it harder to say there was control by the public and nonpublic shareholders "immediately after" the exchange. I did not come across a case on point, but the Regulations suggest the Service would take a liberal approach. *See* Reg. § 1.351-1(a)(1), (3).

[128]*See* Goldberg, *supra* note 114, at 927–929. Those joys will be tempered, however, if the liabilities of the partnership are greater than the partnership's bases in its contributed assets (Option One), or if the liabilities allocated to partners are greater than the partners' bases in their contributed partnership interests (Option Two). In that event, and to that extent, gain will be recognized under section 357(c). Note that gain on incorporation will generally be a consequence of prior deductions which reduced the bases of the assets and partnership interests. Given the time value of money, the deductions will generally be more pleasurable than the gains are painful. Section 357(c) trumps section 351(a), providing an exception to the general rule of nonrecognition. I.R.C. § 357(c). Gain must be recognized to the extent the liabilities of a transferor exceed the transferor's basis in the contributed assets. I.R.C. § 375(c). Operating in parallel, section 752(b) would effectively allocate the gain among the partners. I.R.C. § 752(b). Section 752(b) provides that if a partner is relieved of liabilities, that is treated as a distribution of money to the partner. I.R.C. § 752(b) Section 731(a)(1) in turn provides that if a distribution of money exceeds a partner's basis in her partnership interest, gain is recognized. I.R.C. § 731(a)(1). The gains may be ordinary or capital gains. The gain is generally allocated among the assets based on their relative fair market values, and the character of the gain is generally a function of the type of appreciated assets contributed. *See* Rev. Rul. 1968-55, 1968-1 C.B. 140. Some tax arbitrage is possible here. Depreciation on real estate reduces ordinary income, where as the gain, if the property is held over one year, is long-term capital gain taxed, generally, at a 25% rate up to the depreciation taken, and 15% thereafter. *See* I.R.C. § 1(h)(C), (D).

[129]*See, e.g.*, MD. CODE ANN., TAX-PROP. § 13-201 et seq. (LexisNexis 2007).

original formation and the public offering, the tax advantages of a partnership in the interim often outweigh the cumbersomeness of going public. On the other hand, if a public offering is expected to occur in the near term, a partnership may not be worth the bother. An S corporation may make more sense. It still permits the flow through of losses to the stockholders, provided the stockholders have sufficient stock bases to allow for the deduction of the losses.[130] Note that such "start-ups," particularly in the nanotech, biotech, and information technology arenas, commonly operate at a loss for a number of years.

Venture capitalist funds commonly have a generic preference for the corporate form. While the use of an S corporation would permit a venture capital fund to participate in losses, unlike the individual investor, its interest in tax losses is often limited. When the venture capitalist fund invests in a company, its principal concern is the exit strategy. Usually this is a public offering, though, as I discuss below, it can also include an effort to position the company for a takeover. If the venture capital fund holds common stock, it will want to be able to force the corporation to register the shares at the time of the "initial public offering" or "IPO."

Often, however, the venture capital fund does not want common stock at the time of investment (pre-IPO), but preferred stock that has preferential liquidation and redemption rights, and possibly preferential dividends. If the venture capital fund needs to receive preferred stock, the S corporation form is unavailable because S corporations are only permitted to have one class of stock.[131] The venture capital fund usually also wants an ironclad right to convert this preferred stock into common, and have the right at the time of the public offering to have that common stock registered.

If an LLC or other tax partnership is used instead of a corporation, the documents are much more challenging to draft as the parties have to find a way to obligate a yet-to-be-formed corporation to issue common stock, and register that common stock for public trading, on some sort of fixed conversion basis with the membership units of the existing LLC. Further complicating matters is the fact that in many cases there is not simply one venture capital financing round, but many. It is much easier to create a new series of preferred stock for each financing round than create legally reliable series of special membership interests in LLCs. All this can make LLCs not worth the trouble, particularly when the venture capital funds are far more interested in obtaining a big pay day at the end of the road rather than near-term tax benefits. If the venture is unsuccessful, venture capital funds can still receive a section 165 loss deduction on their investment. Indeed, some venture capital funds, when they find a company that they really like that is currently an LLC, require that it be

[130] I.R.C. § 1366(d) (S corporation shareholders are also allowed to deduct losses to the extent of any debt owed them by the corporation).

[131] I.R.C. § 1361(b)(1)(D). Differences in voting rights are permitted. I.R.C. § 1361(C)(4).

converted over to a C corporation before they invest.[132]

While I discuss ways below to smooth the conversion of LLCs and other tax partnerships into corporations, there are limits. LLCs and tax partnerships do not fit every business model. Sometimes only a corporation will do. While the world can live without S corporations, it cannot live without the corporate form altogether.

b. *ESOPs*. Qualified pension trusts and section 501(c)(3) charitable organizations are permissible S corporation shareholders.[133] Qualified pension trusts and section 501(c)(3) organizations are generally tax exempt.[134] I will therefore call them tax-exempt organizations, though this descriptor is not fully apt, as I will discuss below. An employee stock option plan (ESOP), a type of pension trust, provides a good example of the benefit of the corporate form to this class of shareholders, and I will focus on ESOPs in this discussion.[135]

To abbreviate in the extreme, an ESOP is a qualified pension plan that a corporation adopts.[136] Among an ESOP's purposes is to give the corporation's employees an equity interest in the corporation. The funds contributed to the ESOP by the corporation are generally tax deductible.[137] The stock in the corporation purchased by the ESOP is held in trust, and the corporation's employees are beneficiaries of the trust.[138]

ESOPs are often designed to be cooperative purchasers of the stock of owners of closely held corporations.[139] Assume a corporation has a single shareholder who is also the CEO. The CEO is ready to sell her interest, but cannot obtain an offer for the stock she feels will pay her full value. Instead, she has the corporation form an ESOP. She sells her stock at full value to the ESOP. Commonly, the ESOP borrows the money for the purchase from a bank.[140] The corporation makes periodic, tax deductible contributions to the ESOP so

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[132]The reader will note the complete absence of footnotes for the above discussion. There apparently is little citable authority in this area. I owe my own understanding of this area to conversations with Professor Sean M. O'Connor of the University of Washington School of Law, an expert in the venture capital arena.

[133]I.R.C. § 1361(b)(1)(B), (c)(6); *see also* I.R.C. § 401(a).

[134]I.R.C. § 501(a).

[135]Another reason for the coverage: I have been told informally, that in Congressional circles, some are defending S corporations due to their value to ESOPs.

[136]A "qualified" plan is one to which contributions within certain limits are generally deductible and the income of which is generally tax exempt. These are subject to rules that limit discrimination in favor of highly compensated employees. *See* I.R.C. §§ 401(a), 404, 501(a).

[137]*See* I.R.C. § 404(a)(3), (a)(9)(A).

[138]*See* I.R.C. §§ 401, 4975(e)(7); *see also Uses of ESOPs*, 354 TAX MNGT. PORT. (BNA) A-1, -2 (2005) [hereinafter BNA]. In the words of Senator Long: ESOPs will "ensure that tomorrow's free enterprise system is financed so as to be more broadly owned." 129 Cong. Rec. S33,822 (daily ed. Nov. 17, 1983) (statement of Sen. Long).

[139]The following is based on a conversation I had with Henry Smith, a pension plan expert. *See also* BNA, *supra* note 138, at A-1.

[140]*See* I.R.C. § 4975(d)(3).

that the ESOP can make payments on its indebtedness with the bank.[141] As these contributions are made, the corporation's employees are given equitable interests in the stock held by the ESOP.[142] If an employee retires, the ESOP is obligated to buy back his interest in the stock for fair market value unless it is traded on an established exchange, though the employee can demand to be given the stock.[143] If it works, ESOPs can be a win-win-win situation. The business owner receives full value for her business. As the contributions to the ESOP are tax deductible, the debt payments can be made, in effect, with pretax dollars. And the employees are provided with pension benefits and a participation in the business.[144]

ESOPs are not all that common for two reasons. First, it can be difficult to find a bank that will make the loan. Second, the funds for the ESOP's purchase of the stock ultimately have to come from the corporation, and often it does not want to take on this financial burden.[145]

To prevent tax-exempt organizations from destroying the tax base, Congress provides that "unrelated business taxable income" (UBTI) is taxed to them currently.[146] UBTI is income from a trade or business that is regularly carried on and is substantially unrelated to the tax-exempt organization's exempt functions.[147] Passive income, including dividends and gains on the sale of stock, is generally not UBTI.[148] It is thus normally safe for a tax-exempt organization to own stock in a C corporation, since the tax-exempt earnings will come in the form of dividends and stock gains.[149] A tax-exempt organization's share of the income of an S corporation, on the other hand, is UBTI.[150] (The same is true for its share of income of a partnership.[151]) But, the Code would

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[141] *See* I.R.C. § 404(a)(3), (a)(9)(A).

[142] *See* I.R.C. § 4975(e)(7).

[143] I.R.C. § 409(h), (o).

[144] Of course, in the case of Enron, it was lose-lose-lose. *See* Martin A. Sullivan, *The Flawed Economics of ESOPs and Employee Stock Options*, 95 TAX NOTES (TA) 149 (2002); *see also* I.R.C. § 401(a)(28), (a)(35) (diversification rules).

[145] While ESOPs are permissible S corporation shareholders, it may make more sense to convert the S corporation to a C corporation before the stock sale to the ESOP is consummated. If the owner sells C corporation stock to the ESOP, she recognizes no gain to the extent she invests the proceeds in other qualifying C corporation stock (typically publicly traded securities). *See* I.R.C. § 1042.

[146] I.R.C. §§ 511, 512. "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of . . . organizations enable them to use their profit tax free to expand operations, while their competitors can expand only with profits remaining after taxes." Rep. No. 2375, 81st Cong., 2d Sess. 28, 1950-2 C.B. 483, 504.

[147] I.R.C. § 513; *see* St. Luke's Hos. of Kan. City v. United States, 494 F. Supp. 85 (1980); Rev. Rul. 1985-109, 1985-2 C.B. 165.

[148] I.R.C. § 512(b)(1), (b)(5). Note that the business income ultimately responsible for the dividends and stock gains is generally fully taxable.

[149] To avoid UBTI, the organization cannot control the corporation. I.R.C. § 512(b)(13).

[150] I.R.C. § 512(e)(1).

[151] I.R.C. § 512(c).

not be the Code if the exception did not itself have an exception. And that is the case here. If an ESOP is the shareholder of an S corporation, its share of the income of an S corporation is not UBTI.[152] There is no tax at any level on an S corporation owned entirely by an ESOP, making ESOPs an interesting option for S corporations.

Can an ESOP system be created for partnerships? While theoretically possible, it would be very difficult and highly complex to achieve in practice. Unlike corporations, partners generally must keep capital accounts. Capital accounts can be thought of as a measure of the economic value of a partnership interest, though at times they can be a highly imprecise measure.[153] Keeping capital accounts in proper form for ESOPs or their beneficiaries, with the stock holdings changing and beneficiaries coming and going, would be very challenging. The Service has issued proposed regulations on "regular" options to buy partnership interests.[154] The American Bar Association Tax Section made suggestions both before and after the Proposed Regulations were issued.[155] While the reader will be happy to hear that detailing these efforts is beyond the scope of this article, I will note that I participated in the ABA's part of the process and watched a lot of very smart people destroy a lot of brain cells trying to get to the right answer. Adapting ESOPs to partnerships is not necessary. The solution is straight-forward. Once the ESOP becomes appropriate, the partnership can incorporate. There should be no binding agreement in effect to create the ESOP before incorporation, less the stock being sold to the ESOP not be counted for purposes of the 80% control test.[156] Such a binding agreement is typically not needed. A small number of shareholders are usually in control and thus need not doubt that the corporation, once formed, will adopt the ESOP, which can then buy the stock.

c. *Takeovers*. S corporations, and C corporations for that matter, can be popular if the business's owners want ultimately to be the target of a takeover by a publicly held corporation. As noted above, venture capital funds often

[152] I.R.C. § 512(e)(3).

[153] A partner's capital account is increased by the money and fair market value of property contributed by that partner as well as income and gain allocated to the partner. A partner's capital account is decreased by the money and fair market value of property distributed to the partner, allocations to the partner that are not deductible and not capitalized, and allocations to the partner of loss and deduction. *See* Reg. § 1.704-1(b)(2)(iv)(b). Capital accounts play a vital role in the economic effect test of Regulation § 1.704-1(b)(2)(ii). *See* ARTHUR B. WILLIS, JOHN S. PENNELL, & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 10.03 (6th ed. 1997) [hereinafter WILLIS].

[154] *See* Prop. Reg. § 1.704-1, 68 Fed. Reg. 2930 (2003); Prop. Reg. § 1.83-3, 70 Fed. Reg. 29,675 (2005).

[155] *See* ABA Comments in Response to Notice 2000-29, 2002 TAX NOTES TODAY 45-19, (Jan. 30, 2002); ABA Comments in Response to Prop. Reg. 103580-02, 2003 TAX NOTES TODAY 213-21 (Oct. 9, 2003); Karen Burke, *Taxing Partnership Options*, 100 TAX NOTES (TA) 1569 (2003); Walter Schwidetzky, *The Proposed Regulations on Noncompensatory Options, A Light at the End of the Tunnel*, 21 J. TAX'N OF INV. 155 (2004).

[156] *See supra* text accompanying notes 122–123.

have a takeover as their exit strategy. Section 368 smiles on takeover transactions.[157] For example, the merger of the target into the publicly held corporation can be tax free.[158] So can the exchange of the stock of the target for voting stock of the publicly held corporation (a B reorganization).[159] Thus, the owners can convert an illiquid asset (stock of a closely held corporation) into a liquid asset, without paying a tax charge. The stock received in the publicly held corporation can eventually be sold (likely piecemeal) in a public market.[160]

Can the taxpayer get to the same place starting with a partnership? Assuming a binding agreement with the publicly held corporation that will acquire the stock is in place before incorporation, probably not. Here, unlike the public offering scenario above, there are no helpful regulations to bail out the taxpayer. Further, Revenue Ruling 1970-140,[161] now getting a little long in the tooth, under similar facts says the taxpayer fails section 351(a). In Revenue Ruling 1970-140, pursuant to a preexisting agreement, a taxpayer incorporated a sole proprietorship and then purported to swap the stock he receives on incorporation for the stock of a public corporation in a tax-free B reorganization.[162] The Service concluded that the taxpayer's receipt of stock on incorporation of the sole proprietorship was "transitory and without substance for tax purposes. . . ." The Service reasoned that the two steps, the incorporation and the B reorganization, should be integrated, so that rather than an incorporation and a B reorganization, the taxpayer is simply seen as contributing property to the public corporation. This means that the 80% control test of section 351 has to be applied with regard to the public corporation. The taxpayer, of course, does not meet the 80% control test under these circumstances, and thus the gain or loss inherent in the contributed property is not sheltered by section 351(a). As restructured, there is a full taxable exchange of the taxpayer's property for the stock in the public corporation.[163]

More recently, the Service in Revenue Ruling 2003-51 both affirmed and distinguished Revenue Ruling 1970-140, and surprisingly concluded that the

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[157] *See* I.R.C. § 368; BITTKER & EUSTICE, *supra* note 10, ¶ 12. Gain is recognized to the extent "boot" is received; in this context, boot is money and property other than qualifying stock.

[158] I.R.C. § 368(a)(1)(A). Gain is recognized (and sometimes dividend income is earned) to the extent of cash received. I.R.C. § 356. Basis of shares received is determined under Code section 358, a process which accounts for the cash received as well as the recognized gain and dividend income.

[159] I.R.C. § 368(a)(1)(B).

[160] *See* 17 C.F.R. § 230.145 (2008).

[161] Rev. Rul. 1970-140, 1970-1 C.B. 73. Here the taxpayer started with a sole proprietorship instead of a corporation, but the principle is the same.

[162] I.R.C. § 368(a)(1)(B); Rev. Rul. 1970-140, 1970-1 C.B. 73. I simplify the facts. Actually, the taxpayer transferred the assets of the sole proprietorship to an existing corporation wholly owned by the taxpayer. Rev. Rul. 1970-140, 1970-1 C.B. 73.

[163] There is no tax consequence to the public corporation. I.R.C. § 1032.

control test of section 351(a) was met, notwithstanding a pre-incorporation binding agreement to dispose of the stock, if the taxpayer could have gotten to the same end result tax free using a different series of steps.[164] In the takeover transactions I posited above, that would not be possible. However, Revenue Ruling 2003-51 tantalizingly suggests that section 351(a) could apply to the first step in the takeover transactions I described above.

> Treating a transfer of property that is followed by a nontaxable disposition of the stock received as a transfer described in I.R.C. § 351 is not necessarily inconsistent with the purposes of I.R.C. § 351.[165]

Taken alone, this language might suggest that incorporating a partnership and having the resulting corporation engage in, for example, a B reorganization passes muster, notwithstanding the existence of a pre-incorporation binding agreement for the reorganization. The problem is that the quoted language cannot be read in isolation. Revenue Ruling 1970-140 involved an incorporation followed by a previously agreed upon B reorganization. Revenue Ruling 2003-21 does not revoke Revenue Ruling 1970-140.

Accordingly, the quoted language is either (1) the result of sloppy drafting, or (2) an indication of where the Service wants to go, though it does not have the intestinal fortitude to go there yet.[166]

There are no cases contrary to Revenue Ruling 1970-140.[167] Therefore, owners of a partnership wanting to be the target of a takeover and wanting to have a binding agreement for the takeover before incorporation either have to live with taxable gain on incorporation (*i.e.* usually be, from a tax perspective, suicidal), or be willing to take their chances that Revenue Ruling 1970-140 no longer represents the Service's position. If, on the other hand, there is no binding agreement for the takeover before incorporation, the incorporation should be able to fall within section 351(a). Depending on how literally the Service and the courts apply the binding agreement test, a partnership may be able to make substantial progress toward negotiating the takeover, and then bring it to closure after incorporation. Having the takeover agreement fully prepared and then simply signing it after incorporation might be pushing the binding agreement test past the breaking point. The partnership and its partners could not be confident with facts that extreme that the courts will stay

[164] Rev. Rul. 2003-51, 2003-1 C.B. 938.

[165] *Id.*

[166] While I follow the Service's lead in focusing on section 351, there is also a substance-over-form or step transaction argument, or both, that the taxpayer in Revenue Ruling 1970-140 did not engage in a valid B reorganization. The argument would be that, at essence, what was involved was a swap of assets for stock in the public corporation rather than stock for stock as required by section 368(a)(1)(B). *See* BITTKER & EUSTICE, *supra* note 10, ¶ 12.04. The solution I propose would effectively address this issue as well. *See infra* text accompanying notes 175–186.

[167] Indeed, one case is consistent with Revenue Ruling 1970-140. *See* W. Coast Mktg. Corp. v. Commissioner, 46 T.C. 32 (1966). As discussed *supra* note 122, *West Coast* is of dubious authority.

with the literal language of the binding agreement test as enunciated by the Tax Court. Of course, as noted above, life is much simpler if the owners start with an S corporation. The incorporation of the S corporation will almost always be old and cold before the section 368 reorganization happens.

d. *Section 1244.* A minor benefit for C and S corporations is section 1244. It permits losses on the sale or exchange of corporate stock (normally a capital asset) to be treated as ordinary losses rather than capital losses.[168] Capital losses are deductible from capital gains. In addition, individuals may deduct up to $3,000 of any excess of capital losses over capital gains from ordinary income.[169] Ordinary losses are generally fully deductible, subject to the at-risk rules of section 465 and the passive loss rules of section 469. However, the aggregate amount that can be treated as an ordinary loss under section 1244 is not huge, $50,000 per year for an individual, $100,000 for a husband and wife filing jointly.[170] Section 1244 also only applies to stock issued by a corporation that qualifies as a small business corporation at the time the stock was issued. A small business corporation is one with no more than $1 million of capitalization.[171] Finally, section 1244 tends to be less valuable for S corporations than C corporations, as losses flow through to the shareholders in an S corporation,[172] meaning that often there will not be much stock tax basis left to generate losses on a sale or exchange. As partnerships also permit losses to flow through to partners,[173] there is no crying need, or indeed much justification, for some kind of partnership tax analog to section 1244 in a non-Subchapter S world.

3. *Smoothing the Corporate Pathways*

Serious problems with partnership incorporations currently exist primarily when the incorporations are followed by some form of section 368(a) reorganization. I discuss the justification for permitting incorporations to be followed by reorganizations in more detail below, but before I discuss the "why" of it, I will discuss the "how" of it.

It is at least theoretically possible for the Code to permit partnerships to engage in tax-favored reorganization transactions with corporations directly. But that would require penning a parallel reorganization system. The current corporate system is of long standing and incorporates substantial anti-abuse provisions.[174] Rather than create a parallel system, it is simpler and more elegant to amend section 351(a) to provide that its control test is met even if the incorporation is followed by a section 368 reorganization or other tax-favored transaction, whether or not there is a binding agreement to enter

[168] I.R.C. § 1244(a).
[169] I.R.C. § 1211(b).
[170] I.R.C. § 1244(b).
[171] I.R.C. § 1244(c)(1)(A), (c)(3)(A).
[172] *See supra* text accompanying notes 36–45.
[173] *See supra* text accompanying notes 62–65.
[174] *See* BITTKER & EUSTICE, supra note 10, ¶ 12.21.

into the subsequent transaction at the time of incorporation.[175] This approach means that taxpayers will have to go through the inconvenience of forming an often transitory C corporation, but the burden on the taxpayers is small when compared to the burden to the tax system generally if a parallel reorganization system is created.

Additionally, the section 368 reorganization provisions should be amended to make clear that they apply even if the participating corporation has recently incorporated. This amendment is necessary to deal with an attack from the other end of the transaction. While the focus to date has been on section 351, there also could be an argument, for example, that the B reorganization stock-for-stock swap rules are not met if the stock comes from a recently incorporated partnership. The Service could argue the flip side of Revenue Ruling 1970-140,that in substance the acquiring corporation is not swapping its stock for stock, but its stock for assets.

But the statutory change should go further. Incorporations followed by public offerings and ESOP-type structures appear to be safe now, but the authority for the current treatment could be stronger. The binding agreement test, for example, comes out of the Tax Court. Judges on other courts can disagree or the Tax Court can change its mind, or both. A more hard-wired set of rules to help integrate Subchapters S and K is preferable. The rules of Revenue Ruling 1984-111, the current regulatory rules for public offerings, and the binding agreement test should be made statutory, except that, as noted above, section 351(a) applies even if there is a binding agreement to engage in a reorganization transaction after incorporation.

One might ask why not permit an unrestricted tax-free incorporation, with no limits on what the taxpayer can do with the stock after incorporation. But, as I discuss in more detail below, section 351 provides tax-favored treatment because the taxpayer is, essentially, continuing his investment in a different form. If all or most of the stock is presold, what is really taking place is a sale of the incorporated assets and not a bona fide conversion to the corporate form. Pre-incorporation binding agreements that provide that after incorporation there will be public offerings or corporate reorganizations are inoffensive as the assets stay in corporate solution. But if the substance of the agreement is a sale of the assets, the substance should control. Of course, some taxpayers may negotiate the sale of the stock, then incorporate, and then promptly sell

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[175] I would include "divisive reorganizations" under section 355 within this rule. *See* BITTKER & EUSTICE, *supra* note 10, ¶ 11. Revenue Ruling 1970-140 actually applied a contribution of property to an existing corporation followed by a B reorganization. This too should qualify under an amended section 351(a).

H.R. 4137, discussed *infra* at notes 291 to 308, took a more limited approach, and would have amended section 351 to provide that the step transaction and similar doctrines do not apply for purposes of determining the section 351 control requirement in any case in which a partnership that is actively engaged in a trade or business transfers substantially all of its property to a nonpublicly traded corporation, if that corporation then enters into a reorganization.

the stock. But that problem exists under current law and the current law rules of substance over form remain available to address the problem.

As to the "why" of allowing partnership incorporations to be immediately followed by reorganization transactions: Courts have noted that section 351 is intended to apply where "there has been a mere change in the form of ownership."[176] The taxpayer has not truly "cashed in on the theoretical gain . . . ."[177] Similarly, the legislative history to the predecessor of section 351 notes that the legislation provides new rules for "those exchanges or 'trades' in which, although, a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit."[178] This continuity of investment principle also applies in the section 368 reorganization context.[179] Partners who incorporate a partnership and then engage in a section 368 reorganization have not, it can be defensibly argued, "cashed in on their theoretical gain" either. The question, in other words, is if a section 351(a) transaction can be tax favored and a section 368 reorganization can be tax favored,[180] why not permit the two to happen in quick succession and be tax favored?

In other contexts, the Code permits taxpayers to string tax-favored transactions together. There is no limit on the number of section 351 transactions, section 721 transactions, section 368 reorganizations, and like-kind exchanges under section 1031 that a taxpayer can do. Partners can form partnerships tax free and liquidate partnerships tax free as often as they want. The better, or at least more precise, question is not how many tax-favored transactions can be strung together, but does each Code section allowing a tax-favored transaction make sense on its own terms. To the extent it does, the fact that a taxpayer can engage in several tax-favored transactions in a row need not be offensive. For the two sets of Code provisions under discussion, section 351 and section 368, they indeed usually do make sense independently as the taxpayer's investment is being continued, and thus allowing them to be done in quick sequence is not inherently objectionable.

Does the analysis change if one goes from holding a large illiquid interest in one entity to a small, liquid interest in a publicly held corporation? Here one has not just changed the form of the investment; one has to a great extent changed its fundamental nature. Yet that is currently allowed. One can merge one's closely held corporation into a Fortune 500 company on a tax favored basis,[181] and mergers are just one of several types of reorganizations in section

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[176] Stewart v. Commissioner, 714 F.2d 977, 987 (9th Cir. 1983).

[177] *Id.*; *see also* Hempt Bros. v. United States, 490 F.2d 1172, 1177 (3d Cir. 1974).

[178] S. Rep. No. 275, 11–12 (1921).

[179] See Bittker & Eustice, *supra* note 10, ¶ 12.01[1]. There is an assumption that a section 355 transaction is, in fact, a type of reorganization; *see* Revenue Act of 1951, Pub. L. No. 82-183, 65 Stat. 540; Bittker & Eustice, *supra* note 10, ¶ 11.01[1], [2].

[180] I use the term "tax favored" instead of "tax free," as gain can be recognized. *See* I.R.C. § 354.

[181] *See* I.R.C. § 368(a)(1)(A).

368 that permit this result.[182] If these transactions are to be permitted generally, and I see no prospect for this changing, they should be permitted for partnerships that incorporate shortly before the section 368 reorganization.

Cooperation from the states is also required. As discussed earlier, in many states, incorporating a state law partnership or LLC can pose major challenges.[183] State transfer taxes may apply, and consent by landlords and banks to the transfer of assets may be required, etc.[184] What are needed are conversion statutes. They already exist in many states.[185] Under such a statute, a state law partnership or LLC can convert into a state law corporation while being considered the same entity for state law purposes. This will avoid asset transfer issues.

Where the intention is to take the business of the LLC public, an alternative solution to the state-level problem would be to persuade the market to accept publicly traded LLCs. Then no state law conversion would be needed. The LLC-partnership could convert for tax purposes to an LLC-corporation. Revenue Ruling 1984-111 or its statutory equivalent would need to be amended to make clear which of the "Options" would apply on such a conversion, but generally the transaction should be tax free.[186] Publicly traded LLCs already exist. The difficulty with this approach is the market for publicly traded securities is accustomed to dealing with C corporations as an overarching entity. As noted in the venture capital discussion above,[187] the market is also accustomed to dealing with, and often prefers, C corporation ownership structures, including its classes of common and preferred stock. There will thus likely be resistance to the large-scale use of publicly traded LLCs.[188] Perhaps LLC statutes could be amended to permit owners to hold "common and preferred stock," but at that point it makes as much sense to simply have a state conversion statute.

4. *The Capital Gain Freeze*

Another advantage of an S corporation over a partnership is the so-called capital gain freeze technique. This normally presupposes a taxpayer who owns real estate that is a capital asset[189] with substantial, inherent long-term capital gains. If the property is sold before development, these gains are taxed at

[182] *See* I.R.C. § 368(a)(1); BITTKER & EUSTICE, *supra* note 10, ¶ 12.

[183] *See supra* text accompanying note 129.

[184] *See, e.g.*, MD. CODE ANN., TAX-PROP. § 13-201 et seq. (LexisNexis 2007).

[185] *See* BISHOP & KLEINBERGER, *supra* note 17, ¶ 12.14.

[186] *See supra* text accompanying notes 115–18.

[187] *See supra* text accompanying notes 129–31.

[188] *See* Fleischer, *supra* note 114, at 137; Goldberg, *supra* note 114, at 943.

[189] It is also possible for the property to be a section 1231 asset, which includes real property used in a trade or business. If a taxpayer's gains from section 1231 assets exceed his losses from those assets, all the gains and all the losses are generally characterized as long term capital gains and losses. I.R.C. § 1231. It is probably more common for the property to be a capital asset before it is developed.

favorable rates. In the case of raw land, for example, the rate is 15%.[190] If instead, the taxpayer subdivides and develops the land, selling the lots individually, all of the gain on the sales is ordinary income, including the gain inherent in the property before development. Property held for sale in the ordinary course of a trade or business does not qualify as a capital asset, even it was a capital asset in the hands of the taxpayer previously.[191]

There is currently a solution to this unhappy state of affairs. Before development, the taxpayer can sell the property to an S corporation the taxpayer controls. The S corporation then develops and sells the lots. The S corporation's gain on the sale of the lots is ordinary income, but the predevelopment gain is locked in as long term capital gain to the taxpayer by dint of the taxable sale to the S corporation.[192] The S corporation takes a fair market value basis in the property upon purchase.[193] It is very unlikely that the S corporation can be funded with sufficient cash to be able to pay for the property outright. Most likely the S corporation pays with promissory notes that are payable in the future as the S corporation collects revenues from the sale of the lots. Under the installment sale rules of section 453, normally the selling taxpayer only has to recognize his long-term capital gain as the notes are paid.[194] A heavily indebted corporation with a high debt to equity ratio sometimes has to worry about the debt being reclassified as equity.[195] This is not generally a problem in the S corporation context, however, as long as the debt meets the "straight debt safe harbor."[196]

The taxpayer cannot achieve this result by selling the property to a partnership. Section 707(b)(2) treats a partner's gain as ordinary income if the partner sells property to a partnership which in the hands of the partnership is not a capital asset, and the partner directly or indirectly owns more than 50% of the capital or profits interest in the partnership.[197] The selling partner, perhaps with other related parties, normally controls the partnership, and the property in the hands of the partnership is not a capital asset as the partner-

[190] I.R.C. § 1(h)(1)(C).

[191] *See* I.R.C. § 1221(a)(1); Mauldin v. Commissioner, 195 F.2d 714, 715 (10th Cir. 1952). Section 1237 contains a minor exception. I.R.C. § 1237.

[192] I.R.C. § 1001(c).

[193] I.R.C. § 1012.

[194] *See* I.R.C. § 453(e) (explaining limitations that do not usually pose problems).

[195] *See* BITTKER & EUSTICE, supra note 10, ¶ 4.02.

[196] *See* I.R.C. § 1361(c)(5). The debt must be sum certain payable on demand or on a specified date, the interest rate cannot be contingent on profits or the borrower's discretion, the debt cannot be convertible into stock, and the creditor must be an individual, an estate or trust that is qualified to be an S corporation shareholder, or a professional lender.

[197] The constructive ownership rules of section 267 apply for purposes of determining whether a partner meets the ownership test. These rules would, for example, attribute partnership interests owned by certain family members to the selling partners. *See* I.R.C. § 707(b)(3).

ship uses it in the business of development.[198] Section 707(b)(2) is generally said to be designed to prevent tax arbitrage. The sale gives the partnership a fair market value basis in the property. The likely cost to the related partner seller is long term capital gains likely taxed at low rates. Further, the partnership can now depreciate the property from the new, higher basis.[199] At times, the tax benefits of the higher basis to the partnership offsets the tax cost to the related selling partner. The risk of tax arbitrage is highly unlikely when the sale is of real property. The depreciation rates for improvements to real property are quite long, 27½ years for residential property and 39 years for commercial property.[200] Usually, only a mathematically-challenged partner accepts the tax burden of the sale gain today in exchange for a series of relatively small annual depreciation supplements to the partnership for many years in the future. Further, the real property involved in capital gain freezes probably is most often raw land, which is not depreciable at all. If the sale is of an apartment building which the parties want to convert to condominiums, the gain equal to depreciation previously taken is typically taxed at a fairly high rate, 25%, making the tax arbitrage more uneconomical and more unlikely.[201]

It is not apparent why existing, inherent capital gains should be converted to ordinary income when the use of the property changes. It is appropriate for future appreciation to be taxed in a manner that is consistent with the nature of the new use, but not past appreciation. This raises the question of whether an overarching solution should be found that would apply across the board and not just in the partnership context.[202] That is worth considering, though it is beyond the scope of this Article.

To bring some rationality to subchapter K in this regard and further integrate Subchapters S and K, at a minimum section 707(b)(2) should be amended to provide that it only applies to sales of personal property. Thus, the capital gain freeze technique for real property could be implemented with a partnership.

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[198] *See* I.R.C. § 1221(a)(2). The lots held for sale are also not capital assets. *See* I.R.C. § 1221(a)(1).

[199] Section 707(b)(2) overlaps with section 1239.

[200] I.R.C. § 168(c).

[201] *See* I.R.C. § 167; Simon v. Commissioner, 68 F.3d 41, 46 (2d Cir. 1995); *see also* I.R.C. § 1(h)(1)(D).

[202] Why require any long term capital gain that arose while property was held as an investment to be converted into ordinary income when the property is converted to a different purpose? Why require taxpayers to go through the fiction of a sale? Well, in truth, there could be practical problems. In the classroom, we can make our numbers up, but in the real world it is hard to know with certainty what the value is at the time property is converted to another use. Also, how will the service know if property is truly being held for investment? The current rule effectively requiring a sale to an S corporation (and under my proposal to a partnership) has the advantage of setting a heralding, reportable event that the Service can audit and upon which it can reach an independent judgment. Another possible solution that does not require a sale is to require a minimum holding period for the property during the investment phase where no significant development takes place, perhaps five years, with an appraisal to be done at the time of conversion by an independently licensed and unrelated appraiser.

5. *The Medicare Tax Dodge*

Here I move from the defensible to the sometimes indefensible.[203]

a. *Some Background.* Section 1401 imposes a tax on "net earning from self employment" (NESE).[204] The tax has two components. One component is for "old-age, survivors, and disability insurance," commonly known as the Social Security.[205] The tax is 12.4% of NESE. The maximum NESE to which it applies is $102,000 in 2008.[206] The other component is for "hospital insurance," commonly known as Medicare, and is 2.9% of NESE and applies to all of a taxpayer's NESE.[207] There is no dollar limit.[208]

NESE is defined as "gross income derived by an individual from any trade or business carried on by such individual, less the deductions . . . attributable to such trade or business, plus his distributive share of income or loss . . . from any trade or business carried on by a partnership of which he is a member . . . ."[209] NESE does not include certain kinds of passive income, including portfolio income, capital gain, and similar income (Excluded Income).[210] I will discuss this in more detail below, but note that in this definition *all* partnership income other than Excluded Income in NESE.

The Social Security and Medicare taxes apply differently to employers and employees. They apply to "wages," that is, compensation to an employee for services rendered.[211] The employer and the employee each pay one half of the Social Security and Medicare taxes. The total tax is the same as it is for the self-employed. Thus, the tax that the employer and employee each pay is 6.2% of wages for Social Security (up to the same $102,000 maximum that applies to self employment income) and 1.45% of wages for Medicare (without a maximum).[212]

A partner cannot be an employee of a partnership or receive wages from a partnership for services rendered.[213] Outside of Excluded Income, a gen-

[203] "Indefensible" was once also the name of Warren Buffet's private jet. It is now the "Semi-Defensible."

[204] I.R.C. § 1401.

[205] I.R.C. § 1401(a).

[206] This amount is adjusted for inflation; *see* Notice 2007-92, 2007-47 I.R.B. 1036.

[207] I.R.C. § 1401(b).

[208] Individuals are entitled to a trade or business deduction equal to one half of the self-employment tax. I.R.C. §§ 62(a)(1), 164(f).

[209] I.R.C. § 1402(a).

[210] I.R.C. § 1402(a). Among the exclusions are certain rentals from real estate, most dividends, certain interest, and certain property gains (typically from the sale of capital assets). *See* I.R.C. § 1402(a)(1). Certain retirement payments are also excluded. *See* I.R.C. § 1402(a)(10).

[211] The statutory phrase is "remuneration from employment." *See* I.R.C. § 3121(a).

[212] *See* I.R.C. §§ 3101, 3111; Notice 2007-92, 2007-47 I.R.B. 1036. Notwithstanding this division, there is evidence that employees bear the economic burden of the entire tax. They pay their own share directly and, in effect, the employer's share through reduced wages. *See* HARVEY ROSEN, PUBLIC FINANCE 286 (7th ed. 2005).

[213] Rev. Rul. 1969-184, 1969-1 C.B. 256.

eral partner's distributive share of income is always NESE.[214] NESE does not include the distributive share of any limited partner other than guaranteed payments under section 707(c) for services rendered.[215] Note that a partner can hold both a limited and general partner interest, and section 1402(a) applies to each separately. The limited partner exception was added to prevent passive investors from obtaining Social Security coverage. Limited partners had originally been subject to Social Security and Medicare taxes to the same extent as general partners, but Congress was concerned that limited partnerships might be established as investment vehicles in order to obtain Social Security coverage and excluded limited partners in the late 1970s.[216] Who qualifies as a limited partner is not defined in the Code or Regulations, but it appears from the legislative history and the plain language of the statute that a state law limited partner is meant.[217] Thus, apparently all tax partners who are not state law limited partners, including LLC members, fall under the general NESE rule.[218]

To summarize, all income from a trade or business (other than Excluded Income) of any partner (other than a limited partner) is NESE, regardless of the partner's participation in the business, regardless of the capital invested in the business, and regardless of the character of the business. It is thus very possible for a partner (other than a limited partner) to have NESE that is unrelated to any services performed by the partner.

One might think that both wages and NESE would measure the same thing, income earned from the provision of services. The fact that this is not the case has much to do with the history of the Social Security tax. The Social Security tax structure was originally centered on the employer-employee relationship.[219] In the early years, coverage extended only to limited groups of wage earners.[220] The self-employed were not covered.[221] Thus, originally it was clear that the Social Security tax (the Medicare tax had not yet been created)[222] applied only to income from services. The self-employed originally resisted coverage, but then in the 1950s acquiesced partly due to the fact that meaningful coverage could be had at what at the time was still a low rate of

[214] I.R.C. § 1402(a).

[215] I.R.C. § 1402(a)(13).

[216] *See* Patricia E. Diller, *Breaking the Glass Slipper—Reflections on the Self-Employment Tax*, 54 TAX LAW. 65, 85 (2000).

[217] *See* H.R. REP. No. 95-702 at 40, 1978-1 C.B. 469, 477 (1977). At that time, only a state law limited partnership could been meant as LLCs and similar entities did not yet exist. *See also* David C. Culpepper et al., *Self-employment Taxes and Passthrough Entities: Where Are We Now*, 109 TAX NOTES (TA) 211, 212 (2005). The Service might be authorized to expand that definition. *See infra* text accompanying notes 230–238.

[218] See Culpepper, *supra* note 217.

[219] *See* Diller, *supra* note 216, at 70.

[220] *Id.*

[221] *Id.* at 71.

[222] It was enacted in 1965. *See* Social Security Amendments of 1965, Pub. L. No. 89-97, 79 Stat. 286.

tax.[223] Congress had been concerned about the administrative feasibility of including the self-employed within the Social Security system, particularly with regard to obtaining accurate reports of their income.[224] These concerns were eventually laid to rest and the self-employed were included, but nothing in the legislative history suggests that Congress wanted the focus of the Social Security tax to move from a tax on income from services to a tax on income from services *and* capital. Further, at the time the self-employed were brought into the fold, much of the discussion seems to have centered on applying the Social Security tax to professionals such as doctors and lawyers, that is, service providers.[225] Thus, when Congress brought the self-employed within the Social Security tax system, it likely thought that NESE primarily focused on income from services. Further, by excluding certain passive income and later income of limited partners (historically by definition passive participants), Congress made some effort to exclude from NESE certain kinds of income that are not from services.

Finally, there would have been little logic to expanding the Social Security tax to include income from capital. Why should the type of income subject to Social Security and Medicare taxes for employees be different than that for the self-employed? Employers and employees are not being rewarded for using double-tax C corporations, as S corporations, which also can have employees, are subject to the same employment tax rules as C corporations. S corporations have been on the scene since 1958 and conceptually since 1946.[226] Further, the Social Security benefits one receives are a function of what one pays in.[227] Why would Congress want the self-employed to have a larger base for benefits than employees? Whatever Congress's intent, Social Security and Medicare taxes should not apply to income from capital.

b. *Time Waits For No Congress.* Time has passed section 1402 by. There is not a lot of logic to its current structure in the current business universe. While self-employment taxes should focus on income from services, in an LLC universe NESE can, and often does, include much income that is from capital. There is no good reason why passive owners who are limited partners are not subject to self-employment taxes and passive owners who are LLC members are subject to self-employment taxes. Further, in an increasing number of states limited partners have increasing rights to participate in the affairs of the limited partnership,[228] making their automatic exclusion from NESE dubious. The logic behind these dichotomies has not been apparent to

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[223] *See* Diller, *supra* note 216, at 71–74.

[224] S. Rep. No. 1669 (1950); *see also* Yoder v. Harris, 650 F.2d 1170, 1173 (10th Cir. 1981) (discussing the relevant legislative history).

[225] *See* Diller, *supra* note 216, at 71–74.

[226] Pub. L. No. 85-866, 72 Stat. 1606 (1958); *see* Richard B. Goode, The Postwar Corporation Tax Structure (Treas. Dep't 1946).

[227] *See* Diller, *supra* note 216, at 70.

[228] See Unif. Ltd. P'Ship. Act § 303 (2001).

the Service either.[229]

In 1997, the Treasury proposed regulations in this area. This was one of several efforts I will outline that attempt to limit NESE to income from services, or at least reduce the amount of income from capital that is included in NESE. The Treasury faced a terminological challenge, in that it had to squeeze its regulations into the statutory general-limited partner structure. It did this by freeing the term "limited partner" in the tax statute from that term in state law statutes. Under the Proposed Regulations, a member of any state law entity that is classified as a partnership for federal income tax purposes can be treated as a limited partner for section 1402 purposes under some circumstances.[230] The Proposed Regulations also partially address the overarching issue of when income is from services and when from capital.

The laudable objective of the Proposed Regulations is to insure that similarly situated individuals owning interests in entities formed under different statutes or in different jurisdictions are treated similarly.[231] The Proposed Regulations treat an individual as a limited partner unless the individual (1) has personal liability for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.[232] Note that if a state law limited partner meets one of the three criteria, he is not a limited partner for section 1402 purposes.

If an LLC is "member-managed," all members have the apparent authority to contract on behalf of the LLC, irrespective of whether they hold multiple classes of interests or not.[233] Consequently, no member of a member-managed LLC qualifies as a limited partner under the Proposed Regulations. On the other hand, in a manager-managed LLC, the managers have the exclusive authority to manage the LLC, and members who are not managers normally do not have any apparent authority to contract.[234] Consequently, these non-managing members can qualify as limited partners as long as they do not fail the 500-hour test. By statute they have no general liability for the obligations

[229]Some older private letter rulings treat a LLC member's share of income as NESE. *See, e.g.*, P.L.R. 1994-32-018 (May 6, 1994); P.L.R. 1994-52-024 (Sept. 29, 1994); P.L.R. 1995-25-058 (Mar. 28, 1995).

[230]Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997). These were preceded by Proposed Regulation section 1.1402(a)-18, 59 Fed. Reg. 67,253 (1994), which focused more on LLCs, as such.

[231]*See* Prop. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702, 1702 (1997) (*see* "Background").

[232]*Id.* The 500-hour rule is derived from the regulatory definition of material participation under the passive loss rules of section 469. *See* Reg. § 1.469-5T(a)(1).

[233]*See* Bishop & Kleinberger, *supra* note 17, ¶ 7.02.

[234]*Id.*

of the LLC; thus test (1) of the Proposed Regulations could not apply.[235]

The Proposed Regulations contain a special rule for services partnerships, under the assumption that virtually every one involved will be actively performing services. The Proposed Regulations provided that if substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides such services for the partnership cannot be classified as a limited partner, and thus all of his income is NESE (other than Excluded Income).[236]

The Proposed Regulations permit individuals to hold more than one class of interest in any partnership except a services partnership. A partner may bifurcate his interests, with some interests earning NESE, and other "limited partnership interests" not earning NESE.[237] Thus, the treatment that is available today in a state law limited partnership, the Proposed Regulations make available to all nonservices tax partnerships.[238] It is here that the Proposed Regulations make an initial attempt to tussle with the issue of when income is from services and when from capital. In effect, the Proposed Regulations are saying that for nonservices partnerships (irrespective of the state law classification) it is permissible to create a class of limited partnership interests to which non-NESE income can be allocated. This income can be viewed as coming from capital and not from services. While the Proposed Regulations are hardly comprehensive, they take a step in the right direction.

The Proposed Regulations were generally well received,[239] but Congress imposed a moratorium, stating that they could not be finalized before July

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[235] A limited liability partnership (LLP) is a general partnership with a liability shield. Thus, its partners are general partners, and, in most states, have the authority to contract to the same extent as general partners in general partnerships, and thus also would not have qualified as limited partners under the Proposed Regulations irrespective of whether they hold multiple classes of interests or not. *See* Culpepper, *supra* note 217; *see generally*, BISHOP & KLEINBERGER, *supra* note 17, ¶ 1.05.

[236] Prop. Reg. § 1.1402(a)-2(h)(5), 62 Fed. Reg. 1702 (1997).

[237] Under the Proposed Regulations, it is possible to qualify as a limited partner even if the partner participates over 500 hours and does not hold multiple classes of interest. For this rule to apply, limited partners (as normally defined under the Proposed Regulations) must own a substantial, continuing interest in the partnership, and the rights and obligations of the individual in question must be identical to those for the limited partnership class. The underlying presumption apparently is that the partner would be paid for her services, and the rest of any payment should be seen as return on capital. Note that the partnership would still have to have two classes of interest overall. Prop. Reg. § 1.1402-2(h)(4).

[238] The Proposed Regulations, however, permit the bifurcation of interests only to the extent the individual's rights and obligations with respect to a limited partnership class of interest is identical to the rights and obligations of other partners in that class who (1) qualify as limited partners under the Proposed Regulations without regard to the bifurcation rules, and (2) own a substantial interest in the partnership. Prop. Reg. § 1.1402(a)-2(h)(3), -(h)(4).

[239] *See* John R. Marquis, *Business Problems & Planning: Current Status of Limited Liability Companies and the Self-Employment Income Tax*, 77 MICH. B. J. 440, 441 (1998).

1, 1998.[240] That date has come and gone without the Treasury taking any additional action on the Proposed Regulations, though they have not been withdrawn. Congress appears to have been concerned about the risk of existing state law limited partners being reclassified as other than limited partners for federal income tax purposes.[241] In fact, this risk was quite slight as most limited partners doubtless fail all three tests.[242] Further, in those cases where reclassification might happen, it is likely justified. Political pressure, not for the first time, may have taken precedence over sound tax policy, and to date the Treasury has not had the intestinal fortitude to take another run at it.

The difficulty with the Proposed Regulations is that they do not tackle the income-from-capital versus income-from-services issue head-on. Curiously, the Proposed Regulations provide backdoor endorsement of manager-managed LLCs, as they are the only unincorporated entity other than a state law limited partnership that can effectively create two classes of interests. LLCs are usually preferred to limited partnerships, as limited partnerships require two entities to achieve a full liability shield, the limited partnership itself and a corporation or LLC as the general partner.[243] To muscle the nonservice universe into these two entities—few would want to use C corporations—is perhaps not the most sensible approach. On the other hand, the Service was bound by the limitations of the statute it was interpreting. The only "out" from NESE was the income allocated to a limited partner. Others have had a freer hand.

In 1998, the American Institute of Certified Public Accountants (AICPA), in response to the Proposed Regulations, suggested a statutory change.[244] In broad outline, the AICPA's proposed amendment provides that partners in tax partnerships have NESE to the extent of the reasonable value of the services performed on behalf of the partnership. It contains a safe harbor for determining the reasonable value of services. If a partner's NESE varies from the safe harbor by more than ten percent, the NESE is subject to "reason-

[240] *See* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 935, 111 Stat. 788, 882 (1997).

[241] *See* Culpepper, *supra* note 217, at 222.

[242] Congress itself partially acknowledged the truth of this in 1997. When discussing the passive loss rules, the Statement of Managers for the Taxpayer Relief Act of 1997 observes that limited partners usually do not materially participate in a partnership's activities. H.R. Rep. No. 105-220, at 662 (1997) (Conf. Rep.), *reprinted in* 97 TAX NOTES TODAY 148-32 (Aug. 1, 1997); *see also* Culpepper, *supra* note 217.

[243] In states that allow limited liability limited partnerships (LLLPs) it may be possible to get by with one entity, but only a minority of states allow for LLLPs, and most advisors will insist on a corporation or LLC as a general partner if the LLLP is going to be doing business in a non-LLLP jurisdiction. An LLLP is a limited partnership with a liability shield around the entire partnership so that even the general partners have limited liability. *See generally* BISHOP & KLEINBERGER, *supra* note 17, ¶ 1.02.

[244] *AICPA Forwards Legislative Proposal on Self-Employment Taxes*, 98 TAX NOTES TODAY 39-34 (Feb. 27, 1998) [hereinafter *AICPA Proposal*]. The Small Business Tax Modification Act of 2004, section 3, takes a similar approach to that of the AICPA (doubtless not by coincidence). *See infra* notes 281–300.

ableness testing on the basis of facts and circumstances. . . ." The safe harbor NESE is the partner's distributive share of partnership income or loss *plus* the section 707(c) guaranteed payment for services *minus* a reasonable rate of return on the partner's capital account at the beginning of the year. The rate of return on the partner's capital account is deemed to be reasonable if the rate used is 150% of the applicable federal rate[245] (AFR) at the end of the partnership's tax year.

The proposal has several shortcomings. It does not except services partnerships, the most likely area of abuse, notwithstanding the fact that an objective review of most service partnerships would conclude that all or almost all of their income is NESE. What is worse, given the safe harbor, service partnerships have an incentive to inflate capital accounts to avoid NESE. This could be done by making cash contributions to the partnership and holding them in a money market account. Further, capital accounts are usually not precise measures of the value of partners' invested capital.[246] While they can under some circumstances be "restated" to current value, this is relatively uncommon.[247] A partner's capital account may lag far behind or move far ahead of the value of the partner's partnership interest. Thus, a reasonable rate of return on the partner's capital account may yield a meaningless number. Finally, while there is much to be said for bright, predicable lines, the 150% AFR standard is arbitrary. For some industries the 150% rate could be far high or far low.[248] The AICPA provides for additional fudge room by permitting partners to vary from the safe harbor by ten percent. Of course, what the AICPA is likely trying to do is limit partners' NESE as much as practicable.

In 2005, the Joint Committee of Taxation (JCT) also proposed a statutory change.[249] This proposal eliminates the special rule for limited partners and applies to all tax partnerships. All income, including Excluded Income, is NESE in the case of a partnership engaged in the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting (professional services). For other partnerships, how a partner is treated is a function of whether or not the partner "materially

[245]The Service sets short-term, mid-term, and long-term applicable federal rates monthly. *See, e.g.*, Rev. Rul. 2008-43, 2008-31 I.R.B. 258. Curiously, the AICPA report does not specify which of these three applicable federal rates it would use. *See AICPA Proposal*, *supra* note 244.

[246]Under the Regulations, capital accounts must be increased for the fair market value of contributed property (net of associated debt), money contributed, and allocable partnership income. The capital accounts must be decreased for the fair market value of distributed property, money distributed, and partnership losses. Reg. § 1.704-1(b)(2)(iv)(b).

[247]*See* Reg. § 1.704-1(b)(2)(iv)(f).

[248]*See* Letter from George K. Yin, Acting Chief of Staff, Joint Committee on Taxation, to Senators Charles E. Grassley and Max Baucus, at 34, (Aug. 3, 2006) [hereinafter JCT 2006], *available at* http://www.senate.gov/~finance/press/Gpress/2005/prg101906.pdf.

[249]STAFF OF J. COMM. ON TAX'N, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, 99 (2005), *available at* http://www.house.gov/jct/s-2-05.pdf. I do not discuss their S corporation proposals, as they are moot under my proposal.

participates" in the partnership.[250] If the partner materially participates, all income other than Excluded Income is NESE. If the partner does not, only his reasonable compensation for services rendered is NESE.

This JCT proposal has a few problems. One of them is the provision that Excluded Income is NESE for professional services partnerships. This is a curious change and, as I discuss below, one from which the JCT ultimately backs away. To take one example of Excluded Income to make the point, dividends that a professional service partnership receives are not likely to be somehow "tainted." If dividends should not normally constitute NESE, and since they are not normally compensation for services they should not, there is no apparent reason they should be NESE to a services partnership. Since Excluded Income is easily identified, and needs to be identifiable for non-services partnerships regardless, there is no great additional administrative burden by continuing the exclusion for services partnerships.

Aside from the Excluded Income issue, providing that all income of a services partnership is NESE makes good sense. In a small minority of cases, a services partnership may legitimately have income from capital. There may occasionally be a partner who does not significantly participate in the affairs of the partnership, though he probably did at some point. But it is likely that in an overwhelming majority of services partnerships, an objective analysis would reveal that all the income (other than Excluded Income) is NESE. A rule which makes that real world reality the tax reality is difficult to attack. Trying to except out special cases for income from capital or income of low-participation partners helps few and creates opportunities for abuse, as well as consequent enforcement challenges. Partners would claim income came from capital when it did not, or claim that they participated less than was in fact the case. The Service would have to spend time dealing with the misguided. It all would not be worth the effort. It is not clear, however, why the JCT focused just on professional services partnerships. It seems that the issues would be the same for any services partnership.

Treating all of a partner's income from a nonservices partnership as NESE if a partner materially participates is difficult to justify. A partner might materially participate in a capital intensive partnership where most of the income of the partnership comes from the capital invested, not the partner's services. Furthermore, since services partnerships are already off the table, this rule is very likely to catch situations where the income from capital is substantial. The JCT proposal does have the advantage of providing a bright line, which can provide for administrative ease, but its bright line is too divorced from reality.

[250]The material participation standards were created by section 469, the passive loss rules. An activity generally is not passive with regard to taxpayer if he materially participates in it. *See* I.R.C. § 469(c)(1). The Regulations contain various ways in which a taxpayer may materially participate, for example, by participating more than 500 hours during the taxable year. *See* Temp. Reg. § 1.469-5T(a).

In 2006, the JCT proposed a modified version of its 2005 proposal. It essentially drops, or at least no longer lobbies for, its nonservices partnership proposal. It keeps its services partnership proposal, except that Excluded Income is no longer NESE.[251]

The American Bar Association Tax Section has taken several runs at this issue. I will focus only on the most recent effort, if for no other reason than I participated in the task force that prepared the Section's comments.[252]

In its comments, which are fairly brief, the Tax Section unsurprisingly applauds the fact that the JCT dropped its treatment of Excluded Income of services partnerships as NESE.[253] The Tax Section, however, objects to the "wholesale expansion" of the income treated as NESE.[254] It is not clear to what expansion the Tax Section is referring. The real expansion is occurring because an unchanged section 1402 is applying to a broader range of businesses and thus a broader range of income, and is not coming from the JCT.[255] The Tax Section argues that for both service and nonservice partnerships, the most appropriate rule is to treat as NESE only that portion of the net income of a partnership that represents reasonable compensation for services rendered.[256] The Tax Section recommends that if the JCT approach for service partnerships is adopted, an exception for "de minimis service partners" be created for those who provide low amounts of services.[257] Under the Tax Section proposal, NESE for de minimis service partners consists of guaranteed payments as well as the partners' distributive share of income generally, but in the latter case only to the extent it constitutes reasonable compensation for services rendered.[258] With regard to nonservices partnerships, the Tax Section argues "strongly" that NESE be limited to an amount that constitutes reasonable compensation, as income also will come from capital.[259] Should that be considered to be administratively unworkable, the Tax Section recommends a complex proposal that includes guaranteed payments as NESE.[260] Additionally, a "'material participation partner's' distributive share of income (other than Excluded Income) [is] NESE to the extent of reasonable compensation for services. . . ."[261] The Tax Section further recommends that there

[251] *See* JCT 2006, *supra* note 248.

[252] *See ABA Tax Section Suggests Legislative Fix for LLC Self-Employment Tax*, 1999 Tax Notes Today 133-23 (July 6, 1999).

[253] *See* ABA Section of Taxation Comments on Additional Options to Improve Tax Compliance Prepared by the Staff of J. Comm. on Tax'n 7 (Aug. 3, 2006) [hereinafter ABA Comments]. I do not address the S corporation proposals, as they are mooted by my proposal.

[254] *See id.*

[255] *See supra* text accompanying notes 206–227.

[256] *See* ABA Comments, *supra* note 253 at 7.

[257] *See id.* at 8.

[258] *Id.*

[259] *Id.* at 43.

[260] *Id.* at B-1.

[261] *Id.* at 9.

be a rebuttable presumption that guaranteed payments and the distributive share are NESE up to a "presumption amount;" the Tax Section suggests that the maximum income to which the Social Security tax is applied ($102,000 in 2008[262]) be that presumption amount.[263] As I discuss below, it has become common for advisors to S corporations to recommend that shareholder-employees only take the Social Security tax maximum as a salary and let the rest of the S corporation's income "flow through" as nonwage income. (Elsewhere in its comments, the Tax Section endorses this approach.) The Tax Section is attempting to obtain official sanction for a practice that likely usually understates compensation. If the Social Security tax maximum is the presumption amount, it is a safe bet that the vast majority of partners will limit their compensation to be the presumption amount, and large amounts of what should be compensation income will escape Social Security and Medicare taxes. Congress and the Service should not entertain such an invitation to end run the Social Security and Medicare tax system, particularly given the financial difficulties in which Social Security and Medicare find themselves.[264]

I propose amending section 1402 to catch it up with the real world. I discuss my proposal in terms of partnerships, but would apply it to disregarded entities-sole proprietors as well. What the JCT and the Proposed Regulations do wisely, and will go a long way toward limiting abuse, is to carve out a special rule for partnerships primarily engaged in the performance of services. I agree with the JCT that all income of a services partnership (except Excluded Income) should be classified as NESE. While it is certainly possible that a given service partnership has a substantial investment in capital, allowing service partnerships to allocate earnings to capital opens the door wide for abuse. As I noted above, for the vast majority of service partnerships, capital is mostly likely not a large income producing factor. Additionally, there may occasionally be partners in service partnerships who provide little in the way of services, but they likely once did if the partnership is allocating income to them. Further, the income that is being allocated to them is, most likely, from someone's performance of services. By the mere expedient of shifting income from active to inactive partners, Social Security and Medicare taxes should not be avoided. Treating all income (other than Excluded Income) from service partnerships as NESE will create little unfairness, while avoiding many shenanigans, and reducing the enforcement burdens of the Service. The Proposed Regulations and the JCT, however, limit the rule for service partnerships to those engaged in the performance of professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting. Yet the underlying policy issues apply to any service partner-

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[262] This amount is adjusted for inflation. *See* Notice 2007-92, 2007-47 I.R.B. 1036.

[263] *See* ABA COMMENTS, *supra* note 253 at 9.

[264] *See generally Social Security: Achieving Sustainable Solvency: Hearing Before the S. Comm. on Finance*, 109th Cong. 1–17 (2005) [hereinafter Senate Finance Hearing], *available at* http://finance.senate.gov/hearings/27402.pdf.

ship, so I would apply my proposal to any service partnership, not just those engaged in the specified professions. My broader approach creates the need to formally define a services partnership. A reasonable definition is any partnership less than 20% of the gross income of which is attributable to nonhuman capital.

For nonservice partnerships, I largely agree with the Tax Section. Anyone performing services for a nonservices partnership should be required to be paid reasonable compensation for those services, and that amount should be NESE. I have no "presumption amount" which, as I noted above, will commonly lead to improper tax avoidance. I treat partnership income in excess of reasonable compensation as income from capital and not as NESE.

The reasonable compensation for services standard may seem unduly vague, and indeed will create administrative burdens, but in fact it has been one we have lived with for generations. It had been regularly applied in the C corporation context.[265] Commonly there, shareholder-employees have attempted to avoid the C corporation double tax by paying themselves a large salary. They argued that as salary, the payment is income to the recipient, deductible to the corporate payor, and thus (they hoped) subject to one level of tax.[266] Courts have analyzed these purported salary payments under various standards, and if they concluded the salary was unreasonably high, reduced it, with the excess being reclassified as a nondeductible dividend.[267] There have also been occasions where the courts have looked at whether a salary is too low, as I will discuss below.

Admittedly, allowing courts to resolve compensation issues creates inefficiencies and uncertainties. In a given set of circumstances, taxpayers will not be able to be completely certain if their allocation between compensation and a return on capital will be respected, and it might encourage some to play the audit lottery in the hopes that their abusive scheme will not be uncovered. But the reality is that a fixed rule like that of the JCT for nonservices partnerships often will be far of the mark. What is appropriate compensation varies greatly based on the amount of capital involved, the extent of the services provided, the nature of the industry involved, and doubtless a host of other factors. The inequity of a fixed rule in the nonservices partnership context argues for a more general standard. Further, the fact that all income (other than Excluded Income) of service partnerships is automatically NESE will ease the administrative burden on the Service and the courts, providing

[265] Menard, Inc. v. Commissioner, 2009-1 U.S.T.C. ¶ 50,270, 103 A.F.T.R.2d 1280 (7th Cir. 2009); Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999).

[266] *See Menard*, 2009-1 U.S.T.C. ¶ 50,270, 103 A.F.T.R.2d 1280; *Exacto*, 196 F.3d at 833; I.R.C. § 162(a).

[267] *See Exacto*, 196 F.3d at 833 (7th Cir. 1999) (analyzing the reasonableness of the salary based on whether an adequate return was being paid to the shareholders on their investment); Owensby & Kritikos v. Commissioner, 819 F.2d 1315 (5th Cir. 1987) (applying a multiple-factor test); *see also* Haffner's Serv. Stations v. Commissioner, 326 F.3d 1 (1st Cir. 2003) (applying factors but acknowledging the legitimacy of the *Exacto Spring* decision).

something of an offset.

c. *The Scofflaw Gambit.* The current definition of NESE means that a taxpayer who wants to avoid Social Security and Medicare taxes will not find the partnership soil very fertile. Ah, but an S corporation, that is a very different matter. While a partner may not be an employee of a partnership,[268] there is nothing to keep a shareholder from being an employee of a corporation, whether it be a C corporation or an S corporation. Employers and employees are only assessed Social Security and Medicare taxes on the compensation that is paid to the employee.[269] That fact gives rise to the following tax avoidance technique using S corporations. The S corporation pays a modest salary or perhaps no salary at all to its shareholder-employees. The net income of the S corporation not used to pay salaries "flows through" under the regular S corporation section 1366 rules, arguably as noncompensation, and therefore arguably not subject to Social Security and Medicare taxes.

This gambit has been going on for many years. I spoke about it at CLE seminars some 15 years ago, and advised participants not to form S corporations just for this purpose, as the Service would likely close this loophole soon. No one on the panels ever disagreed. We were less than prescient. The Service has failed to sufficiently police this area. Taxpayers have used S corporations to avoid both Social Security taxes and Medicare taxes. Since Social Security taxes are only applied to limited amounts of compensation ($102,000 in 2008[270]), S corporation shareholders have to pay themselves relatively low salaries or no salaries to save these taxes. And, in fact, they have done so. The Service has challenged the most piggish gambit users, those that have paid themselves little or no salary. The Service has won all of these cases. Courts have generally concluded that the earnings of the S corporation constituted compensation to the shareholder-employees, either under a substance over form analysis or by concluding that the distributed earnings constituted reasonable compensation for the services rendered.[271]

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[268] Rev. Rul. 1969-184, 1969-1 C.B. 256.

[269] *See supra* text accompanying notes 211–17.

[270] This amount is adjusted for inflation. *See* Notice 2007-92, 2007-47 I.R.B. 1036.

[271] *See* Nu-Look Design v. Commissioner, 356 F.3d 290 (3d Cir. 2004); Specialty Transp. and Delivery Servs. v. Commissioner, 2004-1 U.S.T.C. ¶ 50,203, 93 A.F.T.R.2d 1374 (3d Cir. 2004); Spicer Accounting v. United States, 918 F.2d 90 (9th Cir. 1990); Dunn & Clark P.A. v. Commissioner, 853 F. Supp. 365 (D. Idaho 1994); Radtke S.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990); Veterinary Surgical Consultants v. Commissioner, 117 T.C. 141 (2001), *aff'd* 2004-1 U.S.T.C. ¶ 50,209, 93 A.F.T.R.2d 2004-1273 (3d Cir. 2004); W. Mgmt. v. United States, 45 Fed. Cl. 543 (Fed. Cl. 2000); Joly v. Commissioner, 76 T.C.M. (CCH) 633, 1998 T.C.M. (RIA) ¶ 98,361. In these cases, the courts often focused on distributed earnings, and typically most or all of the earnings were distributed. Distribution should not change the analysis. If the S corporation earnings are indeed best classified as compensation to the shareholder-employees, whether or not they are distributed in a given year should not change the answer. Typically, the shareholder-employees have full control over timing. *See also* Charlotte's Office Boutique v. Commissioner, 121 T.C. 89 (2003), *aff'd*, 425 F.3d 1203 (9th Cir. 2005).

Curiously, the Service has never litigated nor expressed an opinion on the more temperate taxpayer who has the S corporation pay her a moderate salary.[272] For example, in 2008 a neurosurgeon with $1 million of net S corporation income (before salaries) might pay herself the Social Security income maximum of $102,000 as a salary, and let the rest of the income flow through as noncompensation. She thus saves the Medicare tax of 2.9% x $898,000 = $26,042.[273] And she is a happy woman. I choose the $102,000 Social Security maximum for a reason. Some advisors are routinely telling their clients to pay this amount to themselves as salary, and to treat the balance of the S corporation income as noncompensation.[274] One of my own doctors told me he takes this approach, and clearly is under the impression that he is not obligated to pay himself more than the Social Security maximum as salary.

In a pure services S corporation, through which, for example, a doctor or a lawyer practices her profession, this is obviously abusive. Most likely, if litigated, a court will find all or almost all of the S corporation's income to be compensation for services as they have in the admittedly more "hoggish" cases that have been litigated to date.[275]

In the closely held corporation context, courts generally have required corporations to pay reasonable compensation to their shareholder-employees.[276] Continuing with the neurosurgeon example, all of the income of the S corporation is attributable to her services. Therefore, normally reasonable compensation is all of the net income of the S Corporation. Reasonable com-

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[272] *See* H.R. 3970, 110th Cong. § 1211 (2007) (attacking the totality of the problem within the S corporation context).

[273] Easily the most famous person to use this technique was former senator, vice presidential nominee, presidential candidate, and bon vivant John Edwards. Over four years (1995–1998), on income of about $27 million, he saved Medicare taxes of over $590,000. See Michael Moss & Kate Zernike, *Campaign Releases Edwards's Earnings*, N.Y. TIMES, Jul. 10, 2004, at A-1. The journalism on this news story left something to be desired. The technique was portrayed as a legitimate "tax shelter." *Id.* If challenged, a court most likely would have held almost all of the S corporation income to be compensation. The specifics: Edwards apparently incorporated mid-way through 1995. In that year he paid himself a salary of $180,000 on income for the year (including pre-incorporation) of $5 million. In 1996, the S corporation earnings were $4 million and Edwards received a salary of $360,000. In 1997, the S corporation earnings were $11 million and Edwards received a salary of $360,000. In 1998, his final year of law practice, the S corporation earnings were $5.5 million with the same $360,000 salary. *See* Tom Daley, *Edwards's S Corp: Can We Get the Numbers Right?*, 2004 TAX NOTES TODAY 178-32 (Sept. 13, 2004). The total earnings reported in the Daley piece are somewhat less than in the N.Y. Times Article ($25.5 million versus $27 million). I have not found a source for this, but I have heard that the $360,000 salary was based on what the average personal injury lawyer makes in North Carolina, the state where Edwards practiced law. *See also*, Kip Dellinger, *Edwards's S Corp: The Revised Numbers are Still Absurd*, 2004 TAX NOTES TODAY 183-33 (Sept. 20, 2004).

[274] I have not come across written evidence of this, but it is often implied. *See, e.g.*, Alan L. Olson, Ten Tax Planning Ideas for Small Business in 2009, http://www.groco.com/readingroom/tax_smallbusiness.aspx (last visited Apr. 3, 2009).

[275] *See supra* note 271.

[276] *See* Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999); *Joly*, 76 T.C.M. (CCH) at 633, 1998 T.C.M. (RIA) ¶ 98,361 at 2148.

pensation must be based on the value of the neurosurgeon herself and not, say, the value of the average neurosurgeon. Otherwise the top neurosurgeon in a state making five times the average could argue that her compensation should be based on what the average neurosurgeon earns, or one fifth of what she is actually earning. That would be an easy way to save Medicare and possibly Social Security taxes. But if that top neurosurgeon went to work for a bona fide employer, she would not accept the average wage, she would insist on being compensated for her actual worth. That is her reasonable compensation, or in the typical case, all of the net income of the S corporation. What makes this argument even more persuasive is the fate of the below average neurosurgeon. Should a neurosurgeon whose S corporation earns less than the average be deemed to have compensation equal to the average? Obviously, that would make no sense.

There might occasionally be an argument that there is a sufficient capital investment so that a small percentage of the income is allocable to capital. But clearly what is usually going on is an effort to make an end-run around the Medicare tax and Social Security tax systems. It is axiomatic that substance controls form,[277] and likely in the vast majority of cases[278] the substance is that all of the net income of the S corporation constitutes the earnings of the service provider, the S corporation form only being used for the purpose of lowering Medicare or Social Security taxes, or both.

Senator Wyden, an Oregon Democrat, calls those who make such inappropriate use of S corporations "Social Security Scofflaws."[279] The cost to the fisc from this technique is not insubstantial. The underpayment of Medicare and Social Security taxes through the use of S corporations is estimated to be about $6 billion per year for each tax, or about $12 billion per year in total.[280]

What is curious is how long the "temperate strategy" has been going on without the Service addressing the issue. Much of the abuse might have been stopped by a simple revenue ruling from the Service outlining a classic case such as the neurosurgeon example and concluding that it does not work; all of the S corporation income is wages. Many practitioners are reluctant to advise clients to violate a revenue ruling. Nor has the Service ever litigated a case similar to the neurosurgeon example, where a meaningful but clearly inadequate salary was paid. That likely would have brought closure to the area. The Service's failure to act has cost the fisc many billions. Of course, the

[277] Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978).

[278] I am aware of no hard data on what percentage of the time this use is made of S corporations.

[279] *See* Senate Finance Hearing, *supra* note 264, at 29–30.

[280] In 2005, the Treasury Inspector General for Tax Administration estimated that for 2006–2010, unless the law is changed, the Medicare and Social Security tax gap resulting from under-compensation of Subchapter S shareholders-employees would be $30.2 billion and $30.8 billion respectively. *See id.* at 51 (prepared statement of Hon. Russell George, Treasury Inspector General for Tax Administration).

repeal of Subchapter S will stop the abuse once and for all.

President Obama, when campaigning for the presidency, proposed expanding the Social Security tax base by having an additional two percent Social Security tax apply to the wages of both employers and employees (four percent of NESE for the self-employed) for those with wages or NESE in excess of $250,000. There would be no new taxes on the "doughnut" between Social Security maximum (currently $102,000) and $250,000.[281] The loss to the fisc of Medicare and Social Security tax revenues will rise exponentially, if President Obama's proposal is enacted without addressing the use of S corporations to avoid these taxes.

If it is clear that S corporations can no longer be used to avoid Medicare and Social Security taxes, the political resistance to the repeal of Subchapter S likely will be dramatically lessened. This is particularly true if the legitimate benefits of Subchapter S are incorporated into Subchapter K, and taxpayers are given a taxpayer-friendly way of exiting Subchapter S. I discuss the latter point in more detail below

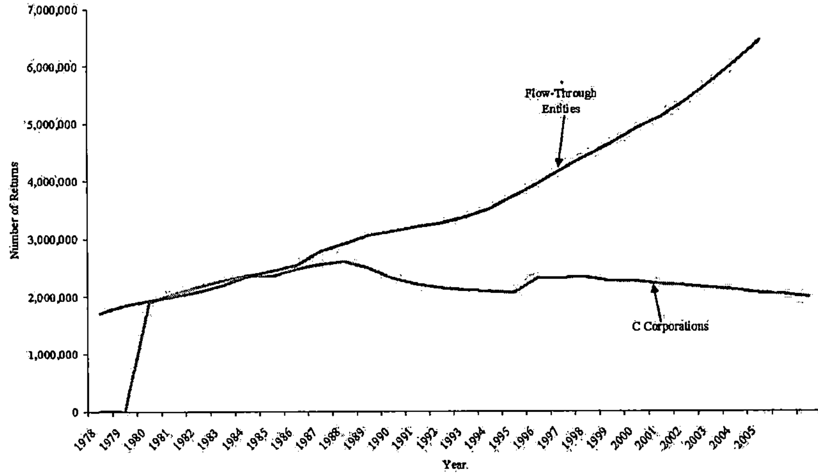
IV. Popularity of the Various Business Entities

Given the way tax law has developed, one would expect C corporations with their double tax burden to have dropped in popularity, and flow-through entities such as LLCs and S corporations to have increased in popularity. The data and expectations are in alignment. Below is a chart showing the

[281] *See* Notice 2007-92, 2007-47 I.R.B. 1036; *see also, e.g.*, Glenn Kessler, *Obama Defines Social Security "Doughnut" Plan*, June 13, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=ahPYltpKKVXA&refer=home.

relative popularity of C corporations and pass-through entities based on tax returns:[282]

Figure 2.--Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2005

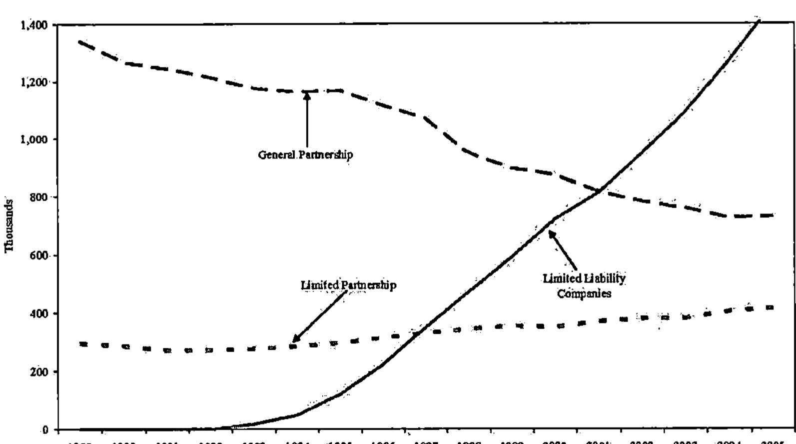


Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

[282] JCX-48-08, *supra* note 5, at 9 (citing Internal Revenue Service, STATISTICS OF INCOME, published and unpublished data).

One would also expect the popularity of LLCs to have grown. As I discussed above, they offer the potential for relative simplicity along with a liability shield.[283] And again, the facts bear this out. This chart shows the relative popularity of LLCs over general and limited partnerships.[284]

Figure 4.—Domestic Partnership Returns by Type of Partnership, 1989-2005



Source: Bill Pratt, "Partnership Returns, 2000," *SOI Bulletin*, 22, Fall 2002, and Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2005," *SOI Bulletin*, 27, Fall 2007, and Tim Wheeler and Nina Shumofsky, "Partnership Returns, 2005," *SOI Bulletin*, 27, Fall 2007.

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[283] *See supra* text accompanying notes 105–08.

[284] JCX-48-08, *supra* note 5, at 11 (citing Bill Pratt, *Partnership Returns, 2000*, SOI BULLETIN, Fall 2002, at 47; Tim Wheeler & Nina Shumofsky, *Partnership Returns, 2005*, SOI BULLETIN, Fall 2007, at 77–78).

The following chart shows the number of partnership tax returns by type.[285] LLCs now dominate.

	Type of Partnership				
Year	Domestic General Partnerships (thousands)	Domestic Limited Partnerships (thousands)	Domestic Limited Liability Companies (thousands)	Domestic Limited Liability Partnerships (thousands)	Foreign Partnerships (thousands)
1990	1,267	285	n.a.	n.a.	n.a.
1991	1,245	271	n.a.	n.a.	n.a.
1992	1,214	271	n.a.	n.a.	n.a.
1993	1,176	275	17	n.a.	n.a.
1994	1,163	283	48	n.a.	n.a.
1995	1,167	295	119	n.a.	n.a.
1996	1,116	311	221	n.a.	n.a.
1997	1,069	329	349	n.a.	n.a.
1998	945	343	470	26	n.a.
1999	898	354	589	42	n.a.
2000	872	349	719	53	3
2001	815	369	809	69	5
2002	780	377	946	78	3
2003	757	379	1,092	88	3
2004	725	403	1,270	89	4
2005	729	414	1,465	100	5

n.a.—not available

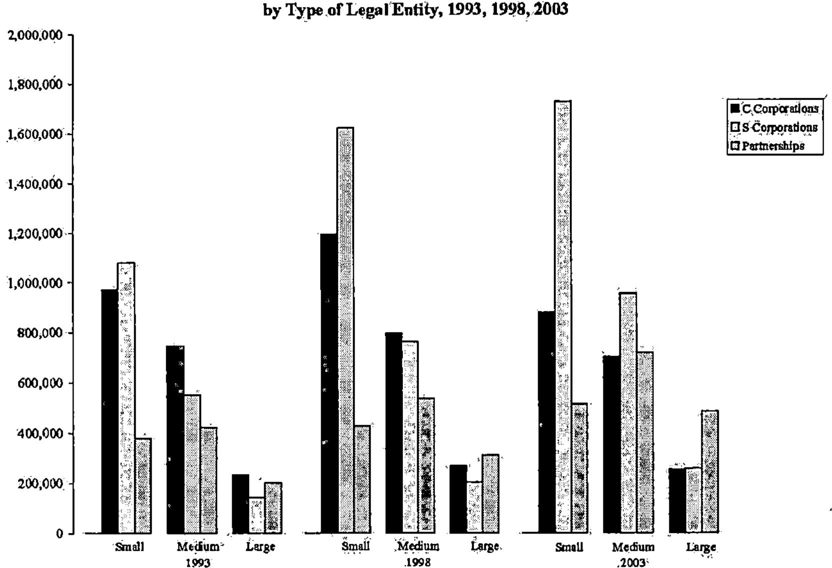
The final chart shows the number of business entities filing tax returns in 1993, 1998, and 2003, classified by asset size and type of entity.[286] Small entities are those with less than $100,000 in assets, medium sized entities are those with between $100,000 and $1 million in assets, and large entities are those with more than $1 million in assets. Note that C corporation use has dropped in all three classes. This is somewhat surprising in the large class, and may be attributable to the fact that the definition of large is not all that large, $1 million. If the large entity class started at $10 million, the results might be different. S corporation and tax partnership use has increased, but S corporations dominated in 1998 and 2003 among small entities and lead in 2003

[285] JCX-48-08, *supra* note 5, at 12 (citing Bill Pratt, *Partnership Returns, 2000*, SOI Bulletin, Fall 2002, at 45; Tim Wheeler and Nina Shumofsky, *Partnership Returns, 2003*, SOI Bulletin, Fall 2005, at 50; Tim Wheeler and Nina Shumofsky, *Partnership Returns, 2005*, SOI Bulletin, Fall 2007, at 69).

[286] JCX-48-08, *supra* note 5, at 10.

among medium sized entities.[287]

Figure 3.–The Number of Small, Medium, and Large Business Entities by Type of Legal Entity, 1993, 1998, 2003



Source: Joint Committee on Taxation staff tabulations of Statistics of Income, published and unpublished data.

It is commonly said that LLCs are the "entity of choice," yet, as of 2003, S corporations continue to lead the pack among small and medium sized business entities, though the prior charts show LLCs to also be very popular in 2003. To what is the S corporation popularity attributable? Taxpayers do not explain why they choose a particular entity when they file their tax returns, but the common belief is that S corporations continue to be popular because of the perceived opportunity they provide to reduce Social Security and Medicare taxes. For service businesses, tax partnerships such as LLCs offer fewer advantages. As they are typically businesses without a large amount of capital, property contributions and distributions likely do not play a large role, and section 754 elections—which can adjust partnership asset bases—tend to be less valuable. These are two areas where partnerships have significant advantages.[288]

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[287] C corporations were popular among small and medium sized entities in 1998. This likely is attributable to the availability of the medical expense deductions. In a C corporation, medical insurance expenses paid to employees, including shareholder-employees, are deductible from income under section 162(a) and are not income to the employees due to section 106. This benefit was only available to S corporation shareholders who owned two percent or less of the stock of the S corporation. I.R.C. § 1372(a)(2). A comparable benefit is now available to the self-employed, including partners and greater-than-two percent shareholders of S corporations, in section 162(*l*). It permits them to deduct the cost of medical insurance. *See* Pub. L. No. 105-206, 112 Stat. 685 (1998); Pub. L. No. 105-277, 112 Stat. 2681 (1998).

[288] *See supra* text accompanying notes 66–74, 84–92.

On the other hand, the ability to vary allocations, which can readily be done in a partnership, can be important to a service business. S corporations cannot vary allocations as such, but must allocate income and losses based on shareholdings.[289] It is possible to give a shareholder–employee an option to buy more shares, but it is highly awkward to continually adjust share ownership. An S corporation can make bonus salary payments, but that does not avoid the Medicare or Social Security taxes, which applies to all salaries paid, and thus a principal motivation for using S corporations is removed.[290] However, the vast majority of S corporations have two or fewer shareholders (over 88% in 2004).[291] For S corporations with few shareholders, the need to vary allocations is much less than it is, for example, for large and medium-sized law firms, which, not by coincidence, are usually not S corporations.[292] Large law firms likely cannot meet the 100 shareholder requirement. Medium-sized law firms that would use the S corporation format likely can only vary incomes, as a practical matter, through bonus salary payments. Again, as salary payments do not avoid Social Security and Medicare taxes, there is little motivation to use the S corporation. That being the case, most medium-sized law firms (as well as most large law firms) are LLCs or LLPs.

Another disadvantage of S corporations when contrasted with partnerships is the inability to include corporate borrowings in the bases of the shareholder's stock.[293] But the need for greater bases is most acute when businesses operate at a loss, not typical of the average service business. Further, the well-informed can arrange for loans to be made directly to shareholders who then can contribute or loan the funds to the S corporation. According to 2005 data, 99% of S corporations have fewer than $1 million in receipts.[294] Shareholder guarantees of debt are likely to be required regardless for firms of this size, so there is no great sacrifice in having the shareholders borrow the funds directly. Further, if the S corporation has only one or two shareholders, some of the problems with such direct borrowings, discussed earlier, are less likely to arise.[295] For example, it is easier for one or two shareholders to buy encumbered property and lease it to the corporation than for 20 shareholders to do so.

In a partnership, the partnership can usually give a service provider a profits interest tax free.[296] But for a closely held service business, this ability is rarely of great import. It is a very valuable feature in a capital intensive enterprise, where one person provides the funds and another the "brains," but in the

[289] I.R.C. §§ 1366(a), 1377(a).

[290] I.R.C. §§ 3101(a), 3111(a).

[291] *See* SOI TAX STATS, *supra* note 110.

[292] Robert W. Hillman, *Organizational Choices of Professional Service Firms: An Empirical Study*, 58 BUS. LAW. 1387, 1401 (2003).

[293] *See supra* text accompanying notes 79–83.

[294] JCX-48-08, *supra* note 5, at 15.

[295] *See supra* text accompanying notes 79–83.

[296] *See supra* text accompanying notes 93–104.

typical closely held, capital-light service partnership, this distinction does not exist. There is relatively little capital involved, and usually everyone is providing services in some form.

As this discussion demonstrates, the main advantages of partnerships are of little value to small, closely held service businesses. When that fact is contrasted with the possible ability to save substantial Medicare taxes and possibly even Social Security taxes with an S corporation, it is no contest, the S corporation wins. Thus, a strong circumstantial case can be made that "Social Security and Medicare tax dodging" is a primary, perhaps *the* primary, force behind the use of S corporations.

While the repeal of Subchapter S will end the abusive avoidance of Social Security and Medicare taxes, it is important not to stop there. It is vital that the rules for assessing Social Security and Medicare taxes be brought into alignment with today's LLC-rich universe.

V. H.R. 4137

It is a happy day for a law professor when a suggestion in a law review article shows up in legislation. I had that good fortune with H.R. 4137, introduced in 2004 by Congressman Amory Houghton, Jr. Alas, that was the extent of my good fortune. H.R. 4137, as it happened, went absolutely nowhere; a pity, really, because it was a forward-looking, if imperfect bill.

H.R. 4137 prohibited further S elections. After a ten-year grace period, it provided that existing S corporations were deemed to elect to be taxed as partnerships under Subchapter K, though the bill also allowed them to elect to make the switch before that.[297] Moreover, it permitted most nonpublicly traded C corporations to elect to be taxed under Subchapter K as well.[298] Under the bill, when an S corporation elected Subchapter K, it was treated as if it liquidated and formed a partnership. Thus, as noted above, the S corporation recognized the gain and could recognize the loss inherent in its assets;[299] that gain or loss, like any S corporation gain or loss, flowed through to the shareholders under section 1366. To make the gain and loss recognition more palatable, the bill provided that the gain and loss recognized by the S corporation was amortized over five years, which lessened the pain if there was a gain and caused pain if there was a loss. There was nothing in the bill, however, to stop an S corporation from actually liquidating and forming, for

[297] H.R. 4137 does not take disregarded entities into account. H.R. 4137, *supra* note 4.

[298] Corporations ineligible to elect under Subchapter S are not allowed to elect subchapter K. *See* I.R.C. § 1361(b)(2). Included in this group are financial institutions which use the reserve method of accounting for bad debts described in section 585 (*e.g.* many banks), insurance companies subject to tax under Subchapter L, corporations to which an election under section 936 applies (relating to Puerto Rico and possession tax credit), and domestic international sales corporations.

[299] Code section 336 provides that gain is recognized on the liquidating distribution of appreciated property but limits loss recognition if the liquidating distribution is to a related person. *See* I.R.C. § 336(a), (d).

example, an LLC. That approach permits a loss (or a gain) to be recognized fully and immediately.[300]

Under the bill, any distribution from the erstwhile S or C corporation–now–partnership to its shareholders–now–partners was a taxable dividend to the extent it would have been a dividend under the rules of Subchapter S.[301] As discussed above, dividends are paid from a corporation's earnings and profits.[302] As also discussed above, an S corporation cannot generate earnings and profits, but it can inherit them from a C corporation; a distribution from an S corporation is a taxable dividend to the shareholders if, to simplify, the S corporation has already distributed its own net income, but has earnings and profits.[303] Under the bill, an S corporation's or C corporation's earnings and profits were passed on to the partnership. H.R. 4137 provided a rule for the S corporation–now–partnership or C corporation–now–partnership that was similar to the rule that currently exists for S corporations. If, again to simplify, the partnership had fully distributed its own post-conversion net income,[304] any additional distributions were taxable dividends to the partners to the extent of the partnership's earnings and profits. This, of course, was an effort by the bill to retain the double taxation that would have applied to the C corporation if it had never elected to be taxed as a partnership (or never elected Subchapter S on its way to being a partnership). Note, though, that the partnership would have had control over the timing by choosing or not choosing to make the distribution. Keeping track of the earnings and profits over time poses a significant burden. Under the H.R. 4137, earnings and profits never expired.

Under H.R. 4137, it often would have made more sense for an S corporation with earnings and profits to actually liquidate and form another entity than to simply elect (or be deemed to elect) Subchapter K. As discussed above, the S corporation that did not actually liquidate was still deemed to liquidate and was still required to recognize the gains and losses inherent its assets. The main tax advantage under the bill to electing K as opposed to actually liquidating was that the recognized gains were taken into account over five years. But in the case of an actual liquidation, the earnings and profits account is wiped clean.[305] No earnings and profits means no dividends. Had H.R. 4137 been enacted, S corporations with earnings and profits and net gains in their assets would have needed to balance the deferral of tax gain against the ability to avoid dividends. Of course, if the S corporation had both net losses in its assets and earnings and profits (less common, but entirely possible), there

[300] Subject to section 336(d).

[301] *See supra* text accompanying notes 47–50.

[302] *See supra* text accompanying notes 21–22.

[303] *See supra* text accompanying notes 47–50.

[304] Any S corporation net income retained upon the conversion is added to this amount.

[305] The authority for this is implicit in the operation of sections 334(a) and 336 and the fact that no provision of the code provides otherwise. *See* BITTKER & EUSTICE, *supra* note 10, ¶ 10.05[2][b].

would have been nothing to balance. Liquidation would have been the order of the day.

H.R. 4137 also expanded the scope of section 1374. Under the bill, upon the election to be taxed as a partnership, a C corporation, unlike an S corporation, did not recognize any gains or losses inherent in its assets.[306] Instead, section 1374 was applied to the C corporation-now-partnership.[307] Recall, that as enacted section 1374 applies to an S corporation if it was once a C corporation or acquired the assets of a C corporation in a tax-favored transaction.[308] When the S corporation recognizes a gain inherent in an erstwhile C corporation asset, whether by sale or distribution to a shareholder, a corporate level tax applies, and it applies at the highest corporate tax rate.[309] The objective of section 1374 is to ensure that the net gain inherent in the assets originally held by the C corporation is subject to a corporate level tax, notwithstanding the fact that the assets are held by an S corporation.

How H.R. 4137 applied section 1374 to the C corporation-now-partnership is not entirely clear. The idea, clearly, was that there be two levels of tax on the net gains inherent in the erstwhile C corporation assets, one at the entity (*i.e.* partnership) level at the highest corporate tax rate, and one at the partner level. Further, the time period during which section 1374 applied was expanded from the ten years that normally applies to 25 years.[310] The section 1374 provision of the bill was, in the main, unworkable. Section 1374 works in the S corporation context because gains and losses normally are recognized if an asset leaves corporate solution.[311] But that is not necessarily true for partnerships. Under section 731(b), a partnership normally recognizes no gain or loss when it distributes property to partners. The distributee partners generally take a carryover basis in the distributed property.[312] The equivalent of an animal tagging rule could have been added to H.R. 4137, providing that whoever disposes of a covered asset within the 25 year time period in a taxable transaction must pay the corporate tax, but that would have been exceptionally difficult to enforce, especially over 25 years. Alternatively, the Subchapter K rules could have been changed to require gain recognition any time a covered asset is distributed, but again that would have been difficult to enforce, especially over 25 years, plus does injury to one of the more fundamental rules of partnership taxation. Also, it is not apparent why the ten year

[306] H.R. 4137, *supra* note 4.

[307] *Id.*

[308] *See supra* text accompanying notes 51–55.

[309] *See* I.R.C. § 1374.

[310] H.R. 4137 is not clear in this regard, but apparently an electing S corporation does not recognize the gains or losses in assets subject to section 1374 before the conversion to a partnership. Section 1374 continues to apply as it would to an electing C corporation. *See supra* text accompanying notes 51–52. Further, if section 1374 already applies, the ten-year rule (and not the 25 year rule) applies, provided the ten years expires before the election is made to be a partnership.

[311] This is normally a taxable event. *See* I.R.C. §§ 311, 336.

[312] *See* I.R.C. § 732(a).

time frame of current section 1374 was increased to 25 years. The extension creates a huge, additional compliance burden, and ten years is a time limit the world has been living with comfortably since section 1374 was enacted.

Clearly, Congressman Houghton was attempting to permit the laudable, allowing C corporations to elect Subchapter K, while avoiding the objectionable, permitting large amounts of C corporation gain to avoid a corporate level tax. He doubtless also wanted to avoid excessive revenue losses to the fisc. I will return to this issue when addressing my own proposal, but applying section 1374 in the manner H.R. 4137 did was at best an awkward solution.

Finally, H.R. 4137 made useful, if insufficient, steps in related areas. It specifically allowed a section 351 incorporation followed by a section 368 reorganization, provided that substantially all of the assets of an active trade or business were involved.[313] It also contained a provision on section 1402 that was close to the AICPA's proposal.[314] The intent behind both provisions was good, but for the reasons I discussed in detail above, I recommend a different approach.[315]

VI. Repeal Subchapter K Instead?

Much ink has been spilled on the problems with Subchapter K.[316] It is surely true that abuses can happen. While it does not usually make the life of a Mom and Pop LLC all that challenging, Subchapter K and its regulations are an extraordinarily complex area of tax law. Of just one piece of this puzzle, the special allocation rules of section 704(b), Professor Lawrence Lokken famously wrote: "[They are] a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject."[317] Professors George Yin and David Shakow, as Reporters for the American Law Institute, produced an impressive study that was critical of Subchapter K. In it they proposed "an optimal tax system" for the "simple private business firm" grounded in

[313]H.R. 4137, *supra* note 4.

[314]*See supra* text accompanying notes 244–48.

[315]*See supra* text accompanying notes 264–67.

[316]*See, e.g.*, William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3 (1991); Curtis J. Berger, *W(h)ither Partnership Taxation*, 47 TAX L. REV. 105 (1991); Noel B. Cunningham, *Commentary, Needed Reform: Tending the Sick Rose*, 47 TAX L. REV. 77 (1991); Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1 (1990); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 109 (1998); William S. McKee, *Partnership Allocations: The Need for an Entity Approach*, 66 VA. L. REV. 1039 (1980); Philip F. Postelwaite et al., *A Critique of the ALI's Federal Income Tax Project-Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423 (1986); Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229 (1993); *see also* Karen Burke, *Partnership Distributions: Options for Reform*, 3 FL. TAX REV. 677 (1998); Darryll Jones, *Toward Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047 (2006).

[317]Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 621 (1986).

Subchapter K, but "with a strong resemblance to Subchapter S."[318] Professors Yin and Shakow did not launch a full frontal assault on Subchapter K, perhaps cognizant of the political perils of such an effort. In addition to the private business firm proposal, they did recommend a number of substantial changes to Subchapter K, however.[319]

I actually think that Subchapter K has much to commend it. The flexibility it offers promotes economic efficiency. Yes, abuses can happen, but I have yet to see any data suggesting that they are a large part of the partnership pie. Further, S corporations, with their rigid qualification rules, particularly the one class of stock requirement, are simply unsuitable for many complex business undertakings where income is often allocated in tranches to different owners. But happily, I do not need to engage that debate here. The reality is that repealing or dramatically changing Subchapter K is a political nonstarter. Perhaps the best evidence of that fact is that Professors Yin and Shakow were not able to persuade the American Law Institute, a reform-oriented and—in the view of some, moderately progressive—organization, to adopt their views, notwithstanding that they did not even go so far as to recommend repeal of Subchapter K. Repeal of Subchapter K has never been give serious consideration by Congress. In contrast, there has actually been a bill in the House recommending repeal of Subchapter S.[320] Further, some kind of partnership taxation will always have to be with us if for no other reason than taxpayers can inadvertently find themselves in a state law partnership.[321] They cannot inadvertently end up in an S corporation. So, if we cannot repeal Subchapter K, surely we should repeal Subchapter S. As the above discussion indicates, the legitimate benefits of Subchapter S are relatively few in number and can either be incorporated into Subchapter K or be achieved by some adjustments to Subchapter C. Having two pass-through regimes is inefficient. Similarly situated taxpayers are taxed differently, to the advantage of those with skilled advisors, often to the disadvantage of those with unskilled advisors. This violates principles of vertical equity. Well-advised taxpayers can effectively choose, albeit within limits, how much tax to pay. Taxpayers will exploit the differences between their regimes for their benefit. A classic example is using S corporations to beat the Medicare tax. These considerations make it more difficult for the government to assess a reliable, appropriate tax.[322] Further, the

[318] *See* ALI Report, *supra* note 91, at 125. This would have been an elective system. For example, it would have in some cases severely restricted special allocations and would have required gain recognition (as well as loss recognition in the case of a liquidation) on the distribution of assets. *See also id.* at 129–30 (Table 1); *id.* at 183 (Proposal 4-2(1)(a)); *id.* at 215 (Proposal 4-5(1)(a)); *id.* at 300 (Proposal 5-1(1)(a)); Jeffery A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223 (2000).

[319] *See generally* ALI Report, *supra* note 91, at 273–425.

[320] H.R. 4137, *supra* note 4; *see supra* text accompanying notes 297–315.

[321] *See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIPS ¶ 2.01(c) (1988).

[322] *See* ALI Report, *supra* note 91, at 45–47.

Service is required to train personnel in two different pass-through regimes.

That said, Subchapter K is a far from perfect taxing regimen. The ALI Report and others have pointed out its deficiencies and made intelligent recommendations for improvement. Reform of Subchapter K should continue. But the fact that Subchapter K is in need of reform is not a reason to continue a parallel pass-through regime in Subchapter S. One of the two systems needs to go. It won't be Subchapter K; therefore it should be Subchapter S. Indeed, the existence of Subchapter S impedes the reform of Subchapter K. Having two systems in play can prevent policy makers and the Service from becoming fully focused on one. It spreads limited human resources thin. Likely, the pace of reform of Subchapter K will pick up, once Subchapter S is off the playing field.

VII. Let Nonpublic Corporations Come to the Party

In my prior article, I discussed the possibility of also permitting nonpublicly traded C corporations to elect Subchapter K. At that time, I demurred. I felt repealing Subchapter S was a daring enough move. While I was (and am) aware of no data on the cost to the fisc of allowing only nonpublic C corporations to elect Subchapter K, there was data on the cost of integration for public and nonpublic corporations in the aggregate, and that number was intimidating: $36.8 billion in 1991 dollars.[323] As I discuss below, the cost of permitting nonpublic C corporations to elect Subchapter K may now not be large.[324] Further, we live in a different tax and nontax universe than when I wrote my prior article. Somewhat emboldened by H.R. 4137, I believe the time is ripe to permit domestic, nonpublic C corporations to elect Subchapter K as well (or become disregarded entities if they have a single shareholder).[325] Like H.R. 4137, I would exclude corporations that are currently ineligible for Subchapter S from making this election.[326]

C corporations can have highly complex stock and debt structures. In many cases, those structures may make the switch to Subchapter K impractical. But usually, Subchapter K will be up to the challenge. Many partnerships

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[323]Various integration proposals were considered. The one referenced in the text involves an allocation to shareholders of a 31% credit for corporate taxes paid. Tax-exempt and foreign shareholders would receive no credit. The credit would accompany an allocation of income to the shareholder. DEPARTMENT OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS 152 (1992).

[324]*See infra* text accompanying notes 358–363.

[325]As did H.R. 4137, I define a nonpublic C corporation as a domestic corporation no stock of which is readily tradable on an established securities market or otherwise.

[326]Generally, a pass-through regime is highly awkward for these types of entities. Section 1361(b)(2) lists corporations that are ineligible to elect to be taxed under Subchapter S. Included are financial institutions which use the reserve method of accounting for bad debts described in section 585 (*e.g.* many banks), insurance companies subject to tax under Subchapter L, corporations to which an election under section 936 applies (relating to Puerto Rico and possession tax credit), and domestic international sales corporations. *See* I.R.C. § 1361(b)(2); *see also* EUSTICE & KUNTZ, *supra* note 59, ¶ 3.05.

have highly complex ownership and debt structures, but thrive in Subchapter K.[327]

The Federal government is regularly changing the ground under the business owners' feet. An owner who 15 years ago rationally chose a C corporation, might not have done so if she had known of the impending LLC revolution. The tax benefits that she may have gleaned by using a C corporation are, given the overall double tax burden, unlikely to have been so great as to justify locking her into a now outdated choice. Further, why should different nonpublic business entities be taxed differently? Closely held businesses should at least have the option of playing on the same field, making for greater horizontal equity. Other countries have taken a uniform approach.[328] I recommend that the United States also take a more uniform approach, though I would not make the election of Subchapter K mandatory for C corporations. As I discussed above, it would be very difficult for nonpublic entities to get by wholly without Subchapter C.[329] As I discuss below, I recommend that C corporations be allowed to switch to Subchapter K on a taxpayer-friendly basis.[330]

VIII. The Nuts and Bolts

A. *S Corporations*

A first step toward repeal is to prohibit any further S elections, as of the effective date of any relevant act. Here I follow the lead of H.R. 4137.[331] No new corporations and no existing C corporations may make S elections. There is no need to create more of a dying entity. There is little unfairness at work here for potential future users, as the LLC usually constitutes a perfectly viable, indeed usually preferable, alternative, especially if the integration proposals I outlined above are adopted.

How should taxpayers who are already operating as S corporations be treated? They cannot be expected to adapt to new rules overnight. But there is also little logic in allowing the indefinite continuation of a dying entity. The sensible answer is to give existing S corporations a meaningful amount of time to exit gracefully. How much time is enough time? There is no certain

[327] *See, e.g.*, Karen T. Lohnes, John Schmalz & Craig Gerson, *Value Equals Basis and Partners' Distributive Share: Stuffing, Fill-ups, and Waterfalls*, 105 J. TAX'N 109 (2006).

[328] Germany, for example; *see* Michael J. Munkert, *Fallstricke der neuen Thesaurierungsbegünstigung*, STEUERCONSULTANT 34 (2007).

[329] *See supra* text accompanying notes 113–67.

[330] One might think that permitting C corporations to continue to elect Subchapter S during the ten-year death watch might be a way of facilitating the transition to Subchapter K, but in fact that often, perhaps usually, will not be the case. The S corporation one-class-of-stock rule of section 1361(b)(1)(D) will make Subchapter S unavailable to many existing C corporations. Also, section 1374 will take away much of any tax benefit that Subchapter S provides. *See infra* text accompanying notes 358–64.

[331] *See* S Corp. Burial, *supra* note 3, at 643.

answer, but the ten-year time period of H.R. 4137 seems reasonable.[332]

During the ten-year death watch, an S corporation may:

1. Elect disregarded entity status, if it has a single owner (and be deemed to liquidate and distribute its assets to the single owner),
2. elect Subchapter K, it is has two or more owners (and be deemed to liquidate and form a partnership),
3. elect Subchapter C (no liquidation),
4. formally liquidate by the end of the ten-year term, or
5. take no action, in which case at the end of the ten-year term it is deemed to liquidate and form a partnership or, if it has a single owner, it is deemed to liquidate and become a disregarded entity.

If the S corporation does not actually liquidate (and does not elect Suchapter C), it needs to be deemed to be liquidated for tax purposes (1) to establish capital accounts for the partners correctly,[333] (2) for section 704(c), sections 707(a)(2)(B), and 737[334] to apply properly in the case of partnerships, and (3) to establish the owner's bases in the assets properly if the S corporation becomes a disregarded entity. The regular S corporation rules apply until the liquidation, deemed or actual, takes place, with one modification. I apply my recommended reform of Social Security and Medicare taxes to S corporations during the transition period. Thus, all income of an S corporation primarily engaged in the performance of services is subject to Social Security and Medicare taxes. For capital intensive S corporations, on the other hand, reasonable compensation for services rendered must be paid, but only that compensation is subject to Social Security and Medicare taxes.[335]

What tax rules should apply to a deemed or actual liquidation? Under the current rules of Subchapter S, the liquidating S corporation must generally recognize any gain or loss inherent in its assets.[336] That gain or loss, of course, generally is not taxed to the corporation but is passed through to the shareholders.[337] The shareholders recognize a gain or loss based on the difference between the fair market value of the assets received and the basis of the stock they hold.[338] It seems inappropriate, however, to apply the current S corporation rules and require gain (or permit loss) recognition on the termination of

[332]In my prior article I suggested five years. Foolish consistency is the hobgoblin of small minds. *See* S Corp. Burial, *supra* note 3, at 644.

[333]*See* Reg. § 1.704-1(b)(2)(ii), -1(b)(1)(iv).

[334]*See supra* text accompanying note 74.

[335]See *supra* notes 264–67. Perhaps the easiest way to accomplish this is to bring S corporations under the self-employment rules, as opposed to continuing their current coverage under sections 3101, 3111, and related provisions. *See* JCX-48-08, *supra* note 5, at 68; H.R. 3970, *supra* note 272.

[336]I.R.C. § 336(a); *see supra* text accompanying notes 39–40.

[337]I.R.C. § 1366.

[338]I.R.C. § 331(a). The gain or loss to the shareholders may not be significant given the flow-through of the S corporation's liquidation gains and losses, which adjusts the shareholders' bases before the distribution is made to them. Reg. § 1.1367-1(f).

S corporation status.[339] The taxpayers are being forced to use another entity, making gain recognition unfair. Typically, no real disposition is being made. Most owners will continue the same business.[340] This makes loss recognition inappropriate. I therefore recommend that S corporations and their shareholders be allowed to move to partnerships or disregarded entities on a tax favored basis. I apply Subchapter K, and not Subchapter S, to the liquidation of S corporations both in the case of partnerships-to-be and (notwithstanding the metaphysical challenges) disregarded entities–to–be. I also, of course, apply Subchapter K to the formation of any subsequent partnership. Subchapter K generally makes the liquidation and formation process tax free. Where a partnership is formed, the typical result of this process is that the erstwhile shareholder's basis in his stock becomes his basis in what is now a partnership interest.[341] Note that this process gives each partner a capital account in the partnership equal to the partnership interest's fair market value, and the partnership "book bases" in the partnership assets also equal to their fair market value.[342] Where the S corporation becomes a disregarded entity, applying Subchapter K-like rules will usually give the single owner a carryover basis in the assets of the S corporation.[343] While the liquidation rules of Subchapter K are much more taxpayer friendly than those of Subchapter S, it is possible for gain or loss to be recognized under Subchapter K on a liquidation in limited circumstances. The liquidation rules are unlikely to apply, however, especially if the assets are distributed (or deemed distributed) to the owners in proportional, undivided interests.[344] I considered rules that would avoid the recognition of all gain or loss in all circumstances, but found that the complexities these rules generated were not worth the statutory effort given that the issue should be a minimal one.

Sufficiently creative taxpayers can find ways of inappropriately taking advantage of these generous rules for liquidation of S corporations. To stop, or at least impede, this, I recommend Congress authorize the Service to adopt

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[339] *See* I.R.C. §§ 331(a), 336(a).

[340] They may want to actually liquidate the S corporation and form, for example, an LLC. Or they may want to continue using the state law corporation, which either is disregarded for tax purposes if it has a single owner, or is taxed under Subchapter K if it has multiple owners.

[341] *See* I.R.C. §§ 731(a), 721(a), 732.

[342] *See* Reg. § 1.704-1(b)(2)(ii), -1(b)(1)(iv). This sentence is probably Greek to those without a partnership tax background. Explaining it here would require a multiple-page footnote. For those wishing to develop that background, see WILLIS, et al., *supra* note 153, ¶ 10.04[3][c].

[343] *See* I.R.C. §§ 721(a), 731(a), 732.

[344] Gain will be recognized if money is distributed in excess of the erstwhile shareholder's basis in her stock. Loss will be recognized if only money, inventory, and accounts receivable are distributed, and the owner's outside stock basis exceeds the carryover basis she takes in these assets. *See* I.R.C. §§ 731(a), 732. One might ask if an artificial loss could be created, for example, by distributing money, inventory, and accounts receivable to a partner in such a way that a loss is generated, notwithstanding the fact that on a fair market value basis the partner has an economic gain section 751(b) usually will kibosh that effort, however.

an anti-abuse rule that applies to this process.[345]

Note that under my proposal, S corporations do not have the option of liquidating under the current S corporation rules. This is to prevent taxpayers from cherry-picking tax treatment, that is, using Subchapter S for S corporations with net losses in their assets and Subchapter K for S corporations with net gains. It is appropriate, however, to have a brief transition period of perhaps six months where S corporations are allowed to liquidate under either Subchapter K or S. Taxpayers planning to liquidate anyway should not be caught unawares by the statutory change. While cherry-picking can happen during the six months, the associated revenue losses are not likely to be great given the limited time frame. Further, S corporation losses and deductions, including depreciation deductions, generally flow through to the shareholders.[346] In other words, the losses have often already been recognized by the shareholders. As a consequence, it is not likely that there are a large number of S corporations with large amounts of losses inherent in their assets, though there will be some with economic losses that have not yet been taken into account for tax purposes.[347]

While it is difficult to predict with certainty in the absence of hard data, it seems doubtful that permitting largely tax-free liquidations of S corporations will generate unacceptable revenue losses for the fisc. Under the current rules, S corporations avoid distributing assets that contain significant amounts of appreciation. Instead, they commonly retain the property in corporate solution, depriving the government of a recognition event. In addition, Social Security and Medicare tax revenues will no longer be lost, creating a substantial offset. If economic calculations reveal that the cost to the fisc is unduly large, some compromise with the suggested approach may have to be found.

What if the S corporation has earnings and profits or unrecognized section 1374 gains?[348] The equities in this regard are not as strong as the equities in favor of allowing nonrecognition of the (nonsection 1374) gains and losses inherent in the S corporation assets. The earnings and profits and section 1374 gains originated with a C corporation, and avoiding any tax consequence also avoids what would have been part of the Subchapter C double tax system, and Subchapter C is not being recommended for repeal. That said, if a C corporation liquidates under the current rules, it recognizes the

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[345] One example: A and B own all of the stock of an S corporation. A individually owns asset X and B individually owns asset Y. They wish to exchange these assets with each other. The assets do not qualify for like-kind exchange treatment under section 1031. To avoid gain recognition, they could each contribute the assets to the S corporation. The contribution would be tax free under section 351(a). As part of a subsequent liquidation of the S corporation under Subchapter K, the S corporation could distribute asset Y to A and asset X to B, potentially tax free. *See* I.R.C. § 731.

[346] I.R.C. § 1366.

[347] A drop in the value of land, for example, would normally only be recognized in the case of taxable disposition, as land is not depreciable.

[348] *See supra* text accompanying notes 47–55.

gains and possibly the losses inherent in its assets, but its earnings and profits account is wiped clean.[349] Further, the section 1374 gains are only recognized for ten years after the C corporation assets find their way into an S corporation.[350] Since under my proposal, the S corporation has up to ten years to liquidate, section 1374 by its own terms normally can be avoided by waiting until the end of the section 1374 ten-year term, which will be reached before the end of the ten-year S corporation liquidation term of my proposal.[351] If the S corporation chooses to liquidate before the end of the section 1374 ten-year term, it is presumably due to some tax or other advantage. Having section 1374 fully apply in these circumstances is not unfair. Accordingly, on liquidation of the S corporation, any remaining section 1374 gains are recognized, but there should be no dividend effect. Below, I raise the possibility of C corporations being allowed to elect to liquidate under Subchapter K. If that is permitted, it would of course not make sense to apply section 1374 to liquidating S corporations.

A danger, though not an especially large one, is that C corporations, anticipating the law change, might elect Subchapter S shortly before the new statute is enacted. Under my proposal, they cannot elect after enactment. The C-now-S corporation could wait out the ten-year section 1374 period and then liquidate, generally tax free, under Subchapter K. But the C corporation must live with Subchapter S and section 1374 for ten years. It is not much differently positioned than a C corporation that legitimately elects Subchapter S, say, one year before the enactment of the new statute. While there is some minor potential for game playing here, I do not believe it is worth addressing statutorily. Of course, if C corporations are permitted to exist under the rules of Subchapter K, discussed below, then there is no abuse potential.

Should the proposed act contain continuity of business enterprise and ownership interest tests? Should the business of the erstwhile S corporation be required to be continued for some period of time? Should the erstwhile shareholders be required to stay on as partners for some period of time?[352] While the failure to apply those tests may mean that some owners will be able to convert corporate assets to personal use without an income tax effect,[353] on the whole, the better answer to the question is not to apply continuity of interest standards. Because S corporations are being forced out of existence,

[349] *See supra* text accompanying notes 25–26, 305.

[350] I.R.C. § 1374(d)(7).

[351] Since no new S elections are permitted, the last possible S election would take place the day before the act takes effect, meaning the section 1374 ten-year term expires the day before the proposed statute's ten-year term.

[352] These rules apply to corporate reorganizations. *See* BITTKER & EUSTICE, *supra* note 10, ¶¶ 12.21, 12.61[2].

[353] This could not happen with an S corporation, since the distribution of property by an S corporation to its shareholders causes gain and possibly loss to be recognized under sections 311(b) and 336. On the other hand, a distribution of property by a partnership to a partner is generally not recognized to either party. *See* I.R.C. § 731; *but see* I.R.C. §§ 704(c)(1)(B), 707(a)(2)(B), 737, 751(b).

the equities favor an owner-friendly set of rules. Also, aside from the possibility of converting business assets to personal use, which will likely be uncommon, the relevant tax consequences after the conversion are similar to, or even worse than, those before the conversion. Some examples: A sale of stock in the S corporation usually generates a capital gain or loss. The sale of a partnership interest may generate ordinary income.[354] The gain or loss on the sale of business assets generally flows through to the shareholders for S corporations and to partners for partnerships. Also, determining whether the continuity tests are met will create additional complexity that does not seem worth the statutory effort. Numerous questions will arise. How long should the business be operated? What if the assets are used in a different business? How much of an ownership change is permitted? Many of these issues have been addressed in the corporate context. But in the case of S corporations being forced out of existence, the courts might address these issues differently.[355] Further, if continuity provisions are enacted, most owners likely will continue the business long enough to pass muster, so little revenue will be raised.

The conversion of S corporations can generate state tax and nontax costs, if the corporation actually liquidates and contributes its assets to, for example, an LLC. State income and, more commonly, transfer taxes can apply. These vary a great deal from jurisdiction to jurisdiction. In some cases they will pose a significant limitation, in others not. Transfer taxes often apply principally to real estate. Partnerships, rather than S corporations, have always been the preferred vehicle in which to hold real estate.[356] Accordingly, transfer taxes may pose less of a burden than appears at first blush. One also hopes that states will follow the Congressional lead, and permit S corporations to liquidate without a significant tax impact. As discussed above, states can assist this process by permitting direct entity conversions of corporations into LLCs, thereby avoiding transfer tax and transfer restriction problems that might otherwise arise.[357]

B. *C Corporations*

For newly formed C corporations electing to be taxed under Subchapter K, rules will need to be developed that track the section 704(b) allocation rules with the multiple classes of stock possible in a C corporation. Other special issues may arise, but they should be manageable. A separate question arises for existing nonpublic C corporations wishing to elect Subchapter K, (or disregarded entity status). How should they get from here to there? It does not seem equitable for them or their owners to pay a substantial tax penalty to get into the entity of choice of the day, a choice that may not even have

[354] *See* I.R.C. § 751(a).

[355] *See* BITTKER & EUSTICE, *supra* note 10, ¶¶ 12.21, 12.61[2].

[356] An exception is when the capital gain freeze technique is used. *See supra* text accompanying notes 192–202.

[357] *See supra* text accompanying notes 183–85.

been available at the time they were formed. Therefore, if it does not break the back of the fisc, I recommend that qualifying, existing C corporations also be allowed to follow the same procedures as described above for S corporations, that is, during the ten-year window, to liquidate under Subchapter K. As Subchapter C is continuing, I do not make this approach mandatory as I do for S corporations. It would be almost impossible to keep track of C corporations liquidating for independent reasons and those liquidating to continue under Subchapter K. Thus, C corporations have the option of liquidating under the current rules, which they will prefer if overall it generates losses.[358]

As noted above, under the current rules, gain and possibly loss is recognized on an actual liquidation, but the earnings and profits account is normally wiped clean.[359] Thus, what the fisc is giving up under my proposal is not the tax on dividend income, which in the case of a liquidation it will not collect, but the tax on the net gains inherent in the assets of some nonpublicly traded C corporations. I say some, because many corporations will not sell or distribute many of those assets if it means paying a tax. Further, for domestic transactions, at least, C corporations are not a popular vehicle for nonpublic businesses. LLCs have become the entity of choice.[360] It will be important for the number crunchers to crunch the numbers, but the cost to the fisc may not be that high.

Some will view my proposal as an unduly liberal giveaway. And indeed, as I discuss below, its cost may be too high. But there are also economic inefficiencies that are created when some taxpayers are forced to operate within an outdated form and others are not. New businesses forming LLCs have a competitive advantage over older businesses trapped in C corporations. Electing S corporation status may not be available if their ownership structure does not permit a single class of stock. Leveling the playing field should make for a more efficient economy.

If the costs to the fisc of my proposal for existing C corporations are too high, a simple solution, and probably as reasonable as any, is simply to leave the current rules for liquidating C corporations in effect with one adjustment. That is to say, existing nonpublic C corporations may; during the ten-year window, elect Subchapter K or disregarded entity status, but if they do so they are deemed to liquidate under Subchapter C, recognizing the gains and possibly the losses per its rules.[361] The adjustment: To limit the tax pain, I propose that the taxes owed be payable over five years.

Whichever of these rules are used for existing C corporations, they should only apply during the ten-year window. To allow these tax benefits for C corporations that liquidate after the ten-year window is to permit them to have

[358] It is not out of the question that they will prefer it in a gain situation, as it means a basis step up.

[359] I.R.C. § 336; BITTKER & EUSTICE, *supra* note 10, ¶ 10.05[2][b]. *See supra* text accompanying note 305.

[360] *See supra* text accompanying notes 19–35, 67–108.

[361] *See supra* text accompanying notes 24–25.

their cake and eat it to, using Subchapter C when it is beneficial and switching to Subchapter K when it is not, indefinitely.

Assuming a favorable environment in which qualifying C corporations can elect Subchapter K at a low tax cost, will the LLC revolution be reversed or at least slowed? Rather than forming LLCs, will taxpayers form corporations and elect Subchapter K? While this is not necessarily a bad thing, it is not a likelihood for nontax reasons. State LLC statutes have more modern, flexible statutory architectures in comparison to typical corporate statutes.[362] Indeed, many who prefer for whatever reason to operate in C corporations for tax purposes often form LLCs and then check the box to be taxed as C corporations to take advantage of the greater state law flexibility LLCs offers.[363] Further, it is safer to be in an LLC if Congress changes its mind. Congress is more likely to change the way state law corporations are taxed than the way LLCs are taxed, given the history of each.

Conversely, would it make sense to *only* allow the use of C corporations for corporations that are publicly held or are about to go public? My recommendations are an attempt to put all businesses on the same playing field, but some could opt to use or stay with C corporations. Should that option be available? Generally, the answer is yes. C corporations are too woven into the economic fabric to not allow people to use them. For example, as noted earlier, C corporations are often preferred for outbound foreign transactions because of the preferential tax rates many treaties give dividends, and preferred for inbound transactions due to the imperfections with the branch profits tax.[364] But, C corporations are reported to often be used for an extra run up the rate brackets, and that likely will become a more common reason for using C corporations in a tax universe where LLCs are otherwise usually the more logical choice.[365] At the same time, taxpayers making legitimate use of C corporations should not have a radically different tax structure than individuals. As a compromise position, and to help offset possible revenue losses from my proposals, I recommend that the 15% corporate bracket of section 11 be eliminated, and thus that the tax rate on the first $75,000 of income be 25%.

C. *The States*

I have already discussed the need for states to cooperate with this process. A related question is whether states will use the new single tax burden on (at least most) closely held business entities as an opportunity to increase their own taxes. That is to some extent already going on. An increasing number of

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[362] *See* BISHOP & KLEINBERGER, *supra* note 17, ¶ 1.02.
[363] LLCs can also elect to be taxed as S corporations. *See* I.R.S. Form 2553.
[364] *See supra* text accompanying notes 28–30.
[365] *See supra* text accompanying notes 30–32.

states are taxing LLCs at the entity level.[366] While this trend may continue, it does not provide a reason for the federal government not to establish a more rational tax system. The 50 states and the District of Columbia compete with one another. Let that competition and their voters determine their tax systems.

XIX. Conclusion

The repeal of Subchapter S is justified both on grounds of tax efficiency and political realism. The country does not need two pass-through business entity tax regimes, and only the repeal of Subchapter S is politically realistic. A few relatively modest Code changes permit the important, defensible benefits of Subchapter S to be retained. The repeal of Subchapter S allows the Service to make better use of its personnel. It also makes for readier reform of Subchapter K. The Treasury and Congress, their attention no longer divided between two tax systems, and their limited human resources no longer spread as thin, can bring greater focus to that task. Finally, the time has come to allow nonpublic C corporations to elect Subchapter K as well, ideally on a taxpayer-friendly basis. Shareholders should not be trapped with an antiquated choice.

[366] *See* Bruce P. Ely, Christopher R. Grissom, & Matthew S. Houser, *Charts Comparing the State Tax Treatment of LLCs and LLPs*, *in* LIMITED LIABILITY COMPANY HANDBOOK § 3:118 (Mark Sargent & Walter Schwidetzky eds., 2008).

Tax Reform in a "World Without *Chevron*": Will Tax Regulations Withstand the Review of Justice Gorsuch?

NIKI FORD*

Abstract

The United States Supreme Court case of *Chevron, U.S.A. v. Natural Resources Defense Council, Inc.* has governed administrative deference jurisprudence for over thirty years. In general, this case requires that courts defer to an administrative agency's interpretation of a statute if the statute is ambiguous and the agency's interpretation is permissible. The Court has made it clear that this unquestionably high standard of deference applies with full force in the tax context. Thus, *Chevron* has been relied upon by both federal and state courts faced with cases that involve the interpretation of a tax statute by the Service or state taxing authority. However, with the addition of Justice Gorsuch—an outspoken critic of *Chevron's* high standard of deference—to the High Court, the future of the *Chevron* doctrine is now very much in question.

This Article discusses the history of the *Chevron* doctrine, and its potential to change under today's Supreme Court. This Article also analyzes what an end to *Chevron* would mean for federal and state tax authorities and taxpayers.

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I. Introduction

Every dance must come to an end. For nearly 35 years, members of the judiciary faced with questions of administrative deference have been forced to dance the famous "*Chevron* two-step," the two-pronged test derived from the watershed Supreme Court decision that pitted the Environmental Protection Agency against environmental organizations challenging the validity of its regulations. The Court's decision therein has, for decades, governed over cases involving judicial challenges to an administrative agency's interpretation of federal and, in some jurisdictions, state statutes.

Under the *Chevron* two-step test, the court must determine if the statute at issue is ambiguous, and second, it must decide whether the agency's interpretation of the statute is permissible.[1] If both prongs of the test are met, under *Chevron*, the court must defer to the interpretation of the agency.[2] *Chevron* has been roundly criticized as impermissibly transferring interpretive power from the judiciary to the administrative state, but no Supreme Court cases have come close to overturning it.[3] But with the recent appointment of Justice Neil Gorsuch to the High Court, a noted and vocal critic of *Chevron* deference is now among the ranks of those with the power to overrule this landmark decision.

From the time that Justice Gorsuch was nominated to the Supreme Court, legal commentators have questioned whether *Chevron's* time is drawing to an end. These questions arise from multiple opinions authored by Justice Gorsuch while he was sitting on the Tenth Circuit—opinions that leave no doubt that Justice Gorsuch believes in the primacy of the separation of powers doctrine and the concomitant conclusion that *Chevron* diverts too much power to the administrative state.[4] The only questions at this point are whether the addition of Gorsuch to the Court is enough to overturn decades

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[1] *See* Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984).

[2] *Id.*

[3] *See, e.g.*, RANDY E. BARNETT, OUR REPUBLICAN CONSTITUTION: SECURING THE LIBERTY AND SOVEREIGNTY OF WE THE PEOPLE 217-18 (2016); PHILIP HAMBURGER, IS ADMINISTRATIVE LAW UNLAWFUL? 12-13 (2014); Jack M. Beermann, *End the Failed* Chevron *Experiment Now: How* Chevron *Has Failed and Why it Can and Should Be Overruled*, 42 CONN. L. REV. 779, 788 (2010); Matthew H. Friedman, *Reviving* National Muffler*: Analyzing the Effect of* Mayo Foundation *on Judicial Deference as Applied to General Authority Tax Guidance*, 107 NW. U. L. REV. COLLOQUY 115, 136 (2012) (noting that, especially when applied to Treasury regulations in particular, "*Chevron* is a largely objective test that places too much power in the hands of the agency"). Notwithstanding these criticisms, subsequent judicial decisions have, as will be explored more fully *infra*, amplified rather than tempered the effect of *Chevron*.

[4] *See* Part II, *infra*.

of administrative deference jurisprudence and, if so, what the resulting standard would be.

Whether *Chevron* will continue to control administrative deference cases with Gorsuch on the bench is of critical importance to taxpayers and practitioners, especially in light of the tax reform legislation recently enacted by Congress. The United States Department of Treasury has never taken its role as an administrative authority lightly, frequently issuing lengthy and complex regulations that often take on as much importance to taxpayers and tax authorities as the statutes of the Code itself.[5] Given the gaps that Congress left Treasury to fill in the Tax Cuts and Jobs Act of 2017, Treasury's impact as a rule maker will be paramount in the coming months—both to taxpayers at the federal level and to states who often base their own tax laws on federal guidance.[6] The level of deference that courts will, jurisprudentially, be required to afford to those regulations will undoubtedly make a difference in the outcome of taxpayer cases in the coming years.

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[5] One needs only to look to section 482 of the Code as an example. The section is only one paragraph in length. In full, it states:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

I.R.C. § 482. However, the Treasury Regulations interpreting section 482 and setting forth the rules regarding whether an intercompany transfer pricing system will be respected by the Service are *over 100 pages in length*. *See* Reg. § 1.482-0 to 1.482-9t. Undoubtedly, when taxpayers and practitioners refer to transfer pricing's validity "under Section 482," they mean that the method passes muster under the *regulations*.

[6] While states, even those with rolling conformity to the Code, are not bound to follow Treasury regulations, many states that conform to the Code conform at least in part to the regulations. *See, e.g.*, ILL. ADMIN. CODE tit. 86 § 100.5270(a)(1) (providing that Illinois generally conforms to the federal consolidated return regulations); Taiheiyo Cement USA, Inc. v. Franchise Tax Bd., 138 Cal. Rptr. 3d 536 (Ct. App. 2012) (holding that general principles of conformity required the application of federal regulations); Delese v. Tax Appeals Tribunal, 771 N.Y.S.2d 191 (App. Div. 2004) (following federal regulation in the gift tax context even though the state never adopted a similar regulation). Given that many states have not yet enacted statutes or promulgated regulations addressing federal tax reform, the import of the forthcoming Treasury regulations will almost certainly be considered by states as they issue their own conforming or decoupling statutes, regulations, and other guidance.

The deference standard will have an impact on state and local tax controversies as well. State revenue departments, like Treasury, frequently issue administrative regulations that are significantly more detailed and comprehensive than the statutes they are designed to implement.[7] Thus, reviewing state courts are often called upon to determine what, if any, level of deference to afford the regulations issued by the state or local taxing authority. While some states have flatly rejected *Chevron* in favor of broad judicial review,[8] others fully embrace the *Chevron* doctrine and its two-step framework.[9] The rejection of *Chevron* at the federal level may cause the latter group of states to reexamine their own deference standards, at the same time that state revenue departments are drafting and issuing guidance in response to federal tax reform.

Part II of this Article summarizes the background and current state of the law on administrative deference. Part III analyzes the Tenth Circuit decisions of Justice Gorsuch addressing the viability of the *Chevron* doctrine. Part IV discusses the potential alternatives to *Chevron* deference, including an analysis of what an end to *Chevron* would mean for state and federal administrative agencies and taxpayers alike in the wake of tax reform.

II. The Rise of Deference

Since the administrative state came into existence, as an extension of the Executive branch of government, courts have struggled with how to handle rules issued by these agencies. The basis of this confusion is, at its root, quite simple. Separation of powers, and, correlatively, the checks and balances that each branch of government exerts over the others, is arguably the fundamental tenet of American government.[10] However, while federal and state constitutions purport to separate the federal and state governments into three discrete and identifiable branches (to wit, the Executive, the Legislative, and the Judicial), administrative agencies have long been an additional player in the game of governance.[11] Moreover, by their very nature, administrative agencies tend to muddle the traditional form of government by combining, rather than separating powers.[12]

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[7] *See infra* Part III.D, discussing state revenue departments' implementation of market-based sourcing statutes.

[8] *See, e.g.*, Pub. Water Supply v. DiPasquale, 735 A.2d 378 (Del. 1999).

[9] *See, e.g.*, Cobb v. Bd. of Counseling Prof'ls Licensure, 896 A.2d 271, 275 (Me. 2006).

[10] THE FEDERALIST No. 51 (James Madison); *see also* Ariz. Christian Sch. Tuition Org. v. Winn, 563 U.S. 125, 132 (2011) ("The concept and operation of the separation of powers in our National Government have their principle foundations in the first three Articles of the Constitution.").

[11] James Q. Wilson, *The Rise of the Bureaucratic State*, 41 PUB. INT. 77, 78 (1975).

[12] *See* STEVEN J. CANN, ADMINISTRATIVE LAW 113-173 (4th ed. 2006). This concentration of power contrasts with the oft-stated purpose of tripartite government, that is, to "diffuse power the better to secure liberty." Youngstown Sheet & Tube Co. v. Sawyer, 343 U.S. 579, 635 (1952) (Jackson, J., concurring).

The interplay of the administrative state's existence, the separation of powers doctrine, and the lack of agencies' textual authorization vis-à-vis the Constitution has been tricky at best. However, while administrative agencies are not expressly provided for in the language of the Constitution, their basic validity at this point is unquestioned. Moreover, their presence has long been justified by the necessity to regulate areas that the traditional three branches of government are not fully equipped to govern—namely, because agencies are generally run, not by politicians or legal theorists, but by practical experts in the areas governed by the agencies.[13]

In short, while the administrative state does not have textualism on its side, it does have tradition. Agencies have long played a crucial role in American government (even George Washington's presidency saw the existence of administrative agencies), and their constitutionality has been repeatedly upheld by the Supreme Court.[14] The modern administrative state, however, is a far cry from that which existed during the time of the framers. At the outset of America's formation, in fact, the administrative state was nearly negligible; only three administrative departments existed during the presidency of George Washington.[15] The number of agencies, and the breadth of laws they were called upon to enforce, steadily increased over the next few decades, with the numbers markedly climbing during the years of the Industrial Revolution.[16]

However, until roughly the 1930s, agencies did not possess the authority to make their own policy decisions, but were viewed merely as conduits

[13]Jeffrey E. Shuren, *The Modern Regulatory Administrative State: A Response to Changing Circumstances*, 38 HARV. J. ON LEGIS. 291 (2001). Administrative agencies typically are charged with regulating areas that are highly specialized or technical. Shuren, *supra* at 296. Such agencies include the Environmental Protection Agency, the Occupational Health and Safety Administration, and the Food and Drug Administration. Shuren, *supra* at 296. While environmental concerns, workplace safety issues, and the sale of healthy food and prescription drugs are areas that the federal government can and should regulate, the ability of politicians who do not necessarily have a background in such areas to implement regulatory policies is low. *See* Shuren, *supra* at 298. Agencies, composed of members who possess specialized knowledge and training in their respective fields, are better equipped to regulate these areas and respond to changing circumstances. Shuren, *supra* at 298.

[14]*See, e.g.*, Morrison v. Olson, 487 U.S. 654 (1988); Bowsher v. Synar, 478 U.S. 714 (1986); Humphrey's Ex'r v. United States, 295 U.S. 602 (1935).

[15]KENNETH F. WARREN, ADMINISTRATIVE LAW IN THE POLITICAL SYSTEM 39, 80-90 (1997). These administrative bodies were the Department of State, the Department of War, and the Department of Treasury. WARREN, *supra*.

[16]Wilson, *supra* note 11, at 77, 97. By 1881, there were 95,000 civilian officers, as compared with only 3,000 during the Federalist period of the late 18th and early 19th centuries. Wilson, *supra* note 11, at 77, 97.

for enforcing the goals of the legislature.[17] Then, with the implementation of President Franklin D. Roosevelt's New Deal, the way agencies would be viewed and allowed to function changed dramatically.[18] The Roosevelt administration not only allowed agencies to implement the policies of Congress, but also entrusted administrative agencies with *their own policy-making functions*—a sea change in the functionality of administrative agencies.[19] During the New Deal era, it was first emphasized that administrative agencies were the experts in the field they represented.[20] This is a concept that has persisted into the twenty-first century.

While it appears beyond argument that administrative agencies, which possess the power to both establish and enforce policy goals, are a critical part of a complex democratic government, the increased power of the administrative state carries with it the potential that such power will be abused.[21] On a basic level, agencies need procedural checks and balances to imbue administrative rulemaking with the same legitimacy afforded to legislative lawmaking.[22] The concerns regarding establishing a framework of legitimate regulatory procedures and protecting the regulated from potential abuse led to Congress's

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[17] *See* Kevin W. Saunders, *Interpretive Rules with Legislative Effect: An Analysis and a Proposal for Public Participation*, 1986 DUKE L.J. 346, 351 (1986). Prior to 1932, it was understood that Congress could not delegate legislative power; thus, the ability of agencies themselves to make legislative rules was weak to non-existent. Saunders, *supra*. *See also* United States v. Shreveport Grain & Elevator Co., 287 U.S. 77, 85 (1932) ("That the legislative power of Congress cannot be delegated is, of course, clear."). However, by 1940, the Supreme Court had changed its course and strayed from the non-delegation doctrine, opening the doors for legislative rulemaking by agencies. *See* Sunshine Anthracite Coal v. Adkins, 310 U.S. 381, 398 (1940) ("Delegation by Congress has long been recognized as necessary in order that the exertion of legislative power does not become a futility.").

[18] Cass R. Sunstein, *Constitutionalism After the New Deal*, 101 HARV. L. REV. 421, 424-425 (1987).

[19] Shuren, *supra* note 13, at 295-96. Prior to the New Deal, the courts along with many political leaders agreed that agencies should possess a limited scope of power. Warren, *supra* note 15, at 39.

[20] Bruce Ackerman & William Hassler, *Beyond the New Deal: Coal and the Clean Air Act*, 89 YALE L.J. 1466, 1468 (1980).

[21] K. DAVIS, ADMINISTRATIVE LAW TREATISE § 3:3 (2d ed. 1978) ("The kind of government we have developed is impossible except through delegation with meaningful standards . . . ."); *see also* Brian Cook, *The Representative Function of Bureaucracy: Public Administration in Constitutive Perspective*, 23 ADMIN. & SOC'Y 4, 107 (1992) (discussing the necessity of a bureaucracy to administer many of the tasks fundamental to running a nation).

[22] *See generally* BERNARD SCHWARTZ, ADMINISTRATIVE LAW § 4.12 (3d ed. 1991); *see also* Pat McCarran, *Forward* to COMM. ON THE JUDICIARY, ADMINISTRATIVE PROCEDURE ACT, LEGISLATIVE HISTORY, 79TH CONGRESS, 1944-46, at iii (1946) [hereinafter APA LEGISLATIVE HISTORY].

enactment of the Administrative Procedures Act (APA) in 1946.[23] Many states have similarly adopted state-level administrative procedures acts, which are often modeled after the APA.[24]

A. *The Basics of Administrative Rulemaking*

The APA was enacted to ensure the same safeguards apply to administrative rulemaking and rule-enforcing as apply to the traditional tripartite system of democratic government.[25]

As noted above, agencies effectively merge the three branches of government that the Constitution intended to separate.[26] Agencies generally fall within the ambit of the executive branch;[27] however, they function as legislatures when they enact regulations that are binding upon citizens and function as courts when they adjudicate or impose sanctions or penalties upon citizens who violate such regulations.[28] Under the traditional executive–legislative–judicial notion of governance, checks and balances are effectuated when each branch is both subject to the control of and can exercise review over the other branches.[29] Because an administrative agency inherently possesses the power of each governmental branch and thus is not subject to the same checks-and-balances monitoring, oversight must be provided in some other way.[30]

Thus, the APA employs three procedural devices as a substitute for traditional checks and balances: public information, administrative operation, and judicial review.[31] Most notably, the APA mandates that agencies submit

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[23] Administrative Procedure Act, 5 U.S.C. §§ 551-59 (2006); *see also* APA LEGISLATIVE HISTORY, *supra* note 22, at 350 (speaking to the abuse potential, Statesman Elihu Root opined, "Yet the powers that are committed to these regulating agencies, and which they must have to do their work, carry with them great and dangerous opportunities of oppression and wrong. If we are to continue a government of limited powers these agencies of regulation must themselves be regulated").

[24] *See* Michael Asimow, *Contested Issues in Contested Cases: Adjudication under the 2010 Model State Administrative Procedure Act*, 20 WIDENER L.J. 707, 713 (2011) (discussing the Model State Administrative Procedure Act statutes adopted by various states, and their similarities to the federal APA).

[25] *See* APA LEGISLATIVE HISTORY, *supra* note 22.

[26] *See* CANN, *supra* note 12.

[27] U.S. CONST. art. II, § 2. However, statutes can also create so-called "independent" agencies whose heads are not appointed by the President. *See, e.g.*, 15 U.S.C. § 41 (1914) (creating the Federal Trade Commission and providing for the nomination of agency officers).

[28] APA LEGISLATIVE HISTORY, *supra* note 22, at 149 (statement of Rep. Francis E. Walter).

[29] BRADDOCK COMMS. & BUREAU OF INT'L INFORMATIONAL PROGRAMS, U.S. DEP'T OF STATE, ABOUT AMERICA: HOW THE UNITED STATES IS GOVERNED 20 (2004), https://photos.state.gov/libraries/korea/49271/dwoa_122709/US_Governed.pdf.

[30] *See* Cass R. Sunstein, *Factions, Self-Interest, and the APA: Four Lessons Since 1946*, 72 VA. L. REV. 271, 271 (1986) ("In attempting to control administrative processes, the drafters of the APA responded to two quite general constitutional themes . . . . The first concerns the usurpation of government by powerful private groups. The second involves the danger of self-interested representation: the pursuit by political actors of interests that diverge from those of the citizenry.").

[31] APA LEGISLATIVE HISTORY, *supra* note 22, at 353.

notices of proposed regulations and allow interested parties to submit comments in lieu of the traditional congressional hearing that would otherwise be held during the legislative process.[32] The process outlined in the APA functions as a substitute for a legislative hearing and is designed to encourage public participation in agency rulemaking.[33] This framework is designed to ensure that agencies function in essentially the same manner as legislatures when performing legislative functions—namely, they develop a rule, submit it for public comment, and entertain and evaluate the comments submitted by interested parties before subjecting the public to the rule's binding nature.[34] While not equivalent to the full bicameralism and presentment regime that exists in the legislature, the APA process does ensure some level of internal debate and public participation in the administrative rulemaking process.

As one can see, when promulgating rules, agencies *function* very much like the legislature. However, functioning like the legislature does not mean that the agency *is* the legislature. Thus, when an agency promulgates a rule that conflicts with the statute enacted by the legislature, even if done within the strictures of the APA,[35] the rule must cede to the statute.[36] The more complicated question arises when the validly promulgated agency rule does not *conflict* with the statute, but does not simply *mirror* the statute either—instead, it sets forth the agency's own interpretation and policy with respect to the statutory scheme at issue. In a situation such as this, must the court treat the agency as if it were the legislature and apply the "plain language" of the regulation without question?[37] Under *Chevron*, as we will see, the answer is generally yes.

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[32] 5 U.S.C. § 553(c) (2018).

[33] Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with the Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1728 (2007); *see also* Am. Hosp. Ass'n v. Bowen, 834 F.2d 1037, 1044 (D.C. Cir. 1987) (noting that notice-and-comment rulemaking "reintroduces public participation and fairness to affected parties after governmental authority has been delegated to unrepresentative agencies").

[34] *See* 5 U.S.C. § 553.

[35] The Author has strong (published) opinions about whether *Chevron* should apply to Treasury (and other) regulations that are published absent compliance with the APA. *See* Nicole R. Ford, *Easy on the* MAYO *Please: Why Judicial Deference Should Not Be Extended to Regulations that Violate the Administrative Procedure Act*, 50 DUQ. L. REV. 799 (2012); Nicole R. Ford, *Administrative Procedure Acts: Another Avenue for Challenging Assessments*, 71 ST. TAX NOTES (TA) 111 (Jan. 13, 2014). While substantial support exists for answering that question in the negative, this Article expands the query to whether *Chevron* is the proper starting point for the application of deference to *any* regulations—both APA-compliant and non-compliant.

[36] *See* Dig. Realty Tr. v. Somers, 138 S. Ct. 767, 776 (2018).

[37] One of the fundamental canons of statutory construction is that if the language of a statute is clear, a reviewing court must apply the plain language of the statute as written, without adding its own interpretation of the language at issue. *See* Carcieri v. Salazar, 555 U.S. 379, 387 (2009) (noting that "[under] settled principles of statutory construction . . . we must first determine whether the statutory text is plain and unambiguous").

B. *The Funny Thing About Tax Regulations*

Treasury regulations play a particularly interesting role in the landscape of administrative rulemaking—and not only because Treasury, although one of the oldest and most rule-heavy administrative bodies in the federal government, is one of the most lax when it comes to following the APA.[38] Treasury also presents an interesting case study in how its rulemaking authority is bestowed. The Code grants Treasury broad interpretive authority over the Code's provisions. This authority is conveyed in one of two ways,[39] either through a specific authorization to promulgate regulations,[40] or pursuant to the Treasury's general rulemaking authority.[41] The Code contains several hundred specific authority grants.[42] Regulations promulgated pursuant to these specific authority grants have traditionally been denoted as "legislative" regulations.[43] In addition, the Code grants the Treasury general rulemaking authority to develop "all needful rules and regulations for the enforcement of" the Code.[44] These rules are known as "interpretive" regulations.[45]

Similarly, state statutes often afford revenue departments comparable interpretive authority with respect to the state's tax code. For example, the New York Tax Law grants the Commissioner of Taxation and Finance the power to "[m]ake such reasonable rules and regulations, not inconsistent with law, as may be necessary for the exercise of its powers and the performance of its duties under this chapter."[46] This grant of authority is similar to Treasury's ability to issue interpretive regulations. State revenue departments are also

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[38] *See* Hickman, *supra* note 33, at 1730. In her empirical study, Professor Hickman found that whether or not the Treasury actually followed the traditional APA steps, the agency disclaimed the applicability of the APA in 92.7% of its projects. *See* Hickman, *supra* note 33, at 1730. Where the Treasury issued final regulations without notice-and-comment altogether, the Treasury claimed established exceptions to the APA's requirements nearly 60% of the time and claimed APA inapplicability with no reason given roughly one-third of the time. *See* Hickman, *supra* note 33, at 1749-51.

[39] The scope of the discussion on Treasury rulemaking is limited to formal regulations. Of course, the Treasury and the Service have much broader interpretive authority than simply issuing formal regulations. The Service also issues official, published guidance in the form of Revenue Rulings, which explain how the Service interprets the law as applied to a given set of facts. Reg. § 601.601(d)(2)(i)(a). Furthermore, the Service may issue a Private Letter Ruling (PLR) when requested by a taxpayer under specified circumstances, informing that taxpayer how the Service would interpret that taxpayer's situation. Rev. Proc. 2012-1, 2012-1 I.R.B. 1. The level of deference that should be afforded less formal types of rulemaking is beyond the scope of *Chevron* and, thus, this Article.

[40] *See, e.g.*, I.R.C. § 1502.

[41] I.R.C. § 7805(a).

[42] *See, e.g.*, I.R.C. § 6103(q); § 7502(c)(2).

[43] *See* Mark E. Berg, *Judicial Deference to Tax Regulations: A Reconsideration in Light of* National Cable, Swallows Holding, *and Other Developments*, 61 TAX LAW. 481, 485-86 (2008).

[44] § 7805(a).

[45] Berg, *supra* note 43, at 485-86.

[46] N.Y. TAX LAW § 171(1st para.) (McKinney 2011).

commonly directed to issue regulations similar to the legislative regulations issued by Treasury (*i.e.*, regulations issued pursuant to a specific directive).[47]

Despite their differing monikers, legislative and interpretive regulations are of equal importance to the taxpayers whom they govern—most importantly, disregarding either type of regulation can subject a taxpayer to penalties.[48] The distinction between legislative and interpretive regulations in the tax context can be misleading in the judicial deference doctrine as well.[49] Interpretive tax regulations do not carry any less "deferential" weight than legislative regulations.[50] For all practical purposes, both types of regulations have the same effect.

Thus, whether the federal and state tax regulations that are sure to follow from tax reform are legislative, interpretive, or a combination of both, they must be approached from the same standpoint of deference—whatever that standard may turn out to be with the addition of Justice Gorsuch to the Court. The evolution of the judicial deference standard, and its particular applicability to tax regulations, is examined in the following section.

C. *The Evolution of Deference and Growth of Agency Power*

Although *Chevron*[51] is considered the landmark decision on judicial deference to agency regulations, Supreme Court jurisprudence in this area does predate the *Chevron* case, and pre-*Chevron* cases have continued to guide

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[47] *See, e.g.*, N.Y. TAX LAW § 1115(s)(3) (McKinney 2018) (directing the Commissioner to "promulgate any rules and regulations necessary to implement the provisions of this subdivision" [related to sales tax exemptions]).

[48] *See* I.R.C. § 6662(a)-(b) (explaining the "accuracy-related penalty." The Treasury regulations interpreting the accuracy-related penalty do not distinguish between specific and general authority regulations in circumscribing section 6662's applicability); Reg. § 1.6662-3 (2011) (finding that both types of regulations are binding on taxpayers, and violating either type of regulation subjects a taxpayer to equal concomitant penalties).

[49] United States v. Shreveport Grain & Elevator Co., 287 U.S. 77, 85 (1932) (explaining that historically, the distinction between legislative and interpretive regulations was very significant). Under the now outdated (although, in Justice Gorsuch's view, still relevant) non-delegation doctrine, Congress could not delegate legislative functions to any other branch of government. Thus, under the non-delegation doctrine, there was no need for a legislative or interpretive distinction. Regulations could only be interpretive, because agencies could not be delegated the power to make legislative decisions. However, after the Supreme Court expressly allowed the delegation of legislative decision-making, *see* Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381, 398-400 (1940), administrative agencies could then either make legislative (*i.e.*, binding) rules or could issue rules that did not have the force of law but merely explained rights already created by statute. *See* Saunders, *supra* note 17, at 350. As explained *infra*, the formal distinction between legislative and interpretive regulations in the tax context has all but disappeared, because even regulations characterized as "interpretive" have the force and effect of law.

[50] Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 57 (2011) (explaining that whether a rule carries the force of law "does not turn on whether Congress's delegation of authority was general or specific").

[51] Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984).

deference jurisprudence (especially in the area of tax law) even after publication of the watershed case.

Long before *Chevron*, courts would consider agency rulings and regulations when making their own judicial determinations. However, the level of "deference" that courts afforded to agency rules was decided on a case by case basis.[52] In some cases, courts would consider whether the agency's interpretation was "reasonable" and defer to the interpretation if the reasonableness standard was met.[53] In other cases, the courts would "retain [their] primary interpretive authority and independently review the statute to find the best interpretation."[54] Generally, courts seemed to default to the "independent judgment" rule, deferring to agency interpretations only if an "affirmative justification" could be elucidated by the court for doing so.[55]

While courts were not beholden to any one deference standard pre-*Chevron*, one of the principal cases that did guide federal courts' review of agency rulemaking was the Supreme Court case of *Skidmore v. Swift & Co.*[56] In *Skidmore*, the Court opined on just how influential agency regulations should be when brought into question in a judicial proceeding. The Court accepted as a matter of course that agency regulations were not "conclusive."[57] However, the Court did acknowledge that "the rulings, interpretations and opinions of the [agency], while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance."[58] The Court explained that judicial tribunals should look to factors such as the validity and consistency of the agency's reasoning when deciding if the agency action deserved deference.[59] Thus, after *Skidmore*, where "an agency's rule 'flatly contradicted' its prior rule, was of recent vintage, or concerned a non-technical area within the court's expertise, courts were less apt to defer to the rule."[60] To the contrary, when the agency had issued a longstanding rule within the scope of the agency's expertise, courts were advised to afford a level of respect to such regulation.

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[52] *See* Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 198-199 (2004).

[53] Polsky, *supra* note 52, at 189-90 (citing Rebecca Hammer White, *The Stare Decisis "Exception" to the* Chevron *Deference Rule*, 44 FLA. L. REV. 723, 729 (1992)).

[54] Polsky, *supra* note 52, at 190 (citing Cynthia R. Farina, *Statutory Interpretation and the Balance of Power in the Administrative State*, 89 COLUM. L. REV. 452, 453-54 (1989)).

[55] *See* Thomas W. Merrill, *Judicial Deference to Executive Precedent*, 101 YALE L.J. 969, 972 (1992).

[56] 323 U.S. 134 (1944); *see also* David M. Hasen, *The Ambiguous Basis of Judicial Deference to Administrative Rules*, 17 YALE J. ON REG. 327, 334 (2000).

[57] *Skidmore v. Swift & Co.*, 323 U.S. at 139.

[58] *Id.* at 140.

[59] *Id.*

[60] Hasen, *supra* note 56, at 334 (citing Packard Motor Co. v. NLRB, 330 U.S. 485 (1947); Frank Diehl Farms v. Sec'y of Labor, 696 F.2d 1325, 1330 (11th Cir. 1983)).

Skidmore does not mandate deference to agency regulations, and does not, unlike *Chevron* and its progeny, assume that Congress impliedly delegated its lawmaking power to the agency. Rather, *Skidmore* recognizes that while administrative interpretations may not be binding on the Court, they are nevertheless entitled to "respect" because of "the notion that the view of an agency—expert in the relevant field and familiar with the statutory scheme—is a relevant consideration."[61]

In the interim of *Skidmore* and *Chevron* a tax-specific judicial deference case, *National Muffler Dealers Ass'n v. United States*, was decided.[62] At issue in *National Muffler* was the interpretation of an undefined term—"business league"—in the context of a tax exemption statute.[63] Treasury had issued regulations defining such term to mean an organization of the same general class as a chamber of commerce or board of trade.[64] The taxpayer argued that such regulations impermissibly narrowed the language of the statute, while the Commissioner argued for deference to the regulations at issue. The Court ultimately decided in favor of the Commissioner's interpretation, but it did so with caution. Like *Skidmore*, *National Muffler* mandated a contextual or factor-based approach to the judicial deference analysis, providing:

> In determining whether a particular regulation carries out the congressional mandate in a proper manner, we look to see whether the regulation harmonizes with the plain language of the statute, its origin, and its purpose. A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of its congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.[65]

Thus, as in *Skidmore*, the Court advised that interpreting courts should look beyond the face of the regulation in determining whether to grant that regulation deference, but it went beyond *Skidmore* in advocating for deference to the regulation, rather than just a measured respect of the regulation's guidance. Still, under both of these decisions, courts had wide discretion to overturn agency regulations and interpretations if the regulations did not ultimately comport with the court's independent judgment. This all changed, however, with the Supreme Court's watershed decision in *Chevron*.

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[61] *See* Polsky, *supra* note 52, at 198 (for this reason, the level of deference afforded under *Skidmore* has commonly been referred to as "*Skidmore* respect").

[62] Nat'l Muffler Dealers Ass'n v. United States, 440 U.S. 472 (1979).

[63] *Id.* at 473.

[64] *Id.* at 482 (citing Reg. 74, § 528 (1929)).

[65] *Id.* at 477 (citations omitted).

1. *The Chevron Power Transfer*

Chevron involved a regulation issued by the Environmental Protection Agency interpreting a provision of the Clean Air Act.[66] Under its general grant of rulemaking authority, the EPA promulgated a regulation defining a statutorily-undefined term: "stationary source."[67] The Natural Resources Defense Council, an environmentalist group, challenged the agency's interpretation of the term.[68] On appeal, the Court of Appeals for the District of Columbia Circuit rejected the EPA's regulation and employed its own interpretation of this ambiguous term.[69]

On a fundamental level, the Supreme Court disagreed with the circuit court's approach to the analysis of whether the regulation at issue was valid.[70] In so doing, the *Chevron* Court set forth a new standard of judicial deference to federal agency regulations and mandated judicial adherence to agency interpretations so long as such interpretation is permissible.[71] While *Chevron* only addresses federal regulations promulgated pursuant to Congressional authority, some states have also applied *Chevron* to state agency regulations, including state tax regulations.[72] The Court's new standard held:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, to the text of the note as would be neces-

[66]Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 839-40 (1984) (citing 40 C.F.R. §§ 51.18(j)(1)(i), (ii) (1983)). In the 1977 amendments to the Clean Air Act, Congress required states that had not attained the national air quality standards set by the EPA to establish a program regulating "new or modified stationary sources" of air pollution. 42 U.S.C. § 7502(b)(6) (2006).

[67]*Chevron*, 467 U.S. at 840.

[68]*Id.* at 841.

[69]Nat. Res. Def. Council v. Gorsuch, 685 F.2d 718, 728 (D.C. Cir. 1982), *rev'd sub nom.* Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837 (1984) (yes, there is a relation—Justice Gorsuch's late mother, Anne Gorsuch, was the head of the EPA at the time of the *Chevron* decision). The lower court found that the legislative history of the 1977 amendments did not explicitly address what Congress intended by the term "stationary source." *Nat. Res. Def. Council*, 685 F.2d at 723. As a result of this ambiguity, the circuit court interpreted the statute by analyzing its own precedent concerning the Clean Air Act and found that the new EPA regulations conflicted with judicial precedent. *Id.* at 726.

[70]*Chevron*, 467 U.S. at 843-45.

[71]*Id.* at 844.

[72]*See, e.g.*, Estate of McVey v. Cabinet, 480 S.W.3d 233 (Ky. 2015). Other states, while not expressly applying *Chevron*, use a deference standard that is quite similar in effect. *See, e.g.*, Tarrant Appraisal Dist. v. Moore, 845 S.W.2d 820 (Tex. 1993) ("[C]onstruction of a statute by an administrative agency charged with its enforcement is entitled to serious consideration, so long as the construction is reasonable and does not contradict the plain language of the statute.").

> sary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.[73]

In certain ways, *Chevron* accords with then-existing jurisprudence, which over time recognized that agencies, which are called upon by the legislature to fill necessary gaps in statutory schemes, should be afforded some level of deference when their regulations are called into question. However, *Chevron*, like no case before it, essentially forces courts to take a backseat to agencies in many instances of statutory interpretation.[74] Commentators have thus characterized the *Chevron* doctrine as "a transfer of interpretive power from the judicial branch to administrative agencies."[75]

The *Chevron* Court correctly recognized that interpreting ambiguous statutes necessarily entails making policy judgments.[76] Traditionally, it was the judiciary that was the branch of government tasked with making policy determinations while fulfilling its constitutionally-derived interpretive power. However, in the *Chevron* Court's opinion, it is the administrative agencies, not the courts, which should be undertaking these policy decisions.[77] The Court explained its rationale as follows:

> If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular occasion is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.[78]

With this statement, the Court made a marked turn in administrative deference jurisprudence—and the pivot centers on *Chevron* step two. The first step of the *Chevron* doctrine is at heart a recognition of fundamental administrative law: if a statute is unambiguous, no deference to the regulation is necessary, for Congress has already spoken on the subject. The *Chevron* opinion incorporated use of the longstanding "traditional rules of statutory construction," such as legislative history, to determine whether Congress has

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[73] *Chevron*, 467 U.S. at 842-43.

[74] *Chevron*, 467 U.S. at 844 ("A court *may not substitute its own construction* of a statutory provision for a reasonable interpretation made by the administrator of an agency." (emphasis added)).

[75] Kristin E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1548 (2006).

[76] *Chevron*, 467 U.S. at 843.

[77] *Id.*

[78] *Id.* at 843-844.

left any ambiguity for the agency to interpret. In other words, step one of *Chevron* was not revolutionary.

The second step is where agencies derive their power and is the prong with which *Chevron* detractors take issue. Under the "permissible" prong, *Chevron* step two, an agency interpretation *must* be upheld so long as it is not arbitrary, capricious, or manifestly contrary to the statute.[79] The opinion, which for the first time mandated, rather than advised, the judiciary to defer to the administrative state, was controversial among administrative law commentators, who recognized the decision as a transfer of interpretive power within the American government.[80]

Scholars and practitioners alike argued in favor of limiting the reach of *Chevron*, raising concerns about the derogation of the judiciary's interpretive authority that Justice Gorsuch continues to echo 30 years later.[81] *Chevron* has also been a favorite target of tax commentators in particular. Although *Chevron* was not limited, on its face, to any particular area of law, scholars and litigants continued to argue, even after *Chevron*, that tax cases were

[79] *Id.* at 844.

[80] *See, e.g.*, Cass Sunstein, *Law and Administration after* Chevron, 90 COLUM. L. REV. 2071, 2075 & n.26, 2077 (1990) ("*Chevron* has altered the distribution of national powers among courts, Congress, and administrative agencies.").

[81] *See, e.g.*, Ellen P. Aprill, *Muffled* Chevron*: Judicial Review of Tax Regulations*, 3 FLA. TAX REV. 51, 64 (1996) ("Critics expressed particular concern that *Chevron* substantially eroded judicial authority to overturn agency decisions by requiring deference to administrative decisions when the delegation is implicit or the statute silent."); *see also* Gutierrez-Brizula v. Lynch, 834 F.3d 1142, 1152 (10th Cir. 2016) (Gorsuch, J., concurring) ("At *Chevron* step one, judges decide whether the statute is 'ambiguous,' and at step two they decide whether the agency's view is 'reasonable.' But where in all this does a court *interpret* the law and say what it *is*? When does a court independently decide what the statute means and whether it has or has not vested a legal right in a person? Where *Chevron* applies that job seems to have gone extinct.").

"exceptional" and should continue to be governed by pre-existing jurisprudence, most notably the *National Muffler* factor-based deference standard.[82]

The argument for tax exceptionalism stems from a viewpoint that tax regulations are fundamentally different from other forms of administrative rules, especially general authority regulations that are not issued pursuant to any specific direction from Congress. Several scholars have suggested that general authority regulations should be given a lesser degree of deference than other types of regulations.[83] Several normative reasons, many of which express the same basic concerns, have been set forth in support of affording a lesser, or at least different, deference standard to tax regulations: (1) that disregarding Treasury regulations carries with it penalties equivalent to criminal sanctions, (2) that Treasury and the Service often push the boundaries of reasonableness in favor of revenue maximization, or (3) that tax laws are so widely applicable to the citizenry that strong judicial oversight is necessary to prevent overreaching.[84] Notwithstanding the merits of the tax exceptionalists' arguments, more recent cases have brought tax jurisprudence squarely within the *Chevron* framework.

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[82] *See, e.g.*, Ellen P. Aprill, *The Interpretive Voice*, 38 LOY. L.A. L. REV. 2081 (2005); John Coverdale, Chevron*'s Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings After* Mead, 55 ADMIN. L. REV. 39, 83 (2003) (arguing that the *Skidmore* standard applies in this context); Noel Cunningham & James Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1 (2004) (summarizing the *Chevron*, *Skidmore*, and *National Muffler* dispute); Thomas W. Merrill & Kathryn Tongue Watts, *Agency Rules with the Force of Law: The Original Convention*, 116 HARV. L. REV. 467 (2002) (indicating that the *Skidmore* standard may apply in the case of interpretive tax regulations); Irving Salem et al., *ABA Section on Taxation: Report of the Task Force on Judicial Deference*, 57 TAX LAW. 717 (2004) (arguing in favor of using factors enunciated in *National Muffler* to assess the validity of interpretive tax regulations); Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185 (2004) (also noting the dispute among *Chevron*, *Skidmore*, and *National Muffler*). Courts, moreover, continued to alternate between the *National Muffler* analysis and the *Chevron* two-step in the years after *Chevron* was decided. *See, e.g.*, United States v. Tucker, 217 F.3d 960 (8th Cir. 2000); Schuler Indus. Inc. v. United States, 109 F.3d 753 (Fed. Cir. 1997); Snowa v. Commissioner, 123 F.3d 190, 197-98 (4th Cir. 1997) (general authority regulations get *National Muffler* review after *Chevron*); Nalle v. Commissioner, 997 F.2d 1134 (5th Cir. 1993). The Supreme Court, while not taking any official stance, continued to cite to both cases post-*Chevron*. *Compare* Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 560-61 (1991) (citing *National Muffler*), *with* Newark Morning Ledger Co. v. United States, 507 U.S. 546, 575-76 (1993) (Souter, J., dissenting) (citing both *National Muffler* and *Chevron*), *and* Atl. Mut. Ins. Co. v. Commissioner, 523 U.S. 382, 387-89 (1998) (citing and applying the two-part test of *Chevron*).

[83] *See, e.g.*, Edward J. Schnee & W. Eugene Seago, *Deference Issues in the Tax Law:* Mead *Clarifies the* Chevron *Rule - Or Does It?*, 96 J. TAX'N 366, 371-72 (2002).

[84] *See, e.g.*, Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731, 758 (2002) (expressing concerns about anti-taxpayer bias); Salem et al., *supra* note 82, at 724-25 (2004) (raising questions about the Service's motivations and willingness to push statutory boundaries).

2. *The Progeny*

In the years since *Chevron*, the administrative deference doctrine has been reinforced, expanded, and applied to tax jurisprudence explicitly. The doctrine was noticeably strengthened in *United States v. Mead Corp.*,[85] wherein the Court held that "administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority."[86] The Court described *Chevron* deference as mandatory in *all* cases where there is a reasonable interpretation of an ambiguous statute, stating:

> *Chevron* sets forth an *across-the-board* presumption, which operates as a background rule of law against which Congress legislates: Ambiguity means Congress intended agency discretion. Any resolution of the ambiguity by the administering agency that is authoritative—that represents the official position of the agency—*must be accepted by the courts* if it is reasonable.[87]

Thus, *Mead* extends the underpinnings of *Chevron* to a proposition that when there is ambiguity in a statute, this necessarily exhibits an intentional choice by Congress to have an administrative agency fill the gap. However, whether Congress is always so intentional when it drafts ambiguous legislation is a subject of open debate and is particularly relevant in discussion on the Tax Cuts and Jobs Act of 2017 in Part III.D of this Article.[88]

An even stronger amplification of pro-*Chevron* deference came with the Supreme Court's 2005 decision in *National Cable & Telecommunications Ass'n v. Brand X Internet Services*.[89] Therein, the Court addressed the question of

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[85] 533 U.S. 218 (2001).

[86] *Id.* at 226-227.

[87] *Id.* at 257 (emphasis added).

[88] Justice Gorsuch, in his most recent Tenth Circuit opinion addressing *Chevron*, takes strong issue with the assumption that Congress's silence on a matter means that it has intended an agency to take the interpretive reins:

> *Chevron* says that we should infer from any statutory ambiguity Congress's 'intent' to 'delegate' its 'legislative authority' to the executive to make 'reasonable' policy choices. . . . But where exactly has Congress expressed this intent? Trying to infer the intentions of an institution composed of 535 members is a notoriously doubtful business under the best of circumstances. And these are not exactly the best of circumstances. *Chevron* suggests we should infer an intent to delegate not because Congress has anywhere expressed any such wish, not because anyone anywhere in any legislative history even hinted at that possibility, but because the legislation in question is silent (ambiguous) on the subject. Usually we're told that 'an agency literally has no power to act . . . unless and until Congress confers power upon it.' Yet *Chevron* seems to stand this ancient and venerable principle nearly on its head.

Gutierrez-Brizuela v. Lynch, 834 F.3d 1142, 1153 (10th Cir. 2016) (Gorsuch, J., concurring) (citations omitted).

[89] 545 U.S. 967 (2005).

whether the judiciary must defer to agency interpretations that contradict a prior judicial construction, that is whether *Chevron* deference or stare decisis should prevail when interpreting administrative regulations.[90] The Court held that *Chevron* deference must be utilized—even when the regulation contradicts judicial precedent.

In *Brand X*, the Court reviewed a U.S. Court of Appeals for the Ninth Circuit decision holding that broadband cable service was properly classified as a "telecommunications service" under the Communications Act of 1934.[91] Although the Federal Communications Commission had issued regulations determining that broadband cable service was not a telecommunications service, the Ninth Circuit chose not to follow the FCC's interpretation of the statute and instead relied on circuit precedent holding that this type of service was a telecommunications service.[92]

The Supreme Court reversed the Ninth Circuit. In so doing, the Court held that:

> A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion. This principle follows from *Chevron* itself. . . . *Chevron's* premise is that it is for agencies, not courts, to fill statutory gaps. The better rule is to hold judicial interpretations contained in precedents to the same demanding *Chevron* step one standard that applies if the court is reviewing the agency's construction on a blank slate: Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.[93]

Brand X, in short, stands for the proposition that even stare decisis will not stand in the way of agency deference. The Court explained that a contrary rule would "mean that whether an agency's interpretation of an ambiguous statute is entitled to *Chevron* deference would turn on the order in which the interpretations issue," and that such a rule would produce anomalous and improper results, because "whether Congress has delegated to an agency the authority to interpret a statute does not depend on the order in which the judicial and administrative constructions occur."[94] As long as the *Chevron* two-step is met, a later interpretation by an agency controls over a prior, and otherwise precedential, decision by a court.[95]

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[90] *Id.* at 980.
[91] *Id.* at 973 (citing 47 U.S.C. § 153(44) (1934)).
[92] Brand X Internet Servs. v. FCC, 345 F.3d 1120, 1130-31 (9th Cir. 2003), *rev'd sub nom.* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967 (2005).
[93] *Nat'l Cable & Telecomms. Ass'n*, 545 U.S. at 982-83 (citations omitted).
[94] *Id.* at 983.
[95] *Id.*

In a more recent tax specific case, *Mayo Foundation for Medical Education & Research v. United States*,[96] the Court analyzed Treasury regulations interpreting the Federal Insurance Contributions Act (FICA), and in so doing, ultimately put to rest the issue of whether *Chevron* deference, as amplified by *Brand X*, applies equally to all forms of Treasury regulations. Under the statutory scheme at issue in *Mayo*, "students" are exempted from FICA taxes.[97] The question presented to the *Mayo* Court was whether doctors who serve as medical residents are properly classified as students for FICA purposes.[98]

"Since 1951, the Treasury Department ha[d] applied the student exception to exempt from taxation students who work for their schools 'as an incident to and for the purpose of pursuing a course of study.'"[99] The determination of whether the student exception applied was made on a case-by-case basis until 2005.[100] The Social Security Administration (SSA) had adopted a similar approach in its regulations interpreting the corresponding exception to the Social Security Act; however, the SSA explicitly held the view that resident physicians did not qualify as students.[101] When the U.S. Court of Appeals for the Eighth Circuit held that the SSA's categorical exclusion of medical residents from the definition of student could not be reconciled with its regulations providing for a case-by-case approach, Treasury correspondingly determined that it would be necessary to issue regulations "clarifying" the meaning of the term student under FICA.[102] Subsequent to the promulgation of its new rule excluding medical students, Mayo Foundation filed suit, asserting that its residents were exempt as students and that the new Treasury regulation was invalid.[103]

The U.S. District Court for the District of Minnesota granted summary judgment in Mayo Foundation's favor, finding that the regulation was inconsistent with the unambiguous text of FICA and applying the *National Muffler* factors to invalidate the regulation.[104] The Eighth Circuit reversed,

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[96] Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44 (2011).

[97] I.R.C. § 3121(b)(10). Under this provision, Congress excluded from taxation "service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." *Id.*

[98] *Mayo*, 562 U.S. at 708.

[99] *Id.* at 709 (quoting Reg. 16, § 12.474 (1951)); *see* Reg. § 31.3121(b)(10)-2(d).

[100] *Mayo*, 562 U.S. at 709. The primary considerations in the factual analysis were the number of hours worked and the course load taken. *Id.* (citing Rev. Rul. 78-17, 1978-1 C.B. 306).

[101] SSR 78-3, 20 C.F.R §§ 404.1004, 404.1026 (Jan. 1, 1978).

[102] Student FICA Exception, 69 Fed. Reg. 8604-01, 8,605 (Feb. 25, 2004) (codified at 26 C.F.R. pt. 31).

[103] Mayo Found. for Med. Educ. & Research v. United States, 503 F. Supp. 2d. 1166-67 (D. Minn. 2007), *rev'd*, 568 F.3d 675 (8th Cir. 2009), *aff'd*, 562 U.S. 44 (2011).

[104] *Id.* at 1176-77 (citing Nat'l Muffler Dealers Ass'n, Inc. v. United States, 440 U.S. 472 (1979)).

determining that *Chevron*, not *National Muffler*, should guide the analysis.[105] Because the specific Code section at issue was silent or ambiguous on the issue of whether a medical resident working full-time qualifies as a student and the amended Regulation constituted a permissible interpretation of the Code provision, the Eighth Circuit held that both steps of *Chevron* were met and the Regulation was enforced.[106]

The Supreme Court affirmed the Eighth Circuit's decision and, in doing, announced that *Chevron* definitively governed the analysis.[107] Under step one, the Court found that Congress had not directly spoken on the question of whether medical residents were subject to FICA taxes.[108] The Court then declared its intention to turn to *Chevron* step two.[109] Before doing so, however, the Court addressed the taxpayer's argument that *National Muffler*, rather than *Chevron*, should govern the Court's standard of review (*i.e.*, the taxpayer was making the tax exceptionalism argument).[110] The Court acknowledged that, since deciding *Chevron*, it had cited both *Chevron* and *National Muffler* when reviewing Treasury regulations.[111] Ultimately, however, the Court refused to "carve out an approach of administrative review good for tax law only."[112]

Instead, the Court explicitly held that the principles of *Chevron* applied with full force in the tax context.[113] This holds true even for Treasury regulations (such as the FICA regulations at issue) that are promulgated under the general authority contained in Code section 7805(a).[114] The authority to "prescribe all needful rules and regulations for the enforcement" of the Code is the type of explicit Congressional delegation of authority identified by *Mead* as worthy of mandatory deference.[115] Treasury regulations issued

[105] *Mayo*, 568 F.3d at 679-84. While the Eighth Circuit found that the discussion in *National Muffler* was "instructive" on whether the regulation was "reasonable," the court was clear that the *Chevron* two-part test was the standard it must use in determining whether to afford deference to the regulation. *Id.* at 680.

[106] *Id.*

[107] Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44, 46, 52 (2011).

[108] *Id.* at 52 (quoting OXFORD UNIVERSAL DICTIONARY 2049-50 (3d ed. 1955)). The Court rejected the taxpayer's assertion that the dictionary definition of student—one "who engages in study by applying the mind to the acquisition of learning"—necessarily encompasses residents. *Id.*

[109] *Id.*

[110] *Id.* at 53.

[111] *Id.*

[112] *Id.* The Court stated that filling gaps in the Code required the Treasury to make complex interpretive choices, and *Chevron* stood for the proposition that agencies are better equipped than courts to make these types of judgments. *Id.*

[113] *Id.* at 55.

[114] *Id.* at 57.

[115] *Id.*

pursuant to this delegation of authority, according to the *Mayo Foundation* Court, merit *Chevron* deference.[116]

Thus, the current state of administrative jurisprudence is that deference to agency regulations interpreting ambiguous statutes is mandatory, unless the Court determines that the agency's interpretation is not permissible—an undoubtedly difficult standard to reach. Courts are very unwilling to overturn agency regulations under step two of *Chevron.*[117] The entire rationale behind *Chevron* is that agencies are the experts in the area of law they have been called to interpret; thus, finding that an agency has "impermissibly" interpreted a statutory scheme in which it is presumed to be expert has proven to be a tough task. However, this has not stopped taxpayers, tax scholars, and now, a Supreme Court Justice, from arguing that the courts, not administrative agencies, should be the final arbiters of what the law means.

Before turning to the critique of *Chevron* offered by Justice Gorsuch, it should be noted that he is not the first figure of authority to refuse to dance the two-step. Several state high courts have outright repudiated the *Chevron* doctrine, for reasons resoundingly similar to those offered by Justice Gorsuch. For example, the Delaware Supreme Court flatly rejected application of the *Chevron* doctrine in its own deference analysis, stating, quite simply, "Statutory interpretation is ultimately the responsibility of the courts."[118] Thus, in Delaware, a "reviewing court may accord due weight, ***but not defer,*** to an agency interpretation of a statute administered by it."[119] Likewise, the State of Michigan has criticized *Chevron* using the same separation of powers argument relied on by Justice Gorsuch, opining as follows:

> The vagaries of *Chevron* jurisprudence do not provide a clear road map for courts in this state to apply when reviewing administrative decisions. Moreover, the unyielding deference to agency statutory construction required by *Chevron* conflicts with . . . the separation of powers . . . by compelling delegation of the judiciary's constitutional authority to construe statutes to another branch of government.[120]

Thus, while Justice Gorsuch may be paving new ground on the Supreme Court with his anti-*Chevron* sentiments, his doctrinal underpinnings find support not only in the text of the Constitution, but in the opinions of multiple state high courts. The following section turns to a detailed analysis of Gorsuch's opinions involving administrative deference.

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[116] *Id. See also* Home Concrete & Supply, LLC, 566 U.S. 478 (2012) (reaffirming that the *Chevron* deference standard applies in the context of interpreting tax regulations).

[117] Incredibly, in a recent study, Professors Kent Barnett and Christopher J. Walker found that when lower courts deciding a *Chevron* case moved on to *Chevron* step two (*i.e.*, whether the agency's interpretation was reasonable), the agency prevailed nearly *94% of the time.* Kent Barnett & Christopher J. Walker, Chevron *in the Circuit Courts*, 116 MICH. L. REV. 1, 4 (2017).

[118] Pub. Water Supply v. DiPasquale, 735 A.2d 378, 382 (Del. 1999).

[119] *Id.* (emphasis added).

[120] *In re* Rovas Against SBC Mich., 754 N.W.2d 259, 271-72 (Mich. 2008).

III. A Critic on the Tenth Circuit

Justice Gorsuch's standpoint with respect to the *Chevron* doctrine has been well-established through a trio of noteworthy opinions all authored while he sat on the U.S. Court of Appeals for the Tenth Circuit: *Gutierrez-Brizuela v. Lynch*,[121] *De Niz Robles v. Lynch*,[122] and *United States v. Nichols*.[123]

In the oldest of the three opinions, *United States v. Nichols*, Justice Gorsuch (in dissent) does not address *Chevron* directly, but rather questions the extent to which Congress may delegate its authority to administrative agencies at all.[124] The "non-delegation doctrine" cited by Gorsuch in *Nichols*, like the concerns surrounding *Chevron*, has its roots in the separation of powers doctrine.[125] As Gorsuch explains, "Many times over and in cases stretching back to the founding the Supreme Court has held that [Article I of the Constitution] limits the ability of Congress to delegate its legislative power to the Executive."[126] Citing the Federalist Papers, Gorsuch opines that the "structural impediments" that a separation of powers system brings to the lawmaking process "were no [sic] bugs in the system but the point of the design: a deliberate and jealous effort to preserve room for individual liberty."[127] Thus, open abandonment of the non-delegation doctrine would, in Gorsuch's view, abandon part of the foundation of American government.[128] Gorsuch concluded that this case represented one in which Congress "effectively passed

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[121] *See* Gutierrez-Brizuela v. Lynch, 834 F.3d 1142 (10th Cir. 2016).

[122] *See* De Niz Robles v. Lynch, 803 F.3d 1165 (10th Cir. 2015).

[123] *See* United States v. Nichols, 784 F.3d 666 (10th Cir. 2015).

[124] The delegation at issue in *Nichols* was the provision within the Sex Offender Registration and Notification Act (SONRA) which afforded the Attorney General the discretion to specify the applicability of the requirements of SONRA to persons convicted of sex offenses prior to the Act's enactment. *Id.* at 666.

[125] *See id.* at 670; *see also* Dina Mishra, *An Executive-Power Non-Delegation Doctrine for the Private Administration of Federal Law*, 68 VAND. L. REV. 1509 (2015). As Mishra explains, the non-delegation doctrine developed in the years leading into and throughout the New Deal era. *Id.* at 1519. The doctrine is essentially concerned with the line between the power to make the law and the authority or discretion to execute the law:

> [Under the doctrine] the line between those powers provides the foundation for the legislative-power non-delegation doctrine's intelligible-principle standard: 'If Congress shall lay down by legislative act an intelligible principle to which the person or body authorized to [take action] is directed to conform, such legislative action is not a forbidden delegation of legislative power.' The best theory for this notion is that the intelligible principle sets the basic policy of the law, which suffices to constitute making the law, such that any gap-filling - or interstitial policymaking with binding legal effect - is not an exercise of lawmaking power, but an exercise of law-execution power instead.

Id. (quoting J.W. Hampton, Jr., & Co. v. United States, 276 U.S. 394, 407 (1928)).

[126] *Nichols*, 784 F.3d at 670 (Gorsuch, J., dissenting).

[127] *Id.*

[128] *Id.* (citing Gary Lawson, *Delegation and Original Meaning*, 88 VA. L. REV. 327, 332 (2002)).

off" its lawmaking authority to the Executive, which created "a result inimical to the people's liberty and our constitutional design."[129]

Having set forth his views on the primacy of the separation of powers doctrine, Justice Gorsuch attacks *Chevron* directly in *De Niz Robles*.[130] *De Niz Robles* analyzed the ability of an administrative agency, the Board of Immigration Appeals, to interpret statutes according to administrative policy, even if such policy conflicts with prior judicial precedent.[131] Justice Gorsuch again framed his analysis within the context of the separation of powers overarching principles. He first explained the distinction between legislative enactments, which are fundamentally designed to operate prospectively only, and judicial pronouncements, which are afforded retroactive effect.[132] He stated that the difference in effect comports with separation of powers, which doctrine "seek[s] to meet a necessity of civil society while mitigating the due process and equal protection concerns sometimes associated with retroactive decisionmaking."[133]

Justice Gorsuch went on, however, to explain that while the prospective application of statutes and the retroactive application of judicial decisions can be squarely reconciled in the separation of powers framework, *Chevron* step two dances outside of this framework—perhaps, notes Gorsuch, because "the framers anticipated an Executive charged with enforcing the decisions of the other branches—not with exercising delegated legislative authority."[134] Justice Gorsuch hinted at his viewpoint, later revealed in full in *Gutierrez-Brizuela*, that *Chevron* may not comport with the separation of powers doctrine, stating that "one might question whether *Chevron* step two muddles the separation of powers by delegating to the Executive the power to legislate generally applicable rules of private conduct."[135] He nevertheless recognized the binding nature of *Chevron* on the Tenth Circuit, and found another way (through the application of due process and equal protection jurisprudence) to reign in the retroactive application of the agency's pronouncements.[136]

The two aforementioned cases segue to Justice Gorsuch's most well-known opinion that leaves no room for doubt as to which way Justice Gorsuch leans in the *Chevron* debate: *Gutierrez-Brizuela v. Lynch*.[137] In this case, Justice Gorsuch interestingly authored both the majority and a concurring opinion. The case itself addressed whether the Board of Immigration Appeals could retroactively change its rules on immigration policy, in effect overruling judicial

[129] *Id.* at 677.
[130] *See* De Niz Robles v. Lynch, 803 F.3d 1165 (10th Cir. 2015).
[131] *Id.* at 1167-68.
[132] *Id.* at 1170-71.
[133] *Id.* at 1171.
[134] *Id.*
[135] *Id.*
[136] *Id.* at 1171-72.
[137] Gutierrez-Brizuela v. Lynch, 834 F.3d 1142 (10th Cir. 2016).

precedent.[138] In his majority opinion, Gorsuch accepted that the existing state of *Chevron* deference meant that "agencies exercising delegated legislative power can effectively overrule judicial precedents"; however, he stated that *Chevron* deference did not permit an agency to apply such decisions retroactively.[139] Thus, while the majority opinion ultimately overrules the agency's action, it reluctantly accepts the governing framework of *Chevron*.

It was in his concurring opinion, however, that Justice Gorsuch let his true feelings on *Chevron* show once and for all. The concurrence begins by establishing the separation of powers doctrine as the fundamental tenets upon which the American democratic system is based:

> [The] allocation [by the Founders] of different sorts of power to different sorts of decisionmakers was no accident. To adapt the law to changing circumstances, the founders thought, the collective wisdom of the people's representatives is needed. To faithfully execute the laws often demands the sort of vigor hard to find in management-by-committee. And to resolve cases and controversies over past events calls for neutral decisionmakers who will apply the law as it is, not as they wish it to be.
>
> Even more importantly, the founders considered the separation of powers a vital guard against governmental encroachment on the people's liberties, including all those later enumerated in the Bill of Rights. . . . It was to avoid dangers like these, dangers the founders had studied and seen realized in their own time, that they pursued the separation of powers. A government of diffused powers, they knew, is a government less capable of invading the liberties of the people.[140]

After explaining the critical and fundamental nature of the separation of powers doctrine, Justice Gorsuch remarks dryly: "Founders, meet *Brand X*."[141] In his scathing commentary on the status of judicial deference jurisprudence, Gorsuch in effect accuses *Brand X* of degrading the "deliberate design" of the founders to ensure "a neutral decisionmaker for the people's disputes."[142] While *Brand X* is arguably the Supreme Court's furthest extension of the *Chevron* doctrine, Gorsuch does not view the case as an anomaly. Rather, Gorsuch opines that "[i]f you accept *Chevron*'s claim that legislative ambiguity represents a license to executive agencies to render authoritative judgments about what a statute means, *Brand X*'s rule requiring courts to overturn their own contrary judgments does seem to follow pretty naturally."[143] Thus, Gorsuch's concurring opinion in *Gutierrez-Brizuela* critiques not only the *Brand X* extension of *Chevron*, but the underpinnings of *Chevron* deference itself.

The concurrence roundly criticizes *Chevron* and the expanded role that administrative agencies have played as quasi-legislators in its wake, stating

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[138] *Id.* at 1143.
[139] *Id.* at 1145-46.
[140] *Id.* at 1149.
[141] *Id.* at 1150.
[142] *Id.*
[143] *Id.* at 1151.

that *Chevron* "permit[s] executive bureaucracies to swallow huge amounts of core judicial and legislative power and concentrate federal power in a way that seems more than a little difficult to square with the Constitution of the framers' design."[144] Gorsuch explains the separation of powers concerns that the founders recognized mean that administrative agencies' interpretations should "warrant[] less deference from other branches, not more."[145] In perhaps the most telling part of his concurring opinion, Judge Gorsuch predicted the consequences of a "world without *Chevron*." He opined:

> [C]ourts could and would consult agency views and apply the agency's interpretation when it accords with the best reading of a statute. But *de novo* judicial review of the law's meaning would limit the ability of an agency to alter and amend existing law. It would avoid the due process and equal protection problems of the kind documented in our decisions. It would promote reliance interests by allowing citizens to organize their affairs with some assurance that the rug will not be pulled from under them tomorrow, the next day, or after the next election.[146]

This passage reveals that Justice Gorsuch would support not just a paring back of *Chevron's* impact (through, for example, a repeal of *Brand X's* mandate that administrative regulations can supersede judicial precedent), but a wholesale repeal of the *Chevron* doctrine itself. De novo review of administrative regulations is about as far from mandatory deference as one can imagine. Justice Gorsuch's refusal to mince words when rendering his opinion on the *Chevron* doctrine has naturally left legal scholars and practitioners questioning what comes next.

IV. Goodbye Two-Step—Onto the New Step?

Justice Gorsuch's views on *Chevron* have been clearly announced in the trio of Tenth Circuit cases summarized in Part III. Now that he sits on the Supreme Court bench, the question is whether his anti-*Chevron* sentiment will be enough to sway the Court to overrule its well-established precedent. It is clear at this point that Gorsuch's mere presence on the Supreme Court has brought the decades-old doctrine to the forefront of popular reporting. In recent months, the Washington Post,[147] the New York Times,[148] and

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[144] *Id.* at 1149.

[145] *Id.* at 1155.

[146] *Id.* at 1158.

[147] Ilya Somin, *Gorsuch is Right About* Chevron *Deference*, WASH. POST, Mar. 25, 2017, https://www.washingtonpost.com/news/volokh-conspiracy/wp/2017/03/25/gorsuch-is-right-about-chevron-deference/?utm_term=.448cdc7e87b2.

[148] Steven Davidoff Solomon, *Should Agencies Decide Law? Doctrine May Be Tested at Gorsuch Hearing*, N.Y. TIMES, Mar. 14, 2014, https://www.nytimes.com/2017/03/14/business/dealbook/neil-gorsuch-chevron-deference.html.

Forbes,[149] among others, have all reported on the continued validity of a 1984 administrative law case—not exactly the typical fodder for popular legal and political commentary. *Chevron* has been on the lips and at the fingertips of legal and political pundits and scholars alike for the past year, and perhaps the question to be asking is not whether *Chevron* will be altered under Gorsuch, but how and when.[150]

Assuming that *Chevron* will be squarely addressed by Justice Gorsuch during his time on the Court, and further assuming that he can garner the necessary votes to abandon the doctrine, it is not entirely clear what the alternative would be, but several options come to mind and are discussed more fully in the following subparts.

A. *From Deference to De Novo*

First is the option alluded to in *Gutierrez-Brizuela*: complete abandonment of deference to administrative regulations in favor of de novo review. This option most closely aligns with a textual reading of the Constitution and its separation of powers framework. Quite simply, Article I of the Constitution gives the legislature the power to write the laws[151] and Article III gives the judiciary the power to interpret the laws.[152] Administrative agencies are not mentioned in the Constitution, and derive their power from the Executive branch, charged with enforcing the law of the land but not with writing or interpreting it.[153] De novo review ensures that the branch of government

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[149] Daniel Fisher, *Bureaucrats May Be the Losers if Gorsuch Wins a Seat on Supreme Court*, FORBES, Jan. 26, 2017, https://www.forbes.com/sites/danielfisher/2017/01/26/bureaucrats-may-be-the-losers-if-gorsuch-wins-a-seat-on-supreme-court/#1fdae9437c15.

[150] Some commentators thought that the case of *Digital Realty Trust v. Somers*, 138 S. Ct. 767 (2018), a case that involved the validity of certain SEC whistleblower regulations, would allow Justice Gorsuch to set forth his views on the *Chevron* doctrine. *See* Ilya Shapiro, *Neil Gorsuch's First Chance to Undermine the Administrative State*, NAT'L REV., Nov. 22, 2017, https://www.nationalreview.com/2017/11/neil-gorsuch-chevron-scotus-case-strike-blow-deference. However, the Court in this case found that the SEC's regulations conflicted with the statute at issue, thus failing *Chevron* step one. As discussed above, Justice Gorsuch's—and other critics'—trouble with *Chevron* generally center around step two, which requires judicial deference in cases involving "permissible" interpretations of ambiguous statutes (thus shifting the interpretive mandate from the courts to the agency). The application of *Chevron* step one, on the other hand, does not give rise to the same concerns of an extra-constitutional power shift. Thus, *Digital Realty* ultimately ended up being a less than perfect case on which to attack the perceived flaws of the *Chevron* doctrine.

[151] U.S. CONST. art. I, § 1 ("All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.").

[152] U.S. CONST. art. III, § 1 ("The judicial power of the United States, shall be vested in one Supreme Court, and in such inferior courts as the Congress may from time to time ordain and establish.").

[153] *See generally*, U.S. CONST. art. II.

tasked with interpreting the law does not cede its constitutionally-derived power to another branch.[154]

However, de novo review represents such a sea change from the current state of administrative deference that it seems an unlikely result even if *Chevron* is overturned. It is difficult to imagine jurisprudence moving from a two-prong test that results in mandatory deference to the absence of any deference standard at all. Notwithstanding the textual merits of affording the judiciary—and the judiciary alone—the authority to interpret the ambiguities of congressional language, the past hundred years of allowing the administrative state to have its say on questions of statutory interpretation may be too strong of a tide to turn.

Moreover, affording a level of deference to administrative rules does not just have tradition on its side. The decades of administrative law jurisprudence in favor of deference, both before and after *Chevron*, recognize (in this Author's opinion, correctly so) that because administrative agencies possess the technical knowledge and subject-matter expertise that a general court may lack, the rulings and regulations issued by such agencies should at least be taken into consideration during the court's deliberative process.[155]

Recognition of agency expertise is particularly crucial in the highly complex and technical area of tax law. Whatever procedural shortcomings Treasury may be guilty of when issuing regulations,[156] the detailed and comprehensive regulations issued by Treasury play a critical role in the administration of the Code. Congress has, on multiple occasions, deliberately left gaps in the Code with the express stated intention that Treasury issue clarifying regulations. The regulations governing section 482,[157] check-the-box regulations,[158] and the Subchapter K anti-abuse regulations[159] are but a few examples of the way that Treasury has taken its delegated authority and created a substantial legal framework that, in practical effect, is even more important than the statute being interpreted. To completely disregard these regulations and review the Code anew could bring its own unwanted consequences—most notably, uncertainty among taxpayers who rely upon Treasury regulations when structuring their own internal affairs.

[154] *See* Gutierrez-Brizuela v. Lynch, 834 F.3d 1142, 1155 (10th Cir. 2016) (Gorsuch, J., concurring) ("After all, *Chevron* invests the power to decide the meaning of the law, and to do so with legislative policy goals in mind, in the very entity charged with enforcing the law.").

[155] *See* Skidmore v. Swift & Co., 323 U.S. 134, 139 (1944) (emphasizing that agency interpretations are "based upon more specialized experience and broader investigations and information than is likely to come to a judge in a particular case").

[156] *See* Hickman, *supra* 33, at 1728.

[157] *See* Reg. § 1.482-0.

[158] *See* Reg. § 301.7701-1.

[159] *See* Reg. § 1.701-2.

B. *A Modified Two-Step*

On the other end of the spectrum from abandoning *Chevron* altogether is retaining *Chevron's* two-step framework, but modifying step two in a way that affords the judiciary with additional oversight. As explained above, courts are exceedingly reluctant to invalidate a regulation under the current rubric of *Chevron* step two. This makes logical sense. The standard—whether the agency's action is "permissible"—is hardly a standard at all. To fail at *Chevron* step two, the agency's regulation must be so far outside the bounds of propriety that it rises to the level of arbitrary and capricious rulemaking.[160] Retroactive regulations have been held to not reach this level of impermissibility. Even retroactive regulations that are specifically targeted at unfavorable judicial decisions have been held to be permissible under *Chevron* step two.[161] Thus, one way of alleviating the concerns of *Chevron* detractors is to make the second prong of *Chevron* a true hurdle for agencies to overcome.

For example, scholars have suggested that the second prong of the deference test be reworked to include a factor-based analysis, such as the test set forth in *National Muffler*.[162] The *National Muffler* analysis—which looks to factors such as the harmonization of the regulation with the origin and purpose of the statute, whether the regulation is a substantially contemporaneous construction of the statute at issue, the longevity of and reliance interests placed on the regulation, the consistency of the agency's interpretation, and the degree of attention Congress has devoted to the regulation—calls for a much higher level of judicial scrutiny than a look at whether the regulation is permissible. Moreover, these factors in particular do address some of the concerns raised by Justice Gorsuch, including his concerns that regulations can be changed by the agency, based on political whim alone, with each election cycle.[163] However, the factor-based analysis still steers the court toward deference if the appropriate guidelines are met.

While a revision of the *Chevron* two-step to include a heightened level of judicial scrutiny at step two alleviates some concerns that the judiciary's interpretive authority is negated under *Chevron* proper, it may not be enough for Justice Gorsuch. Gorsuch very much frames his critique of *Chevron* within

[160] *See* Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 842-45 (1984) and text accompanying note 79 *supra*.

[161] *See* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967 (2005). Note, however, that the Court has stopped short of affording deference to retroactive regulations aimed solely at ongoing litigation, noting that "[d]eference to what appears to be nothing more than an agency's convenient litigating position would be entirely inappropriate." Bowen v. Georgetown Univ. Hosp., 488 U.S. 204, 213 (1988).

[162] *See* Aprill, *supra* note 81. Professor Aprill reworks the second prong of the *Chevron* analysis to judge "the reasonableness of [the] administrative interpretation . . . against [the] origin and purpose of [the] statute, particularly as shown in legislative history." *Id.* at 84 tbl.2.

[163] *See* Gutierrez-Brizuela v. Lynch, 834 F.3d 1142, 1158 (10th Cir. 2016) (Gorsuch, J., concurring) (characterizing the benefit of de novo review as "promot[ing] reliance interests by allowing citizens to organize their affairs with some assurance that the rug will not be pulled from under them tomorrow, the next day, or after the next election").

a separation of powers argument, making it clear that he favors the judiciary alone as the law's interpreter—a conclusion that seems clear in the very first paragraph of his *Gutierrez-Brizuela* concurrence:

> There's an elephant in the room with us today. We have studiously attempted to work our way around it and even left it unremarked. But the fact is *Chevron* and *Brand X* permit executive bureaucracies to swallow huge amounts of core judicial and legislative power and concentrate federal power in a way that seems more than a little difficult to square with the Constitution of the framers' design. Maybe the time has come to face the behemoth.[164]

Throughout his concurrence, Gorsuch continues to argue in favor of restoring the interpretive power of the courts to that which was contemplated by the Constitution's framers. A modified *Chevron* approach, which demands heightened judicial scrutiny but still requires the court, when appropriate under the elucidated standards, to defer to an extra-constitutional administrative body, may not be the type of "world without *Chevron*" that Gorsuch contemplates.[165]

C. *Reversion to* Skidmore *Respect*

Finally, the Court could decide to turn back the jurisprudential clocks to the time of *Skidmore*. *Skidmore* both acknowledges the benefits of affording deference to agencies who possess the expertise that general courts may lack in certain technical areas of law, yet stops short of an outright transfer of interpretive authority from the judiciary to the administrative state.

Like *National Muffler*, *Skidmore* uses a factor-based formula to analyze the validity of an administrative regulation. However, unlike under *National Muffler*, even a regulation that passes the factor-based test is not *necessarily* afforded deference—the *Skidmore* outcome is respect for the regulation, not deference thereto. The *Skidmore* opinion takes as a given that agency interpretations are "not controlling upon the courts by reason of their authority[.]"[166] However, the Court also explains that there is good reason for both litigants and the tribunal to resort to the administrative pronouncements for guidance—namely, the agency's "body of experience and informed judgment."[167] A lower level of deference, more akin to deliberate consideration and measured respect, is already utilized by several states that have chosen not to follow *Chevron* outright, but not require pure de novo review either.[168]

[164] *Id.* at 1149 (Gorsuch, J., concurring).

[165] *See id.* at 1158 (Gorsuch, J., concurring).

[166] Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).

[167] *Id.*

[168] *See* Aaron Saiger, Chevron *and Deference in State Administrative Law*, 83 FORDHAM L. REV. 555, 559 (2014) (noting that "[e]ach survey of state doctrine notes a substantial number of states that defer to agency determinations in the style of *Skidmore v. Swift & Co.*, to the extent that they are persuasive").

Perhaps most importantly in light of Gorsuch's Tenth Circuit *Chevron* critiques, *Skidmore* does not really *mandate* a deference standard at all. It merely recognizes what subsequent cases and commentary have come to view as a truism: agencies are the experts in the fields under their purview. Administrative agencies—and Treasury is far from an exception—spend substantial time and effort to interpret the laws they are tasked with enforcing. There does not seem to be a valid reason, short of evidence of outright corruption and abuse, for failing to give measured respect to an agency's interpretation of an ambiguous statute within its area of expertise. However, measured respect and mandatory deference are vastly different standards for the court to apply. The latter requires the court to cede its interpretive power, while the former merely guides the court as it exerts its own independent judgment.

At the same time, while a *Skidmore*-type standard does not require courts to defer to agency interpretations, it does not reach the level of pure de novo review that Gorsuch mentions in *Gutierrez-Brizuela*. Even under *Skidmore*, courts are counseled to consider the agency's interpretation and allow it to guide their own interpretation of the law. Thus, there is at least a presumption that the agency's interpretation should be accorded respect, if the relevant factors are met. *Skidmore* respect in a way thus strikes a balance between outright de novo review and mandatory deference, though on the total deference spectrum, *Skidmore* respect is clearly closer to independent judgment than it is to *Chevron* deference.

The biggest problem with a reversion to *Skidmore* respect is just that—it is a reversion. Almost 75 years of jurisprudence stand in between the *Skidmore* decision and today's Court, and both the power of administrative agencies and volume of administrative regulations in existence have multiplied exponentially in the intervening period. While a court's "measured respect" toward administrative pronouncements does not quite reach the level of de novo review, it comes close. Nevertheless, it is obvious that Justice Gorsuch will, when given the opportunity (and, as explored in the following subpart, tax reform may provide just such an opportunity), argue in favor of abandoning mandatory deference, and *Skidmore* provides an alternative that at least retains the notion that agency expertise is a valid and valuable consideration within a fulsome judicial review of an ambiguous statute.

D. *Application to Tax Reform: Treasury as Interpreter*

The Tax Cuts and Jobs Act (TCJA) implemented the most comprehensive set of reforms to the U.S. tax system since the 1986 overhaul to the Code.[169] It was not lost on practitioners, scholars, or the taxpaying public at large that Congress acknowledged its reform legislation to be imperfect, and directed Treasury to fill the gaps that the furiously negotiated legislation left behind. The TJCA contains a number of provisions that expressly direct the Treasury

[169] *See* Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 1224.

to issue regulations carrying out such provisions;[170] in other cases, the TJCA contains inherent ambiguity, which Treasury may (and likely will) choose to interpret under its general grant of interpretive authority.[171] Treasury has already begun working on the monumental task of implementing tax reform, and its work is certain to continue in the months (and years) to come.

On February 7, 2018, Treasury released its 2017–2018 Priority Guidance Plan, which contains guidance on projects the Department hopes to complete during the twelve-month period commencing July 1, 2017.[172] The Priority Guidance Plan contains 18 separate bullet points outlining guidance that Treasury hopes to issue in its initial implementation of the TCJA. Included in Treasury's action items are issuing guidance related to new section 168(k) (immediate expensing of certain qualified property), rules implementing new section 965 (the deemed repatriation transition tax), and, generally, guidance addressing "the other international provisions of the TCJA." These regulations will have an impact on taxpayers for both federal and state purposes, as states will certainly issue their own guidance on how tax reform applies at a state and local level, including whether the Treasury regulations apply or must be modified.

There is no doubt that the regulations, whatever their substantive content holds, will be complex. Repatriation alone is already the subject of multiple Service Notices, comprising dozens of pages, describing the regulations that Treasury and the Service intend to issue.[173] These forthcoming regulations will address, inter alia, specified foreign corporations with different taxable years than their United States shareholders; treatment of related party transactions in determining the aggregate foreign cash position of the United States shareholder; treatment of certain complex financial instruments in determining the U.S. shareholder's foreign cash position; and the coordination of new section 965 with the Code's previously taxed income provisions.[174] Given the thorough nature of the *preliminary* guidance issued by Treasury and the Service, the final regulations are sure to be detailed, substantial, and filled with pronouncements of departmental policy. One can already see that, when

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[170] *See, e.g.*, Tax Cuts and Jobs Act, § 13501(b)(6) (codified at I.R.C. § 1146 (2017)) (directing Treasury, within the context of the new partnership provisions, to "prescribe such regulations or other guidance as may be necessary to carry out the purposes of this subsection, including regulations providing for exceptions from the provisions of this subsection"); § 14101(a) (codified at I.R.C. § 245A(g)) (providing the same with respect to the amended deduction for foreign-source dividends); § 14202(a) (codified at I.R.C. § 250(c)) (providing the same with respect to the global intangible low-taxed income provisions).

[171] *See generally* Part I.B *supra* and its discussion on general authority regulations.

[172] DEP'T OF TREASURY, 2017–2018 PRIORITY GUIDANCE PLAN (2018), https://www.irs.gov/pub/irs-utl/2017-2018_pgp_2nd_quarter_update.pdf.

[173] *See* IRS NOTICE 2018-26, IRB 2018-16 (2018); IRS NOTICE 2018-13, IRB 2018-06 (2018); IRS NOTICE 2018-07, IRB 2018-04 (2018); *see also* IRS ISSUES ADDITIONAL GUIDANCE ON TRANSITION TAX ON FOREIGN EARNINGS (2018), https://www.irs.gov/newsroom/irs-issues-additional-guidance-on-transition-tax-on-foreign-earnings-0.

[174] *See* Notice 2018-07, 2018-4 I.R.B. 317; Notice 2018-13, 2018-6 I.R.B. 341.

it comes to tax reform, Treasury will not merely be enforcing the Code, it will be using its interpretive power to tell the taxpaying public what the new Code means.

Clearly, the task that Treasury faces in the coming year is monumental. Issuing a comprehensive set of regulations that seeks to implement uncharted sections of and policies behind the new Code, including a wholesale switch from a worldwide to modified-territorial system of taxation, will require Treasury to use its interpretive authority to the fullest extent. At the same time, taxpayers and practitioners are aware that a Justice sits on the Supreme Court who may be the catalyst for a sea change in the field of judicial deference to administrative regulations, including the very regulations that are currently being drafted by the Treasury. Depending on the course that the forthcoming Treasury regulations take, they may provide the perfect opportunity for a litigant to make an outright attack on *Chevron* deference.

E. *Impact on the States*

The interplay of a potentially changing deference standard and the substantial Treasury regulations that will follow tax reform could have a significant impact on the states. One way or another, states (at least those with a corporate income tax) will be forced to figure out how to respond to the federal reform legislation.[175] For states that respond through the issuance of administrative regulations—whether the regulations are issued in direct response to federal reform or as implementation of the state legislature's response to the TCJA—the viability of such regulations when challenged will depend in large part upon the level of deference that the reviewing court affords to state tax regulations.

As noted *supra*, several states already refuse to follow the *Chevron* holding, and have explained the rationale for their divergence in no uncertain

[175]Some states are already off to a head start, either legislatively or through administrative guidance. New York is an example of a state that has responded through legislation directly responsive to federal tax reform. The New York Tax Law amendments decouple from several provisions of the TCJA, including providing that the federal deduction provided by Code section 965(c), which reduces the amount of a taxpayer's subpart F income inclusion in connection with the deemed repatriation of foreign earnings under Code section 965(a), is disallowed for New York corporation franchise tax purposes. N.Y. Tax Law § 208(6)(a-b) (McKinney 2018) (added by N.Y. Leg. S7509-C, Part KK, § 1 (signed Apr. 12, 2018). The Pennsylvania Department of Revenue, on the other hand, chose to respond almost immediately to tax reform administratively, by issuing Corporation Tax Bulletin 2017-02, which stated that no deduction is allowed for Pennsylvania corporate income tax purposes with respect to the 100% expensing provision in new section 168(k). Pa Dep't of Revenue, Corporation Tax Bulletin 2017-02, Disallowance and Recovery of 100 Percent Depreciation Under IRC 168(k) (2017). The Pennsylvania legislature subsequently enacted a bill reversing the Department's position, and the Department thereafter issued a bulletin consistent with the legislation. *See* 2018 Pa. Laws 2018-72 (signed June 28, 2018); PA Dep't of Revenue, Corporation Tax Bulletin 2018-03 (2018) (superseding Bulletin 2017-02).

terms.[176] For these states, the death of *Chevron* would simply support the existing administrative deference jurisprudence. However, other states adhere to *Chevron*, either through outright incorporation of the holding into the state's own case law or by following the opinion's principles. The Maine Supreme Court, for example, has explained that it uses "the same two-step analysis developed by the Supreme Court in *Chevron*" when determining whether to defer to an agency's construction of a statute.[177] If the Supreme Court overturns *Chevron*, states directly adopting the *Chevron* holding may choose to alter their own deference standards rather than continue to follow outdated federal precedent.

The deference standard used at the state level is just as important as the standard used by federal courts. State revenue departments are no less willing than Treasury to issue sweeping regulations implementing state taxing statutes. One striking example of this is in the area of market-based sourcing. While state statutes mandating market-based sourcing may be succinct,[178] the regulations interpreting the meaning of the "market" can be famously lengthy.[179] Thus, similar to the impact of the Treasury regulations on Section 482 of the Code, in many states, the market-based sourcing regulations, rather than the statute itself, are *the* authority taxpayers and tribunals look to when determining how to properly source a sale of services or intangibles.

The market-based sourcing example may also be a preview of what state revenue departments will do when confronted with tax reform. The introduction of market-based sourcing was a wholesale shift from the previous way that states had sourced revenue from sales of other than tangible personal property.[180] State revenue departments provided substantial input as

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[176] *See supra* notes 118-120 and accompanying text; *In re* Rovas Against SBC Michigan, 754 N.W.2d 259, 272 (Mich. 2008) ("[T]he unyielding deference to agency statutory construction required by *Chevron* conflicts with . . . the separation of powers . . . by compelling delegation of the judiciary's constitutional authority to construe statutes to another branch of government.").

[177] Cobb v. Bd. of Counseling Prof'ls Licensure, 896 A.2d 271, 275 (Me. 2006). Other states, while not explicitly adopting *Chevron*, use deference standards that are basically carbon copies of the *Chevron* doctrine. *See* William R. Andersen, Chevron *in the States: An Assessment and a Proposal*, 58 ADMIN. L. REV. 1017, 1025-26 (2006).

[178] For example, Georgia's market-based sourcing statute simply provides that "[g]ross receipts are in this state if the receipts are derived from customers within this state or if the receipts are otherwise attributable to this state's marketplace." Ga. Code Ann. § 48-7-31(d)(2)(A)(i) (2018).

[179] Massachusetts is the most oft-cited example of a state that led the way in issuing substantial market sourcing regulations. In 2015, the Massachusetts Department of Revenue implemented the state's 2013 market-based sourcing statute with over 50 pages of regulations. Mass. Gen. L. Ch. 63 § 38(f).

[180] *See* Jerome Hellerstein & Walter Hellerstein, STATE TAXATION ¶ 9.18. (3d ed., Thomson Reuters 2016 & Supp. 2018-1).

to how this new method of sourcing should be implemented.[181] Likewise, the TCJA is in many ways a foundational shift in the taxation of business income. States whose taxing statutes are in any way keyed to the Code will be forced to address the impact of the TCJA on the state's corporate income or franchise tax.[182] Several key provisions, most notably the shift to expensing from depreciation and the changes to the international tax system, will need to be addressed by the states—many of which already decouple from bonus depreciation and all of which will be subject to constitutional restrictions on discriminating against foreign commerce.[183] Given that all states that tax corporate income will, in some way, need to respond to the TCJA, it seems inevitable that at some point in the process—whether before or after state legislatures pass statutes implementing or decoupling from the TCJA—state revenue departments will issue administrative regulations responsive to tax reform.

Thus, state taxpayers, just like federal taxpayers, will have the opportunity to challenge the regulations that are issued. In states that have adopted a *Chevron* or *Chevron*-like standard of deference, taxpayers are currently limited to arguing that the regulations are contrary to the statute or that the revenue department's interpretation is unreasonable—both of which are generally a high bar to overcome. However, if *Chevron* is overturned at the federal level, it may provide the impetus for states to adopt their own more lenient deference standards, allowing judges to take a more liberal look at areas of state and local tax law that are governed more by regulation than by statute.

V. Conclusion

While Treasury toils away drafting its final regulations interpreting the TCJA, tax litigators are already forming arguments in favor of their clients with respect to the ambiguities inherent in the reform legislation. It seems unavoidable that, at some point in the near future, the courts will hear a dispute between taxpayer and taxing authority involving the meaning of a statutorily undefined term in the TCJA. The question remains: What will

[181]Other wholesale shifts in state tax treatment—for example, the move from separate to combined reporting—have also commonly been addressed through comprehensive tax department regulations. *See, e.g.*, N.Y. COMP. CODES R. & REGS. tit. 20, § 6-2.1 to -2.8 (2018) (implementing the New York corporation franchise tax combined reporting provisions).

[182]States with static conformity to the Code (*i.e.*, conformity to the Code as of a given date) and with selective conformity (*i.e.*, conformity to only select provisions of the Code) will most clearly need to decide whether and when the TCJA will be implemented into the state's corporate tax. Even states with rolling conformity (*i.e.*, conformity to the most recent version of the Code on a rolling basis) will be forced to determine whether all aspects of the TCJA should be incorporated into the state tax code, as this will happen absent state legislative action decoupling from federal reform.

[183]With this restriction, states will need to determine how to implement the new section 245A, which provides a 100% deduction for foreign (but not domestic) dividends, and will likely be prohibited from implementing new section 59A (the base erosion and anti-abuse tax, or "BEAT"), as this tax is arguably a direct tax on foreign commerce. *See* I.R.C. § 245A.

the deference standard be when that dispute finally makes its way through the courts? Will *Chevron* continue to rule the day, such that the court will be limited to determining whether the Treasury's regulation is permissible? Will some lesser standard of deference apply, allowing the courts to utilize a multi-factor analysis of the regulations and ultimately decide for itself whether deference is appropriate or mandated? Or will Gorsuch's dream of a world without *Chevron*, and a return to de novo review of agency actions, allow the tax bar to mount unprecedented challenges to unfavorable Treasury regulations?

One thing seems certain: an administrative deference case will eventually make its way to the Supreme Court, and Justice Gorsuch will have the chance to set forth his views on *Chevron* deference as a member of the nation's highest judicial authority. In a time of undeniable political turmoil, it will be interesting to see whether Justice Gorsuch can garner a majority opinion that reins in the administrative state and restores some of the balance of power envisioned by the Constitution's framers. If so, the tax reform regulations could be subject to a level of judicial scrutiny that Treasury regulations have not experienced in decades. Meanwhile taxpayers—and their advocates—will have the freedom to persuade courts that their interpretation of the Code is the correct one, without having to conquer the nearly insurmountable hurdle of proving that Treasury's contrary interpretation was "impermissible." Finally, as both the regulatory action of implementing tax reform and the judicial response to the deference standard trickles down to the state level, state taxpayers and tax practitioners will be tasked with not only learning what the state revenue department's view on federal tax reform is, but analyzing whether that view is likely to be afforded deference by a state tribunal. A world without *Chevron* will be a brave new one, indeed.

Chevron Revisited

Introduction

"It is emphatically the province and duty of the judicial department to say what the law is. Those who apply the rule to particular cases, must of necessity expound and interpret that rule. If two laws conflict with each other, the courts must decide on the operation of each."[7] All the participants in the three branches of government have the obligation to abide by the commands of the fundamental document. In the absence of agreement among them, the Article III judiciary has the inherently deciding vote.[8]

Before the age of statutes, the common law, judge-made law, predominated. The members of the judicial brethren originally developed the rules of torts, contracts, and property.[9] The failure to

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[7] *Marbury v. Madison,* 5 U.S. 137, 1 Cranch 137, 177 (1803). On page 163 of the decision appears another well-known statement: "The government of the United States has been emphatically termed a government of laws, and not of men. It will certainly cease to deserve this high appellation, if the laws furnish no remedy for the violation of a vested legal right."

[8] Professor Bernard Schwartz. "The basic remedy against illegal administrative action is judicial review....Judicial review is the balance wheel of administrative law.." Schwartz *Administrative Law* § 8.1 (1991). As a former student of the constitutional law expert: "Talk about a fountain of information. His lectures on administrative law made it abundantly clear, crystal in fact, that the separation of powers doctrine had undergone a major case of radical surgery in an increasingly and technically complex society. Take the Internal Revenue Service, please. In padlocking the door for failure to remit escrow funds to the federal depositary, the revenuers are executing the law. In assisting the Treasury Department in promulgating estate tax regulations, the agency is assuming the role of lawgiver. Finally, in issuing private letter rulings, the agency performs a quasi-judicial function.] Professor Schwartz has written an entertaining judicial biography about Earl Warren. In *Super Chief* I first became aware of Justice Robert Jackson's pithy description of the Supreme Court's role in the legal hierarchy.

[9] The lay reaction to this judicial "sleight of hand" is startling in its intensity: "I'm gonna tell you the biggest disappointment. This is the second time John Roberts has done this. [Perhaps a third opportunity will occur in the 2020 October term.] His reasoning is beyond belief, beyond the expectation of conservatives that supported him for this position. Sounds to me like he said and did everything he needed to do and say to get this lifetime appointment to the Court.

"Now there are some very important things evident in this decision. We have now as a country – *this is profound here* – (emphasis added) we have now reached a point where a majority of the Supreme Court of the United States of America, nine justices in black robes, have literally argued in this law, in this case, that words that are written into law are meaningless. That these words are empty vessels in which the Supreme Court justices, these nine, if they choose, or majority thereof -- they can fill any meaning they want into them."

"Now it's obvious that the language of the law limits [tax] credits to state exchanges only, not the federal exchange. Otherwise, it would have specified as such. It's so plain, the language. You could not have produced any clearer language if you tried. But that didn't influence six Supreme Court justices. It didn't matter to them.

"Because for John Roberts, and Anthony Kennedy, and Sonia Sotomayor, and Elena Kagan, and Ruth Bader Ginsburg, and Stephen Breyer, those words are, like, infinitely elastic. You can turn it into anything you want to turn it in to. They can mean whatever you want it to mean, which is, of course, a dagger at the heart of the rule of law, which they're sworn to uphold -- our Constitution.

"It means that everything is up for grabs. And it means that there's nothing objective that we can anchor our words, our law in.

"This is going to go down in history, these two Obamacare rulings, as two of the worst examples of judicial activism in American history. That's my prediction.

"And I want to point out another thing, what this decision illustrates here, and as clearly as anything that I can think of is you now have a group of nine people -- a Supreme Court that is acting not as a judicial branch of government, but as a political arm for a political party with a political agenda. That is the only way you can justify the contortion of words and the dissemination of words that they have done here.

"And what I mean is, it's so obvious, this court, that they were gonna uphold Obamacare by any means necessary. And in doing so, they invented the most transparently obscene and absurd arguments you could ever imagine, and to the point where they have

recognize that judges make law is exemplified by the political comments in the immediately preceding footnote. Any 1L (first year law student) understands what the political commentator's diatribe in footnote 9 demonstrates what is essentially unknown by the laity. As the common law gave way to the age of statutes in the nineteenth century, the judges, no longer the creators of law, were forced to tread lightly by becoming "interstitial" legislators, filling up the holes or the interstices, completing the tasks left undone by the legislature. And then came the age of administrative agencies.

Do the administrative agencies constitute a fourth branch of government not provided for as the Article IV branch? Perhaps it is best to go to the wording in the Chevron case itself:

"When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[10] The first question, then, or, Chevron step one, is when the Congressional intent expressed in the statute is clear. If such clarity is present, then both the courts and the administrative agencies are required to follow the legislative directive. Chevron step two, where the statute is ambiguous or does not address the issue, allows the administrative agency to interpret the statute and such interpretation is entitled to judicial deference if the interpretation is reasonable. Reasonableness is not an exceedingly high standard to achieve. Finally, Professor Sunstein, has suggested that there is a step zero, [11]which essentially asks the question whether Congress intended to give the administrative agencies or the courts interpretative authority. For example, the Environmental Protection Agency would not possess such interpretative authority over a statute not within its bailiwick such as the requirements of the Administrative Procedure Act.

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decided not only to ignore the words that were written into the law, or to even reinterpret them, but to actually make them say precisely the opposite of what they were.

"This is a very dark day for the United States Constitution and the rule of law. It is a shameful day for these six justices on this court who ruled in favor of supporting Obamacare....

"We've now entered a period of American history where the Supreme Court is not only discrediting itself, it is literally eviscerating the meaning of words and the rule of law. It has done tremendous damage as a result of this decision and its previous decision." And who pray tell is the author of the preceding diatribe?

[10] *Chevron Inc v. Natural Resources Defense Council, Inc, American Iron and Steel Institute v. Natural Resources Defense Council, Inc., Ruckelshaus v. Natural Resources Defense Council, Inc*, 467 U.S. 837, 842 (1984)

[11] "Chevron Step Zero" (University of Chicago Public Law & Theory Working Paper No. 91, 2005).

If it is for the Article III courts "to say what the law is", then the Chevron doctrine is, in a manner of speaking, a new counter-Marbury.[12] The argument for transferring interpretative authority to the administrative agencies makes the following three favorable points: Expertise in the regulatory area; decision by a politically[13] accountable institution (unlike the lifetime serving members of the judiciary); and the ability to respond more readily to the needs of an ever changing environment.

Perhaps, to better understand what is at stake in the two herring boat cases before the United States Supreme Court, a quick review of the nature of appellate jurisdiction would be salutary. A question of fact is a jury issue and may only be reversed by an appellate court if the finding below by a jury or trial judge is "clearly erroneous." "Under this standard, a judgment will be upheld unless the appellate court is left with the firm conviction that an error has been committed."[14] Moving to the opposite side, a question of law may be determined by an appellate court *de novo,* that is, "a court's non-deferential review of the administrative decision, usually through a review of the administrative record plus any other evidence the parties present."[15] And then there are "mixed questions of law and fact", that is, "an issue that is neither a pure question of fact nor a pure question of law...Mixed questions of law and fact are typically resolved by juries."[16] "Whether these be referred to as mixed questions of law and fact, or legal inferences from the facts, or the application of law to the facts, there is substantial authority that they are not protected by the 'clearly erroneous' rule and are freely reviewable."[17] I t should not be surprising that appellate review is divided due to the unique mixed nature of such questions. The legal definition of negligence which centers upon the reasonably prudent person is a classic example of a mixed question of law and fact.

Court Decisions Cited At Oral Argument

The brethren of the United States Supreme Court, unlike the Congress, make a mistake in not televising oral arguments. To better follow such arguments in *Loper Bright Enterprises* and *Relentless,* a few of the more prominent precedents, such as *Skidmore*[18], *Chevron*[19], *Auer*[20],

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[12] Richard W. Murphy, A "New" Counter-Marbury: Reconciling Skidmore Deference and Agency Interpretative Freedom, 56 Admin. L. Rev. 1 (2004)

[13] Frankly, I have no partiality for elected members of the bench. It is the lifetime appointment itself that lends tremendous credibility to the exceedingly high level of judicial decision making.

[14] *Black's Law Dictionary,* Ninth Edition

[15] *Black's Law Dictionary,* Ninth Edition

[16] *Black's Law Dictionary,* Ninth Edition

[17] 9A Charles Alan Wright & Arthur R. Miller, *Federal Practice and Procedure* §2589, at 608-11 (2d ed. 1995)

[18] *Skidmore v. Swift,* 323 U.S. 134 (1944)

[19] *Chevron USA v. Natural Resources Defense Council,* 467 U.S. 837 (1984)

[20] *Auer v. Robbins,* 519 U.S. 452 (1997)

Michigan v. Environmental Protection Agency[21], *Brand X Internet Services*[22], *American Hospital Association*[23], *Digital Realty Trust*[24], *Kisor*[25], *and City of Arlington*[26] will be examined first.

Skidmore v. Swift The first of the nine cases dealt with employees of a fire department. The Fair Labor Standards Act provided additional compensation for overtime work. The issue was whether wait time beyond the normal work week constituted overtime.. For three and one half to four nights a week a fire man had to remain in the fire station or within hailing distance to monitor any alarms that might occur. The employee was able to pursue personal activities during such time. The statute's administrator did issue interpretative bulletins and informal rulings. Associate Justice Jackson noted that there was no statutory provision stating what deference, if any, that courts should give to administrative conclusions. In memorable language, frequently quoted in many subsequent cases, the following words described the circumstances governing judicial deference: "We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control." The case was reversed and remanded to the district court for its erroneous holding that waiting time may not be considered to be work.

Chevron USA v. Natural Resources Defense Council This be the case that launched a thousand scholarly articles. In a decision concerning the Clean-Air Act Amendments of 1977, the Court held that the Environmental Protection Agency definition of the statutory term "stationary source" as referring to the plant as a whole was permissible construction of that term as the statute did not contain a specific definition of the term "stationary source".` In often quoted language that succinctly defines what is meant by the Chevron Doctrine: "First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." Very simply, the judiciary is the ultimate authority on statutory interpretation, which requires a rejection of an administrative construction which is not in accord with clear congressional intent. "If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." The legislative body may expressly or by implication authorize the

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[21] *Michigan v. Environmental Protection Agency,* 576 U.S. 743 (2015)
[22] *National Cable & Telecommunications Assn. v. Brand X Internet Services,* 545 U.S. 967 (2005)
[23] *American Hospital Association v. Becerra,* 142 S.Ct. 1896 (2022)
[24] *Digital Realty Trust v. Somers,* 138 S.CT. 767 (2018)
[25] *Kisor v. Wilkie v. Secretary of Veterans Affairs,* 588 U.S.__(2019)
[26] *City of Arlington v. Federal Communications Commission,* 569 U.S. 290 (2013}

administrative agency to provide the necessary interpretation. The resulting legislative regulation by the executive department, if a reasonable construction of the statute, is one that a court may not substitute its own interpretation. In essence the plant wide definition meant that as long as all the pollution emitting devices within the plant did not increase the overall level of pollution, such a stationary source was eligible for a permit. All such devices were considered part of a "single bubble". Associate Justice Stevens' opinion states that policy arguments regarding the "bubble", "should be addressed to legislators or administrators, not to judges. The reasonable compromise between economic growth and environmental protection was entitled to deference. Finally, "the responsibilities for assessing the wisdom of such policy choices and resolving the struggle between competing views of the public interest are not judicial ones. 'Our Constitution vests such responsibilities in the political branches..'"

Auer v. Robbins Another overtime pay case under the Fair Labor Standards Act by police sergeants and a lieutenant, arguing that they were not covered by the statutory exemption for "bona fide executive, administrative, or professional " employees. The absence of a non-salary-reduction means of discipline as applied to public-sector employees is not an unreasonable interpretation of the statute, and the Secretary's interpretation of her own test is not "plainly erroneous". The Secretary's interpretation as set forth in an amicus brief does not make such an interpretation unworthy of deference as that does not constitute a position adopted in response to litigation. The rule dictating that exemptions be interpreted narrowly does not prevent the Secretary from exercising her power to resolve ambiguities. The case must decide whether the Secretary has "reasonably interpreted the salary-basis test for the determining the applicability of the exemption. Petitioners maintained that the exemption was inapplicable since their compensation could be "reduced for a variety of disciplinary infractions related to the 'quality or quantity' of work performed." Exempt employees would typically not have their pay reduced for such infractions but rather would be terminated, demoted, or given restricted assignments. Associate Justice Scalia moves to step 2 of the Chevron analysis as Congress did not address the precise question involved. "Because the FLSA entrusts matters of judgment such as this to the Secretary, not the federal courts, we cannot say that the disciplinary-deduction rule is invalid as applied to law-enforcement personnel." In the absence of an application to the agency stating that the regulation is "arbitrary" and "capricious" for failure to conduct rule-making in violation of the Administrative Procedure Act, the issue cannot be addressed at this late date. "Because the salary-basis test is a creature of the Secretary's own regulations, his interpretation of it is, under our jurisprudence, controlling unless 'plainly erroneous or inconsistent with the regulation.'" The rule for construing the exemption narrow is directed to a court, not to an administrative agency that may promulgate regulations broadly conceived subject only to the limited enunciated in the statute.

Michigan v. Environmental Protection Agency [List of law firms involved ran over two pages.]The Clean Air Act directs the Environmental Protection Agency to regulate emissions of hazardous air pollutants from stationary sources only if it concludes that such "regulation is appropriate and necessary/" The Supreme Court reversed against the agency for an unreasonable interpretation that failed to consider the estimated costs of regulating power plants. [EPA

estimated costs of $9.6 billion a year; quantifiable benefits from the reduction in hazardous-air-pollutant emissions of $4-$6 million a year. While "ancillary" benefits—including cutting power plants' emissions of particulate matter and sulfur dioxide, substances that are not covered by the hazardous-air-pollutants program with an estimated $37 to $90 billion per year.] The District of Columbia Court of Appeals had upheld the agency's refusal to consider costs. The process by which an agency reaches its conclusions must be logical and rational. The agency had concluded that "[c]ost does not have to be read into the definition of 'appropriate.'" One does not need the assistance of a dictionary to realize that the phrase "appropriate and necessary" can be extraordinarily capacious. "No regulation is 'appropriate' if it does significantly more harm than good." When a statute directs regulation based upon a factor other than cost, then cost would not ordinarily be considered, but the expression "requisite to protect the public health" ins not nearly as comprehensive as "appropriate and necessary". The agency had the held that the initial decision to regulate need not include cost, but the subsequent decision of how much to regulate could at that time include cost. The court may uphold an agency's decision on the ground upon which the decision was made, not upon the basis upon which the decision could have been made. In this case the agency decision was not based upon the ancillary benefits. The judgment of the appellate court below is reversed as it was unreasonable to hold the costs were irrelevant to the decision to regulate power plants. In a concurring opinion, Associate Justice Thomas raised a serious constitutional issue on the separation of powers issue when an agency rather than a court is allowed to do the interpretative work. Chevron causes a court to be unable to exercise its own independent judgment in deciding upon the best (not just reasonable) interpretation of an ambiguous statute. Quite often agencies are not involved in the interpretative process but rather are engaged in the formulation of policy. Taking over the legislative function is in violation of Article I's vesting of the legislative power of the Congress. The four dissenters: "On the majority's theory, the rule is invalid because EPA did not explicitly analyze costs at the very first stage of the regulatory process, when making its 'appropriate and necessary' finding. And that is so even though EPA later took total costs into account again and again and … so on." The dissent continued: "The kick-off finding preceded the cost-benefit analysis by years and so could not have taken its conclusions into account. But more fundamentally, the majority's account is off, because EPA knew when it made that finding that it would consider costs at every subsequent stage, culminating in a formal cost-benefit study. And EPA knew that, absent unusual circumstances, the rule would need to pass that cost-benefit review in order to issue.".. "it made that finding that it would consider costs at every subsequent stage, culminating in a formal cost-benefit study. And EPA knew that, absent unusual circumstances, the rule would need to pass the cost-benefit review in order to issue.". "Simply put, calculating costs before starting to write a regulation would put the care before the horse." "In sum, EPA considered costs all over the regulatory process, except in making its threshold finding—when it could not have measured them accurately anyway."

National Cable & Telecommunications v. Brand X Internet Services The Federal Communications Commission classified broadband cable modem services as an "information service" but not a "telecommunications service", and thus not subject to mandatory common

carrier regulation by the Commission. The Commission had held that the broadband cable modem companies were exempt form mandatory common-carrier regulation. The Ninth Circuit Court of Appeals, selected by judicial lottery, held otherwise based on one of its prior decisions, but such a prior decision may trump agency construction under Chevron deference "only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion." The Ninth Circuit's prior decision was based on the best reading of the statute without holding that the interpretation holding that a telecommunication service as involved without holding that such interpretation was the only permissible reading of the statute. Such a prior holding would make the application of Chevron dependent on the order of the judicial and administrative decisions. The Commission's holding satisfied Chevron at both of its steps. Viewed from the end user's perspective, cable wire is not just simply used to transmit ordinary-language messages without computer processing or storage of the message. "Where a statute's plain terms admit of two or more reasonable ordinary usages, the Commission's choice of one of them is entitled to deference." Even if what cables companies "offer" is ambiguous as to whether the offer includes telecommunications with cable modem service, the Commissions interpretation is permissible. No violation of the Administrative and Procedure Act as there is nothing arbitrary and capricious to take changed market conditions into account to apply a fresh analysis to the cable industry. An unexplained inconsistency with past practice may be reason to hold such a changed construction as arbitrary and capricious. Analogy run rampant: "[W]e doubt that a statute that...subjected offerors of "delivery" service (such as Federl Express and United Parcel Service) to common carrier regulation would unambiguously require pizza-delivery companies to offer their delivery services on a common-carrier basis." Associate Justice Scalia's dissent commences: "The Federal Communications Commission ...has once again attempted to concoct 'a whole new regime of regulation (or of free-market competition)' under the guise of statutory construction." "[T]he telecommunications component of cable-modem service retains such ample independent identity that it must be regarded as being on offer...consisting of two separate things", that is, that telecommunications component does not disappear as an independent component despite the fact that a car dealer is not perceived as a seller of engines. "The functions [provided by the Information Service Provider] are separate from the transmission pathway over which the date travels." Would affirm the Ninth Circuit simply because the selling of cable modem service is the offering of telecommunication service. The majority has produced a "breathtaking novelty.: judicial decisions subject to reversal by executive officers." :...how many hundreds of past statutory decisions are now agency-reversible because of failure to an 'unambiguous' finding...." "It is indeed a wonderful new world that the Court creates, one full of promise for administrative-law professors in need of tenure articles...."

American Hospital Association v. Becerra May the Department of Health and Human Services, not having conducted a survey of hospital acquisition costs for drugs so that the reimbursement rate for different groups of hospitals may not be varied, vary the reimbursement rate? A unanimous court answered in the negative and reversed in favor of petitioners. The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 expanded Medicare to cover

prescription drugs. If the survey had been conducted, the department could vary reimbursement rates for different hospital groups. Hospitals serving low income or rural populations obtained prescription drugs from manufactures at prices paid by other hospitals. Because of the profits obtained because of such prices, the department attempted to institute a new rule to lower the reimbursement rate. Petitioners asserted that the statute in essence provided a subsidiary for the other services provided to low income and rural populations. $1.6 billion was at stake under the reduced reimbursements. Health and Human Services maintained that its statutory authority to "adjust" the average prices as" necessary for purposes of (the statutory provision)..." permitted modification of the reimbursement rule by implication. A divided District of Columbia Circuit reversed the ruling in favor of the department. "Judicial review of final agency action in an otherwise justiciable case is traditionally available unless 'a statute's language or structure' precludes judicial review." The statute requires the survey before hospital groups may be targeted for different reimbursement rates. "HHS may not make 'billion-dollar decisions differentiating among particular hospital groups.'" Adjusting a price is not the same thing as modifying reimbursement rates. Associate Justice Kavanaugh suggest that the new rule was promulgated fifteen years after enactment is quite "telling". Under the department's interpretation, it would never have to conduct a survey under option one. The special program for low income and rural populations was established in 1992, so Congress was well aware of the program at the time that prescription drug part of Medicare was enacted. The Court is not the proper forum for a policy debate concerning the subsidiary. With mentioning Chevron defence, this is a case decided under step one.

Digital Realty Trust v. Somers The Sarbanes-Oxley Act of 2002 (responding to the collapse of Enron Corporation) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (responding to the 2008 financial crisis)shield whistleblowers in the struggle against corporate fraud. The former protects and rewards employees who report misconduct to the Securities and Exchange Commission (SEC) the latter defines "whistleblower as a person who provides to the Commission information of conduct that violates the securities laws. The issue is whether the second piece of legislation provides protection against retaliation to a person who has not reported a violation of the securities laws to the SEC. The anti-retaliation protection of Dood Frank applies whether or not the conditions for obtaining an award are satisfied. So it ss possible to obtain anti-retaliation protection without providing information to the SEC. The respondent was an employee of petitioner, a real estate investment trust, who had reported a securities-law violation to senior management. Finding the statutory scheme ambiguous, Chevron was applied by the district court, which was affirmed by a divided panel of the Ninth Circuit, which held that employee protection whether or not the SEC was informed in addition to internal reporting to the employer, so that the SEC's resolution of nay statutory ambiguity was entitled to deference. Associate Justice quotes a prior Supreme Court decision that "'[w]hen a statute includes am explicit definition, we must follow that definition', even if it varies from a term's ordinary meaning." Also quoted is a prior Court decision stating that "[w]hen Congress includes particular language in one section of a statute but omits it another[,]...this Court presumes that Congress intended a difference in meaning." Under step 1 of Chevron the

statutory definition of whistleblower is clear." The statute's unambiguous whistleblower definition, in short, precludes the Commission from more expansively interpreting the term." The SEC had issued an interpretative rule stating that anti-retaliation is not contingent on a whistleblower's provision of information to the SEC.

Kisor v. Wilkie, Secretary of veterans Affairs Federal Circuit affirmed lack of retroactivity for a veteran's claim for disability attributable to post-traumatic stress disorder. An original claim was made in 1982 but was denied. A claim made in 2006 was accepted. The Federal Circuit had applied a doctrine call *Auer* deference under which the Supreme Court "has long deferred to an agency's reasonable reading of its own genuinely ambiguous regulations." Petitioner seeks the Court to overrule *Auer.* Judgment was vacated and case remanded without overruling *Auer* and its predecessor *Seminole Rock. Auer* rests on a presumption concerning Congressional intent, that is, it would want the agency to play the primary role in resolving regulatory ambiguity. In delegating the regulatory function to agencies, Congress knew that sometimes those regulations would contain ambiguities. The assignment may not be expressed, but is more likely presumed."[T]he power authoritatively to interpret its own regulations is a component of the agency's delegated lawmaking powers" as an agency is in a better position to know the regulation's original meaning. "Want to know what a rule means? Ask its author." To the extent that a regulation is grounded in policy, all the more reason for an agency and not a court to provide its meaning. Expertise and political accountability argue in favor of the assigned role. And, of course, uniform administrative interpretation to piecemeal litigation with different and irreconcilable decisions. There are exceptions to the application of *Auer,* as when "an interpretation does not reflect an agency's authoritative, expertise-based 'fair[or]considered judgment.'" Before a regulation is held to be ambiguous, a court must exhaust all the traditional tools of construction (text, structure, history, and purpose of a regulation). But there are limits to deference. So a "speech of a mid-level official" as an "authoritative departmental position" would not be entitled to *Auer* deference. Again, deference is not warranted if "'[t]he subject matter of the [dispute is] distan[t] from the agency's ordinary" duties or 'fall[s] within the scope of another agency's authority.'" Similarly, some questions are more suitable to resolution by judiciary, such as elucidation of a simple common-law property term, one concerning the award of attorney's fees, or where an agency attempts to interpret a judicial review provision. Parroting or paraphrasing the language of a statute as a regulation would also not be entitled to any deference. Similarly, "'[P]ost hoc rationalization[n] advanced' to 'defend past agency action against attack'" would not be an appropriate occasion for deference. Associate Justice Kagan: "What emerges is a deference doctrine not quite so tame as some might hope, but not nearly so menacing as they might fear>" When the Administrative Procedure Act of 1946 which is considered to have restated the law existing at that time, nothing required all judicial review of agency interpretations to be de novo. No real evidence supports the assertion that *Auer* "encourages agencies to issue vague and open-ended regulations, confident that they can later impose whatever interpretation of those rules they prefer." Quite simply, clarity promotes compliance, As ti a "separation of powers" argument, "we have explained, because even when agency 'activities take "legislative" and "judicial forms", they continue to be "exercises of the

'executive Power'" or otherwise said, ways of executing a statutory plan."" In addition, overruling precedent runs up against state decisis, which is "a foundation stone of the rule of law." Special justification for overruling requires more than that the precedent was wrongly decided." And, of course, Congress always remains free to alter a rule of judicial review. As to Kisor himself, retroactive benefits depend on "the meaning of the term 'relevant' records in a Veterans Administration regulation. There are 100 members of the VA Board that act individually and not in concert so that its 80,000 annual decisions have no precedential value. The case must be remanded to the Federal Circuit to make a more searching decision on the applicability of *Auer.*

In an opinion concurring in judgment, Associate Justice Gorsuch states that the decision "is more a stay of execution than a pardon." It was the Court's decision in *Seminole Rock and Sand* in 1945 that first stated without citing authority that "'if the meaning of [the regulation were] in doubt,' the agency's interpretation would merit 'controlling weight unless it is plainly erroneous or inconsistent with the regulation.'" Ultimately *Seminole Rock* was divorced from *Skidmore.* Some commentators have described the Administrative Procedure Act as '"kind of constitution for our 'administrative state.'" Gorsuch states that the APA the reviewing court must 'resolve for itself any dispute over the proper interpretation of an agency regulation." Giving deference is not the equivalent of deciding a question of law. "In doing so , the court is abdicating the duty Congress assigned to it in the APA." Section 706 of the statute requires de novo review on questions of law. Quoting House and Senate reports on the Administrative Procedure Act. The act "weas intended to 'provid[e] that questions of law are for courts rather than agencies to decide on the last analysis". Quoting Senator McCarran, the Chairman of the Judiciary Committee: "[t]t would be 'hard ...for anyone to argue that this Act did anything other than cut down the "cult of discretion" so far as federal law is concerned.'" Gorsuch further opines: "Not only is *Auer* incompatible with the APA; it also sits uneasily with the Constitution." Quotes Chief Justice Marshall on the duty of the judicial department. "While Members of this Court sometimes disagree about the usefulness of *pre-enactment* legislative history, we all agree that legislators' statements about the meaning of an already-enacted statute are not "a legitimate tool of statutory interpretation,'" much less a controlling one.[97] So why on earth would we give 'controlling weight' to an agency's statements about the meaning of an already-promulgated regulation?" An interpretative methodology that purports to govern "future dispute over the meaning of every regulation should not be entitled to stare decisis as such; it would exceed the limits of what is considered to constitute stare decisis. "[T]he *Auer* doctrine is an abstract default role of interpretive methodology that settles nothing of its own force."

<u>City of Arlington v. Federal Communications Commission</u> [Scalia] Allowing the issue of jurisdiction to be decided under *Chevron* has been compared to "putting the wolf in charge of the hen house". The Communications Act of 1934, as amended, "requires state or local governments to act on wireless applications 'within a reasonable period of time after the request is duly filed.'" The Commission determined that 90 days presumptively, subject to rebuttal, was a reasonable time to process an application to place a new antenna on an existing

tower, and that 150 days was reasonable for the processing of any other applications. The 5th Circuit Court of Appeals held that the statute was ambiguous and that under *Chevron* the 90- and 150-day deadlines were a permissible interpretation of the statute. Reciting the "canonical" *Chevron* formulation, in the presence of ambiguity, the background presumption is that Congress intended the administrative agency to have the task of resolving the ambiguity. Congress speaks in "capacious" terms "when it wishes to enlarge agency discretion". So must a court defer under *Chevron* when the issue concerns the scope of the agency's statutory authority, that is, its jurisdiction. "That premise is false because the distinction between 'jurisdictional' and 'non-jurisdictional' interpretations is a mirage." "In the judicial context, there is a meaningful line." A court's power to decide a case is independent of whether its decision is correct so that a substantively incorrect decision is entitled to res judicata as long as the court has jurisdiction. Colorfully, "[l]ike the Hound of the Baskervilles, it (the dichotomy relating to jurisdiction) it is conjured by those with greater quarry in sight. Make no mistake—the ultimate target here is *Chevron* itself." "But in rigorously applying (step two of the *Chevron* doctrine), a court need not pause to puzzle over whether the interpretative question presented is 'jurisdictional'. If the agency's answer is based on a permissible construction of the statute' that is the end of the matter." [Breyer] Whether an agency has stayed within the bounds of its statutory authority, is a jurisdictional interpretation that is a mirage. [Roberts] Whether an agency has interpretative authority (jurisdiction) must be decided by a court without deference to an agency. Quoting the Federalist papers: "[T]he accumulation of all powers, legislative, executive and judiciary, in the same hands,...may justly be pronounced the very definition of tyranny." This accumulation is "not an occasional or isolated exception to the constitutional plan, it is a central feature of modern American government." "President Truman colorfully described his power over the administrative state by complaining, 'I thought I was the president, but when it comes to these bureaucrats, I can't do a damn thing.'" "[W]e have repeatedly described [jurisdiction] as a word with 'many, too many, meanings.'" Quotes Administrative Procedure Act as "instruct[ing] reviewing courts to decide 'all relevant questions of law.'" We defer to an agency's interpretation under *Chevron* when the Congress "has delegated ...the authority to interpret those ambiguities 'with the force of law.'" This is not ignoring the constitutional command to say what the law is, but rather "simply applying the law as 'made' by the authorized law-making entity." "[A] precondition to deference under *Chevron* is a congressional delegation of administrative authority." "[I]t is fundamental 'that an agency may not bootstrap itself into an area in which it has no jurisdiction.'" Courts should not allow an agency to determine whether the Congress has allocated interpretative authority on a particular statutory provision. It is for a court to determine the boundaries of delegated statutory interpretative authority.

One Herring Boat, Two Herring Boats, "Then a great big fleet of great big boats"[27]

Relentless v. United Staters Department of Commerce[28] Appellate court affirmed district court granting of summary judgment holding that administrative rule promulgated by the National Marine Fisheries Service, a division of the National Oceanic and Atmospheric Administration (NOAA) requiring herring boats to carry monitors on board was not arbitrary and capricious. The agency had the task to promote the sustainability of the nation's fisheries. At times, the vessel owners must procure and pay the government's monitors. The statute under which the agency acted was the Magnuson-Stevens Fishery Conservation and Management Act. Implementing regulations are issued through the notice and comment procedure. The government bears the cost of training and certification of monitors. The agency acknowledged that the cost of industry funded monitors ($710 per day) could reduce vessel returns by about 20 per cent. The district court had held that the familiar two-step analysis of *Chevron* applied. "When Congress says that an agency may require a business to do 'x', and is silent as to who pays for 'x', one expects that the regulated parties will over the cost of 'x'." Appellants argued that the salaries of the monitors was not the typical cost of adhering to regulatory requirements and providing room on the vessel for such monitors is something far sort of paying the cost of such monitors. The appellate court analogies such costs as no different than the costs incurred by a publicly held company to hire independent accountants to audit the company's financial statements as required by the Securities and Exchange Commission. Where the statute provides for the caring of observers it is reasonable for the agency to conclude that its exercise of such authority is not contingent on the payment of the costs of compliance by the government. Citing the Patient Protection and Affordable Care Act of 2010 litigation in *NFIB v. Sebelius,* by forcing the herring boat owners to participate in the market for industry funded observers, there is a violation of the interstate commerce clause similar to being forced to buy health insurance. On the contrary, appellants have chosen to participate in a fishing market that has long been subject to regulation. There is no difference in being forced to buy nets or life preservers or monitoring services.

Supreme Court Oral Argument in *Relentless*

An initial reading of the oral arguments of January 17, 2024 is not particularly illuminating. A second reading, with particular attention to cited cases is clearly more informative.

Roman Martinez, representing *Relentless,* states that "[f]or too long *Chevron* has distorted the judicial process and undermined statutory interpretation", citing three reasons: 1. Violation of Article III of the constitution since that judiciary is empowered to "say what the law is", as *Chevron* has reallocated the interpretative process from the judiciary to administrative agencies where statutory constructions are sometimes based on political or policy reasons. 2. *Chevron*

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[27] Carousel, Rogers and Hammerstein

[28] 62 F.4th 621 (1st Cir. 2023)

also violates the provision in the Administrative Procedure Act whose section 706 requires the courts to provide *de novo* review of legal questions, both statutory and constitutional. 3. The implied delegation theory is based on a fiction that the Congress has silently authorized administrative agencies to provide statutory interpretations. Surely the rule of law requires adherence to the best judicial interpretation as opposed to a permissible administrative agency interpretation.

Justice Thomas notes that appellate courts give deference to the factual determinations of the trial courts. Martinez responds that *Skidmore* is acceptance by its reference to persuasion, which is not controlling the court's decision. *Chevron* deference, on the other hand, is controlling forcing the court to accept the agency's decision in favor of X when the court believes that the best interpretation is Y.

Justice Kagen asks whether a new product promoting healthy cholesterol levels is a dietary supplement or a drug, both are statutory terms.?

Martinez: Responds that that is legal question for a court.

Justice Kagan: Sometimes because of the limits of language or the difficulty in predicting the future, there is a gap in the statute. Who is to fill that gap?

Justice Kagen: Does "power production capacity refer to AC power that is sent out to the electric grid or DC power that's produced by a solar panel?'

Martinez: If an agency has not considered the question, is a court going to say that it's not going to be able to decide.

Justice Kagen: Congress wishes the court "to defer to people who actually know things about these things."

Justice Sotomayor: "I don't know how you *can* say there's best answer when justices of this court routinely disagree at 5-4." "[W]hy shouldn't the person with all the qualities, expertise, experience, on-the-ground execution, knowledge of consequences, why shouldn't deference be given to that entity?"

Martinez (responding to Justice Gorsuch); Under *Chevron,* an agency may overrule a prior court's decision made in the absence of administrative guidance. An agency is also permitted to change its mind a select another reasonable solution. The agency can flip-flop and cause courts to flip-flop with them. "*Chevron* is a reliance-destroying doctrine."

Justice Jackson: You assume that all statutory interpretative questions are legal questions, but *Chevron* prevent courts from becoming involved in policy making decisions, so that if *Chevron* is overruled courts will become involved in policy decisions, which is not the proper function of the judiciary. In the presence of statutory silence, whether the vessels owners must pay the salaries of the observers is not really a legal question, but rather one with policy implications.

Martinez: ::[I]f agency is operating within the range of discretion (what is reasonable mean in the statute),that's arbitrary and capricious review. If the agency is sort of operating at the edges, you have to figure out where the guardrails are. That's the legal question." "[W]hen you're enforcing the text, you come to the same place as our Article III argument, which is that courts have to exercise independent judgment." The Major Question Doctrine (King v. Burwell) demonstrates that *Chevron* has required the court to adjust the doctrine that emanated from the 1984 decision. And, of course, the doctrine is inapplicable when the agency is operating out of its area of expertise.

Justice Kagen: The implicit delegation by Congress to an agency is not simply a fiction, but rather is a presumption. The administrative agencies have political accountability through the elected president. Courts should not decide "issues as to things that they nothing about, courts that are completely disconnected form the policy process, the political process, and you know, that just don't have any expertise and – and experience in an area...."

Martinez: Congress could not codify *Chevron,* as that would be like the Supreme Court how to legislate. That would be an interference with the constitutional framework of these distinct and independent branches. One cannot give away core judicial interpretive authority just as Congress could not tell the president how to exercise his veto and pardon powers. He does not think that overturning *Chevron* would require overturning all the old cases.

Justice Gorsuch: Should we avoid overruling *Chevron* on constitutional grounds.

Martinez: He would certainly welcome a resolution in favor of the herring boats based in the Administrative Procedure Act.

Justice Kavanaugh: Better to speak of *Skidmore* respect, rather than deference.

Martinez: Delegation to agencies should be expressly made by Congress, it should not be presumed. The reliance issue under stare decisis is less under *Chevron* since the agency may change its mind, flip-flop, if you will. "[I]f the question is the meaning of a statutory term, that's an interpretive question, that's a legal question and would be treated as a legal question if you got that exact same question before the agency had acted."

Justice Jackson: A so called legal question may produce conflicting judicial interpretations, while an agency resolution would provide a single uniform rule.

Martinez: In a *Chevron* world there is less likely to be litigation as a potential plaintiff knows that a court's best interpretation is unavailable in the presence of an agency's reasonable interpretation.

General Prelogar: The *Chevron* method of statutory interpretation "is a bedrock principle of administrative law...." Refers to mandamus jurisdiction during Chief Justice Marshall's era concerning "judicial review of executive action in the early republic" to show inconsistency with Article III requiring de novo review. As far as the Administrative Procedure Act requiring de novo review, that assertion is contradicted by the statute's history and precedential interpretations

under *Chevron*. Cannot overrule the precedent when reliance by Congress, agencies, and regulation parties is at its apex. Such action is particularly unwarranted given Congress itself could modify or overrule *Chevron* but has yet to take that step even when given the opportunity.

Justice Thomas: The *Chevron* decision failed to mention section 706 of the Administrative Procedure Act.

General Prelogar: Section 706 does not "prescribe a universal standard of review to govern" statutory interpretations by administrative regulations. Remember that the courts do considerable statutory interpretation under step one of *Chevron*. When Congress has left a gap or ambiguity it has authorized the

Justice Sotomayor: Congress has frequently called for "de novo review: in a statute, but did not do so in the Administrative Procedure Act. The precise language: "[T]he reviewing court shall decide all relevant questions of law...." It would be revolutionary to say that Congress can't limit judicial review." "[T]here is legislation to overrule *Chevron*, requiring de novo review, that hasn't passed."

General Prelogar: Cannot ignore stare decisis as future litigants will assert that the prior decision was based on reasonableness, not which would be the best interpretation of the statute.

Justice Kavanaugh: Refers to footnote 9 of *Chevron:* [9. The judiciary is the final authority on issues of
statutory construction and must reject administrative constructions which are contrary
to clear congressional intent." When one uses the traditional tools of statutory interpretation one always gets an answer, and that must occur when an administrative agency has not yet entered the fray. How would you define "ambiguity"?

General Prelogar: "A court has exhausted the tools of interpretation and hasn't found a single right answer." ""[T]here are some limits of language here and it's not subject to precise mathematical quantification, but that's because I think it's a standard that inherently requires the application of judgment." Step 2 is reached when the court concludes that Congress has conferred discretion upon the agency to take a range of permissible approaches.

Justice Gorsuch: "[E]ven in a case involving herring fishermen and the question whether they have to pay for government officials to be onboard their boats, which may call for some expertise, but it doesn't have much to do with fishing or fisheries, it has to do with payments of government costs." "And the world seemed to continue on its axis just fine" under Skidmore for almost forty years after the enactment of the Administrative Procedure Act. Brand X reminds us that a new administration can come in a provide a different reasonable interpretation. That does not seem to be a recipe for stability. "Do you think that's an appropriate understanding of the law too, that judicial precedents...can be overturned by agencies." "*Chevron* itself ushers in shocks to the system very four or eight years when a new administration comes in, and goes from pillar to post." "That is at war with reliance. That is not stability."

Justice Kavanaugh: A new administration does "it because they have a disagreement with the policy of the prior administration and they're using what *Chevron* gives them and what they can't get through Congress do it themselves, self-help, and to do ti themselves unilaterally, which is completely inconsistent with bicameralism and presentment to get your policy objectives enacted into law."

General Prelogar: "The Major Questions Doctrine is a species" of the kind of statute where Congress has not given the interpretative question to the agency to resolve.

Justice Thomas: Could Congress require courts to give deference to agency interpretations of constitutional provisions as section 706 of the Administrative Procedure Act refers to both the interpretation of statutory and constitutional provisions?

General Prelogar: There has been no longstanding history of courts giving deference to agency constitutional interpretations, which would raise a unique Article III issue. Remember that agencies are directed by Congressional statutory directives to administer a particular statute. But the principle of deference has a long history as "reflected in things like mandamus practice, where virtually all executive action for the first hundred years of our nation's history was reviewed deferentially.

Justice Alito: What would be a concise definition of ambiguity?

General Prelogar: "Ambiguity exists when the court has exhausted the tools of interpretation and hasn't been able to arrive at confidence that there is a right answer that Congress spoke to the issue."

Justice Alito: "[I]n cases that don't involve an agency, we never say we have exhausted all of our tools of interpretation and we just can't figure out what this means. So that would seem to suggest you never get to step two."

Justice Sotomayor: Taking up stare decisis again, *Chevron* per se does not provide holdings to all those previously decided cases because "it's a method only, and we have said in the past that a method that lower courts use is subject to change in – change we can make without considering stare decisis."

General Prelogar: "...here thousands, of decisions that could stand to be displaced and create chaos if *Chevron* is overruled."

Justice Kagen: Without a *Chevron,* 800 district judges will weigh in and "those differences were looking awfully partisan in nature, and *Chevron,* all the empirical evidence suggests, dampens that kind of ideological division between the courts."

General Prelogar: }[O]ne of the reasons why this inference of legislative intent is sound, because agencies can provide that kind of uniform rule for the nation, subject to the ground rules, of course, of judicial review under *Chevron.* ' "You lose the uniformity value, and it diminishes the force of the political accountability value." "[W]hat the history shows at the very least is there

has been no fundamental rule in this country leading up to the APA's enactment that you have to review all questions de novo. And that's where the history of the APA really matters."

General Prelogar: Congress has a reliance interest as it legislates against a *Chevron* background.

Martinez (in rebuttal): *Chevron* should not set the ground rules for how the different branches should operate. That is the function of the constitution. Footnote 11 of *Chevron:*[11. The court need not conclude that the agency construction was the only one it permissibly could have adopted to uphold the construction, or even the reading the court would have reached if the question initially had arisen in a judicial proceeding.] *Chevron* requires a court to follow the agency's interpretation, which is not one the court would have selected. "[A]mbiguity has always been understood as a situation where reasonable people can disagree about what the law means." "There is no reason to believe that because Congress has accidentally left an ambiguity in a statute, that what it's really trying to do is have that ambiguity resolved by policy decisions made by an agency." "[W]e shouldn't be, you know, basing our doctrine and reconceptualizing how we think about statutory interpretation based on this fictional premise." "So the statute (APA) says courts do the interpretation, *Chevron* says agencies get interpretative authority, not courts. These are inconsistent. *Chevron's* not consistent with the APA." Trying to amend the *Chevron* Doctrine without overruling it will place a lot of pressure on the Major Question Doctrine.

One Herring Boat, Two Herring Boats, "Then a great big fleet of great big boats"[29]

Loper Bright Enterprises v. Gina Raimondo, Secretary of Commerce[30] The National Marine Fisheries Service promulgated a rule that required industry funding of at-sea monitoring by government observers. Appellants contend that the interpreted statute does not call for such industry funding and the means by which the rule was promulgated was improper. The summary judgment of the district court is affirmed as the agency's interpretation was reasonable and the requisite notice and comment produced an enforceable rule. "The court's review ... is limited to the familiar questions of whether Congress has spoken clearly, and if not, whether the implementing agency's interpretation is reasonable, citing *Chevron.* The text of the statute is clear as to carrying monitors on board the vessel but is silent as to the issue of the manner of compensation. While the capacious terms of the statute, "necessary and appropriate", give considerable flexibility, the cost of compliance must be evaluated. The direction to minimize costs implies that such costs may be imposed. "Congress' specific authorization of a single fishery program funded by fees paid to the government does not unambiguously demonstrate that the Act prohibits the Service form implementing a separate program in which industry pays the costs of compliance to service providers without any government pass-through." A special industry funding for foreign vessels is not by the canon that specificity excludes the general provide an unambiguous statement as to domestic vessels. The administrative rule for compensation provides a reasonable means by which the statute's objective of fishery conservation is accomplished. It is clear by the attention paid to imposed costs by the agency that its conclusion is not arbitrary or capricious. On the procedural issue pointing to delay in

[29] Carousel, Rogers and Hammerstein
[30] 45 F.4th 359 (D.C. Cir; 2022)

promulgation of a final rule, "procedural errors that are 'technical' in nature and 'therefore harmless' are 'not grounds for vacating or remanding. In addition, 'if a statute does not specify a consequence of noncompliance with statutory timing provisions, the federal courts will not in the ordinary course impose their own coercive sanction.'" The dissenting judge states that the Magnuson Stevens Act does not unambiguously force the fishermen to pay the wages of federal mandated monitors.
The dissent asserts that statutory silence indicates a lack of authority. The burden on the issue should bear upon the agency. Unlike the additional fuel cost for a heavier boat or surrendering a sleeping bunk for an eliminated crew member, the salary of a monitor do not necessarily follow from the requirement of an on board monitor. The "necessary and appropriate" measures relate to items other than compensation of the monitors." "[C]ould the agency require the fishermen to drive regulators to their government offices if gas gets too expensive." The power of the purse by Congress should not be undermined. "It is hard to believe that, when Congress decided to *explicitly* allow industry-funding for observers in one way (fees) in one place (the North Pacific), it also decided to *silently* allow all fisheries to fund observers in any other way they choose."

Supreme Court Oral Argument in *Loper Bright Enterprises*

The second oral argument was hardly repetitive of the first argument.

Paul Clement (for Solicitor General of the United States) "[F]or my clients, having to carry federal observer on board is a burden, but having to pay their salaries is a crippling blow." Argues that both constitution avoidance principles and the Administrative Procedure Act call for de novo review. "The whole point of statutory construction is to bring clarity, not to identify ambiguity." Stare decisis is not an adequate reason for not the best read of the APA. Further, the *Chevron* methodology is entitled to a reduce stare decisis effect. The *Chevron* doctrine is unworkable "as its critical threshold question of ambiguity is hopelessly ambiguous. "It is also a reliance-destroying doctrine because it facilitates agency flip-flopping." "Footnote 9 (of *Chevron)* tells you clearly as you can what you're doing in a *Chevron* case is statutory interpretation. But then, in footnote 11, it says, at a certain point, you stop doing statutory interpretation, even though you think there's a better answer, and you defer to a different branch of government." *Chevron* is egregiously wrong from an Article III perspective.

Justice Sotomayer: "[I]f the statutes uses 'reasonable", that Congress is delegating the definition of 'reasonable" to the agency." "[But, we do delegate, we have recognized delegations toa agencies form the beginning of the founding of interpretation."

Clement: "[N]obody knows where step tow ends and step two begins."

Justice Kagan: "[W]e have lots of presumptions that operate with respect to statutory interpretation, and this is just one of them/" The answer is often policy-laden judgments which should be left to an agency, not a court. The House of Representatives "can reverse *Chevron* tomorrow with respect to any particular statutes and with respect to statutes generally, and it hasn't."

Clement: [I]t's really convenient for some members of Congress not to have to tackle the hard questions and to rely on their friends in the executive branch to get them everything they want." "[A]mbiguity is not always a delegation." "I'm going to leave it ambiguous, that how we're going to get over the bicameralism and presentment hurdle, and then we'll give it to my friends in the agency and they'll take it from here." "They don't' get addressed because *Chevron* makes it so easy for them not to tackle the hare issues and forge a permanent solution." "But the reality is the kind of uniformity that you get under *Chevron* is something only the government could love because every court in the country has to agree on the current administration's view on a debatable statute."

Justice Alito: Was *Chevron* so initially popular "because ti would take judges out of the business of making what essentially policy decisions [?]"

Clement: Skidmore "is not actually a deference doctrine. Call it a doctrine of weight or persuasiveness/"

Justice Kagan: :"Skidmore is not a doctrine of humility, but *Chevron* is." "[A]gencies know things that courts do not. And that's the basis of *Chevron.*"

Clement: "[W]hen the question is judicial methodology, I think it's very weird to ask Congress to fix your problem for you. I don't think you actually want to invite, in all candor, that particular fox in your hen—henhouse...."

Gorsuch: "[L]ate in life, [Justice Scalia} came to regret that decision (*Chevron).* What do we make of that lesson about humility?"

Clement: Justice Scalia has sad that the decision in *Chevron* was completely heedless of section 706 of the APA."

Justice Kavanaugh: If an agency changes its position every four years, *Chevron* may support a decision, but Skidmore will not.

Clement: "*Chevron's* the only one I know that says that at a certain point you just stop de novo stuff and you sort of surrender, even under circumstances where, if the agency weren't a litigant, you would keep going."

Justice Barret: What effect will overruling *Chevron* have on the Major Questions Doctrine?

General Prelogar: Petitioners have conceded that Congress can expressly delegate to administrative agencies the power to issue regulations interpreting statutes. That complies with Article III of the constitution as such delegation to fill gaps and remove ambiguity allows the executive branch it gave core Article II authority. What Congress can do explicitly; it can do implicitly. There may be of course an issue in the latter as to whether an order to promulgate regulations has actually been made.

Justice Thomas: "[H]ow do we discern statutory delegation from statutory silence"?

General Prelogar: The statute having expressly authorized the placement of monitors, "the residual authority to enact necessary and appropriate terms in these fishery management plans. So we don't think that this is a case about silence at all." The District of Columbia Circuit "in Loper Bright acknowledged that, ultimately, it couldn't conclude with confidence that the statute definitely authorized the agency explicitly."

Justice Gorsuch: "Yeah, because we have this ambiguous ambiguity trigger that nobody knows what it means."

General Prelogar: "and (Congress) necessarily recognize[s] that the agency is going to have to fill the gap along the way, it is perfectly sensible to preclude that Congress would want the agency to do it." "[T]here is a presumption here that Congress intended it to be the agency but always subject to those guardrails about making sure the agency's construction is reasonable."

Justice Sotomayor: "Mr.. Clement suggested that we should ignore *Chevron* because it didn't deal with 706. Do you have a theory as to why it didn't address 706...."

General Prelogar: "706 has never been understood at any time, at the time it was enacted or in any of the eight decades since, to have dictated a de novo standard of review for all statutory interpretation questions." The Supreme Court, in all its cases, has not recognized the existence of a tension between the APA and Chevron. "So my understanding is about half the states still have something akin to a principle of deference." "But I acknowledge that some states have abolished any form of deference to administrative agencies. I do think there is a lot less concern at the state level about the lack of uniformity or consistency...." In states, the political accountability rationale es absent because many state court judges are elected.

Chief Justice Roberts: When an administrative agency interpretation raises a constitutional issue, is *Chevron* still applicable?

General Prelogar: In such a case a court may be able to apply the canon of constitutional avoidance.

Justice Gorsuch: Often the government seeks deference for administrative adjudications which or course does not involve notice and comment which may accompany administrative rules.

General Prelogar: *Chevron* is one of the most frequently cited decisions of the Supreme Court. With Congress not having chosen to displace it. Congress legislates knowing that gaps and ambiguities will be dealt with at the administrative level. So the implicit grant of interpretative authority is hardly a fiction, but more like a presumption. "It matters that Congress hasn't sought to change *Chevron* in any kind of fundamental way" Step one of *Chevron* should be applies with more rigor, that is, the ambiguity flag should not be raised to readily. "Don't give up just because the statute id dense or had to parse .Instead, there are a lot of hard questions out there that can be solved and reveal Congress' intent if the court applies all of the tools and really exhausts them." At step two "reasonableness" does not mean that anything goes. Disagreeing with Justice Gorsuch, such step two standard does not just mean that the government wins. Remember that the presumption in step two is rebuttable. As to changes in interpretation, "Congress would want

to give the agency the ability to adapt of changing circumstances, to new factual information, or to the experience its accumulated under the prior program."

Clement (in rebuttal): "I can't think of anything that's more antithetical to an intelligible principle than ambiguity and silence" "'Reasonable' is a term of capaciousness and elasticity. 'Telecommunication service' is not. Good old-fashioned statutory interpretation can do the job." "Expertise and deference do not have to go hand in hand in a way that precludes de novo review. We have things called bankruptcy courts. We have things called bankruptcy courts. We have the Court of International Trade. They all deal with technical specialized issues. Every one of them, the legal questions are reviewed de novo. That's the basic understanding with a statute like section 706." "*Chevron* imposed a two-step rubric that was fundamentally flawed. The right answer here is a one-step rubric that simply asks how is the statute best read."

Chief Justice Roberts: "The case(s are) submitted."

Subcommittee on Regulatory Reform, Commercial and Anti-Trust Law of the Committee on the Judiciary House of Representatives

The *Chevron* Doctrine: Constitutional and Statutory Questions in Judicial Deference to Agencies

The hearing took place on Tuesday, March 15, 2016. Chairman Marino stated that "the 30-plus-year-old *Chevron* doctrine presents interesting questions on the current state of the separation of powers, and the role of today's administrative state....[H]as judicial review of agency action evolved in a manner that respects the Constitution and the roles intended for the legislative, executive, and judicial branches? If there are issues, what can and should Congress do to address them?"

The Chairman quotes Chief Justice Marshall in Madison v. Marbury: "It is the province and duty of the judicial department to say what the law is." Administrators of the legislative process have become legislators themselves. "[A]s long as *Chevron* stands, it still will; not eliminate the opportunity and incentives for unelected bureaucrats, removed from the effects of their actions to set policy for our entire nation."

Ranking Member Johnson: As is true of the administrative law section of the American Bar Association, "I similarly opposed any attempt to abolish judicial deference through legislation." "These proposals, which are transparently the design of the donor class to minimize their exposure to legal accountability, are just another example of how some not only want to allow the fox to guard the chicken coop, they want the fox to install the chicken wire as well."

Chairman of the Judiciary Committee Goodlatte: "In the Administrative Procedure Act of 1946, often called the 'constitution' of administrative law, Congress provided for judicial review of agency action in terms, like Marbury, were plain and direct. It stated that 'the reviewing shall decide all relevant questions of law [and] interpret constitutional and statutory provisions[.]"

Quotes Madison in Federal 47: "[T]he accumulation of all powers, legislative, executive, and judiciary, in the same hands may justly be pronounced the very definition of tyranny."

The witnesses consisted of six full professors of law, all authoritative experts in the field of administrative law:

Jonathan Turley (George Washington University) "I'd like to say , as Woody Allen once said; 'I wish I could think of a positive point to leave you with. Will you take two negative points.'" "In 2007, Congress enacted 138 public laws, in that same year federal agencies enacted about 3,000 rules. To put it in a judicial standpoint, judges that year in a given year handled about 100,000 cases. Federal agencies have adjudicatory proceedings ranging around 1 million." "[T]he most problematic aspect[] of *Chevron* is seen in the City of Arlington case where the deference was given to an agency in defining its own jurisdiction." Two negatives do not make a positive, at least from a Madisonian perspective. "If the [Supreme] Court were judged under the medical standard that the first duty is 'to do no harm', *Chevron* would be viewed as nothing short of legal malpractice." It is the fourth branch, the Administrative State, not the Congress, "which now functions as the dominant 'law giver' in our system." "In the APA, Congress specifically instructed courts to decide 'all relevant questions of law. When read in combination with the APA, *Chevron* reads as much a delegation of judicial function as legislative function." "As noted by Chief Justice [] Roberts. '*Chevron* importantly guards against the judiciary arrogating to itself policymaking properly left, under the separation of powers, to the executive.'" "Even though Congress can override agency decisions, it is unrealistic to expect millions of insular corrections to be ordered over agency decisions." "[U[nder the concept of '*Chevron* Step Zero', the court first inquires into whether Congress delegated the authority (to make rules having the force of law) before applying *Chevron* deference." "The most obvious avenue for limited or even eliminating the *Chevron* doctrine is through judicial action. After all, the doctrine is the creation of the Court and , while certainly reflecting constitutional values, it not imposed by any constitutional provision." The Congressional Review Act has had little effect in regaining control over agencies as it requires both houses to pass resolutions of disapproval and the president had to sign the law. "The APA could be altered to expressly reject any claimed presumption of delegation and to reject the application of the *Chevron* standard absent an express standard of deference given to an agency." "Putting aside the APA, Congress could also use a standard provision to add to statutes that expressly denies any delegation of authority to agencies to determine their jurisdiction."

John F. Duffy (University of Virginia) "If the Court considered statutory law, it would have found that the first sentence of section 706 of the APA requires the reviewing court to decide all relevant questions of law. And it would have found that the text structure, legislative history and a consistent line of judicial precedence all supported reading that sentence as requiring de novo review of agency interpretations." Legislation should "make clear that the agency's power is grounded in the congressional delegation and not in deference. Congress might also consider recognizing the traditional view that some administrative issues are mixed questions of law and fact, the courts might properly give some deference to the agency's application of law to the facts

of a particular case." "There is one argument that does avoid a conflict between *Chevron* and section 706. Under this view, *Chevron* is a presumption that any statutory ambiguity should be interpreted as implicitly delegating to the administrative agency with jurisdiction over the statute, the lawmaking authority necessary to resolve the issue." "The Court should need not and should not have relied on any sort of 'implicit' delegation theory." "[T]he Congress should reassert, in the clearest possible terms, that reviewing courts are to decide all questions of law de novo, without any deference to administrative agency positions." "[M]ake clear that the agency's authority should be grounded on the existence of delegated rulemaking powers, not on the agency's supposed superior abilities at statutory interpretation." "Congress might consider recognizing the traditional view that, in formal agency adjudicatory proceedings, some issues decided by the agency are not pure issues of statutory interpretation but are instead mixed questions of law and fact."

George Shepherd (Emory University) The Administrative Procedure Act was a compromise intended to state what the law was prior to enactment, that is, to codify the existing administrative common law, not to enact new law. "*[C]hevron* and the later decisions that interpreted it broadly are wrongly decided, in the following sense: the system of deference that the decisions establish even for agency's decisions of pure law conflicts with the commands of the APA." "The [statutory] provisions say nothing about giving deference to the agencies' interpretations. The courts are simply required to 'decide all relevant questions of law.'" "For many years, memories of the APA's true meaning were fresh. Only when memories start to fade, or to die out, did it become possible for the courts to adopt an approach that ignored administrative law's fundamental statute."

Richard J. Pierce (Washington University) "[Justice Scalia, who was the strongest proponent of *Chevron*] is the justice who votes least frequently to uphold agency actions. By contrast, Justice Breyer, has always been a strong critic of *Chevron* , and he's the justice who votes most frequently to uphold agency actions." Since the degree of deference has been going down over the last several years, there is no lead for legislative action. "The Administrative Procedure Act (APA) divides rules into several categories. The most important type of rules is often called a legislative rule, because, if it is valid, it has the same legally binding effect as a statute. Subject to some exceptions, an agency cannot issue a legislative rule without first conducting a notice and comment proceeding." Interpretative rules are exempt from the notice and comment procedure. Reminiscent of the writ of mandamus Going back to the late nineteenth century, "[a court could review an action taken by the executive branch (or a refusal to act) only in the rare case in which a statute compelled an agency to act in a particular manner. In that situation, the court was simply requiring the agency to take a non-discretionary ministerial action." "Since there is only one agency and many circuit courts, [the] increased rate of upholding agency statutory interpretations necessarily produced increased geographic uniformity in interpretation of national statutes." *Chevron* is controversial when a new administration changes a statutory interpretation as long as such changed interpretation is reasonable. Skidmore remains alive and well and was not replaced by *Chevron.* Auer decided by the Supreme Court held that *Chevon*-like deference is given to an agency's interpretation of its own regulations. Unlike Congress,

"[c]ourts are in the best position institutionally to make the kinds of changes in legal doctrines that would have a realistic chance of improving the legal framework within which agencies make rules and the quality and timeliness of the resulting rules."

Emily Hammond (George Washington University) "[T]here are important reasons for giving deference to the agencies. Agencies have experience with the statutes they administer. Relative to the courts, agencies have superior expertise, particularly with respect to complex scientific and technical matters. And deference is an exercise in judicial self-restraint. By deferring to agencies' reasonable explanations, rather than substituting their own judgments, the unelected courts can avoid injecting their own policy preferences into judicial review." FDA v. Brown & Williamson and King v. Burwell are illustrative of the few instances where Congress did not want agencies to exercise interpretative authority,. "[A]lthough this system is imperfect; a legislative fix is unlikely to improve the system and would likely have the opposite effect." "Congress can craft substantive statutory language more tightly if it wants to cabin an agency's discretion in carrying out its mandate." "No legislative standard can account for all of the variety in administrative law, and a piecemeal approach would severely interfere with the balancer between and among the deference doctrines and remedies."

Jack M. Beermann (Boston University) "[O]ne of the effects we need to think about is the fact hat it encourages agencies to be more adventurous in their statutory interpretations so that regardless of what the result is going to be at the court, the agencies can feel that they can go farther away from Congress' expressed intent when they are interpreting a statute." "Are *Chevron* decisions about policy or about statutory interpretation?" "Now, one important point about this, Justice Scalia, in his defense of *Chevron*, was very concerned about flexibility. He viewed one of the virtues of *Chevron* that it preserved agency flexibility to change its views as conditions warranted." The Administrative Procedure Act text "strongly implies that Congress expected the federal courts to play a strong role ensuring that agencies follow Congress' statutory commands." "It is in this light (prior Supreme Court decisions) that the APA's language was understood by some to assign the primary role in statutory construction to the reviewing courts." "[T] he Administrative Procedure Act did not merely express a mood that questions of law are for the courts rather than agencies to decided—it so enacted with explicit phraseology." "In my view, major decisions concerning the distribution of authority among the branches of the federal government should not be based on fiction (presumed Congressional intent to assign interpretative authority)." "But with regard to the vast majority of statutes, there is no reason to believe that ambiguity or incompleteness implies delegation to an agency." "The Supreme Court has, on occasion, states that *Chevron* step two is the equivalent of judicial review of the wisdom of agency policy under the arbitrary, capacious standard." "*Chevron* was wrong to equate silence and ambiguity with delegation of lawmaking power and Mead is incorrect when it equates procedural formality with delegation of lawmaking power." Recommendation of statutory reform adding the following provision to section 706 of the APA. "Unless expressly required otherwise by statute, the reviewing court hall decide all questions of law de novo, with due regard to the views of the agency administering the statute and any other agency involved in the decision-making process." "Concerns over excessive deference would be met by application

of the Skidmore factors, informed by fidelity to Congress' expressed preference for less deference than has been the case under *Chevron.*"

The Administrative State Has Stimulated Whole Book Responses

The *Chevron* Doctrine: Its Rise and Fall, and the Future of the Administrative State by Thomas W. Merrill (Harvard University Press; 2022)

Professor Merrill, a scholar of Columbia Law School, has been a *Chevron* commentator for decades. A few references to his book and those of two other legal scholars are now provided below (quotation marks omitted):

1. Justice Kennedy said he was troubled by what he perceived to be the "reflexive deference" accorded to agency interpretations by lower courts based on "cursory analysis".
2. Donald Elliott, who previously served as general counsel of the Environmental Protection Agency, has maintained, agencies began to see less need to go to Congress to secure new statutory authority because they could simply reinterpret existing law to reach the desired result.
3. Virtually every statute is unclear or silent on many points.
4. The *Chevron* doctrine may countenance one of the largest transfers of political power in our history, from Congress to the executive. One might think that would require a constitutional amendment, not a decision of the Supreme Court.
5. Critical comments about the *Chevron* doctrine by then Judges Neil Gorsuch and Brett Kavanaugh seem to have played a role in their nomination to the Supreme Court by President Trump.
6. The Separation of Powers Restoration Act has passed twice in the House of Representatives but was not taken up by a Democratically controlled Senate.
7. The Supreme Court after 2016 effectively stopped applying the *Chevron* doctrine as a reason to uphold an agency interpretation. A decision by the Court to overrule the *Chevron* doctrine seems unlikely.
8. One objective of the book is to suggest what form reasonable modifications of the doctrine might take.
9. A better approach is to try to figure out where agencies have a comparative advantage and where courts have a comparative advantage.
10. Adrian Vermeule concedes that a serious constitutional question would arise if Congress said that agencies, rather than courts, will decide if there is an ambiguity in the law.
11. When it comes to interpretation of the constitution, no court is going to accept what an agency says. Constitutional values would tend to fall into three categories: individual constitutional rights, separation of powers, and federalism.

12. Those who object to the *Chevron* doctrine assert that Marbury stands for the proposition that the judicial power vested in the courts by Article III cannot be shared.
13. But outside the context of foreign and military affairs (and arguably immigration) , the conventional understanding is that the President, no less than many administrative agencies, can exercise only those powers that have been delegated to the executive by Congress pursuant to the Necessary and Proper Clause.
14. One possibility is that the Constitution gives Congress the exclusive power, if it does not set policy itself, to delegate authority to another institution, like the President, the courts, or an agency to set policy in a legally binding fashion. Congress, one can say, has exclusive authority to decide who decides.
15. The established formula is that delegation is permissible as long as the statute lays down an "intelligible principal" for the agency to follow.
16. If we want interpretations that involve discretionary interpretative choice to be made by the relatively more accountable decision maker, and the relevant choice is between an agency and a court, the agency wins hands down.
17. Expertise was implicitly regarded as scientific, neutral, and apolitical, and hence as something that had to be shielded from crude political actors. In other words, expertise was seen as incompatible with accountability.
18. Consider how to fix the money supply to provide the proper balance between inflation and employment. The public does not want these sorts of decisions made by White House operatives or by judges with law degrees.
19. One is whether the agency has followed a process that provides a meaningful opportunity for public participation before the interpretation is adopted. The other is whether the agency has offered
20. The "attractive simplicity" of the *Chevron* doctrine is undoubtedly the primary reason for its popularity over the years with lower courts and administrative lawyers.
21. The agency should be free to change its mind in the future, if it provides a cogent reason for modifying its interpretation.
22. Clarity in step one and reasonableness in step two are of indeterminate nature.
23. Justice Stevens made clear he regarded his *Chevron* opinion as essentially a restatement of existing law. This remained his position for all his remaining years on the Court. Stevens never changed his view that *Chevron* did not apply to pure questions of law.
24. The *Chevron* story reveals a remarkable course of legal evolution in which a decision regarded by the Supreme Court as business-as-usual was interpreted by one of the courts of appeals as effecting a fundamental change in the law—and then the Supreme Court gradually acquiesced in this understanding.
25. Sometimes the doctrine has been described in opinions as "well settled"; sometimes it has been completely ignored. Sometimes it has been treated like a canon of tnterpretion to be used at the discretion of the opinion writer; sometimes it has been regarded as a binding rule of law. A Court that is ambivalent about a legal doctrine is unlikely to invest significant effort in clarifying it.

26. One can imagine a statute that does not address the precise question but contains a general principle that renders the answer clear. Title VII of the Civil Rights Act contains not a word about discrimination based on sexual orientation, but a divided Supreme Court has concluded that the statute's prohibition on sex discrimination logically compels the conclusion that discrimination bases on sexual orientation is also prohibited.
27. The *Chevron* opinion also said nothing about what is included in the reference to the "traditional tools of statutory construction". Unsurprisingly, disputes arose as to what is and what is not properly included in this category. Whether substantive canons of interpretation should be included in the toolbox, such as the canon that courts should interpret statutes to avoid constitutional questions.

Is Administrative Law Unlawful? by Philip Hamburger (The University of Chicago Press; 2014)

Professor Hamburger is also a scholar at the Columbia Law School that challenges the legitimacy of the administrative state, essentially challenging the existence of a branch of government not within the terms of our written constitution that consolidates the powers of the three explicit branches.

1. "Is administrative law unlawful?" The first sentence of the first page of the 635 page tome.
2. The federal government traditionally bound the people only through acts of Congress and judgments of the courts.
3. Although the mode of power is unrecognized by the Constitution, it has become the government's primary mode of controlling Americans, and it increasingly imposes profound restrictions on their liberty. It therefore is time to reconsider the lawfulness of administrative law.
4. Nowadays, however, the executive enjoys binding legislative and judicial power. First, its agencies make legislative rules dictating what Americans can grow, manufacture, transport, smoke, eat, and drink. Second, the agencies make binding adjudications—initially demanding information about violations of the rules, and then reaching conclusions about guilt and imposing fines.
5. Instead, what is questioned under the rubric of "administrative" is the executive's exercise of binding legislative and judicial powers.
6. Incidentally, although administrative power is centrally an executive venture, it is not exclusively executive. For example, the Tax Court is a nonexecutive tribunal that binds members of the public outside the regular courts and thus exercises administrative power.
7. The history of administrative law, however, reaches back my centuries. Indeed, this sore of power, which is said to be uniquely modern, is really just the most recent manifestation of a recurring problem. It thus is not a coincidence that administrative law looks remarkably similar to the sort of governance that thrived long ago in medieval and early modern England under the name of the "prerogative".
8. Thus book therefore like the god Janus looks both backward and forward, searching the past to recognize the nature of the present, if not quite the future.

9. Nonetheless, prerogative power has crawled back out of its constitutional grave and come back to life in administrative form.
10. The liberty established by the Constitution is a liberty under law, not a liberty under administrative fiat.
11. Although it is said that administrative power is a necessary response to the complexities of modern society, this argument is remarkably close to the old suggestion about the necessity of the prerogative, and once again such an argument justifies a consolidated power profoundly at odd with the nature of modern life and liberty.
12. The necessary and proper clause makes clear that Congress cannot use the clause to shift the legislative and judicial powers to other institutions.
13. Accordingly, the grant of legislative powers to Congress clearly prohibits any executive exercise of such power, and the grant of judicial powers to the courts clearly forbids any executive adjudication. A further apology for administrative power comes in the mantra that it is subject to judicial review. But this is no excuse for constitutional violations prior to judicial review. Nor is it an excuse for the deference that passes as judicial review.
14. Far from offering reassurance, congressional delegation and judicial review have become fig leaves that cannot cover up the reality of nearly independent administrative power.
15. Administrative law therefore should be recognized for what it is. It is a version of absolute power, although it is mild compared to other versions, it is more than bad enough.
16. As put by Justice William Howard Taft, an administrative tribunal is "miscalled a court."
17. Although the judges must recognize the power established by law in the other branches of government, they cannot show deference to the other branches of government, without giving up their own, independent judgment and recognizing a power above the law.
18. It questions the tendency to justify administrative law in terms of necessity—the old excuse for absolute power.
19. The scholarship questioning the constitutionality of administrative law reveals that such law violates the separation of powers, bicameralism, due process, judicial independence, and jury rights.
20. Scholars often bluntly admit that administrative law constitutes a fourth type of power—the suggestion being that it is new and that it therefore could not have been anticipated by the Constitution. And this is significant, for it openly recognizes administrative power as a power distinct form those granted by the Constitution.
21. Necessity therefore has long been the intellectual foundation for absolute power.

Law's Abnegation by Adrian Vermeule (Harvard University Press; 2016)

1. The long arc[31] of the law has bent steadily toward deference—a freely chosen deference to the administrative state. Law has abnegated its authority, relegating itself to the margins of governmental arrangements.
2. In area after area, lawyers and judges have come to the view that administrators have broad leeway to set policy, to determine facts, to interpret ambiguous statutes, and even—in an intolerable affront to the legal mind—to determine the boundaries of the administrators' own jurisdiction, acting as "judges in their own cause".
3. The last and greatest triumph of legalism was that the law deposed itself.
4. It leaves judges in possession of a nominal supremacy, reigning without ruling, like a Frankish king who does whatever his own Mayor of the Palace suggests.
5. Judges are the rois faineants (do nothing) of the administrative state, with the difference that they have voluntarily ceded power.
6. I make no claims about what law's role ought to be from the standpoint of eternity.
7. The curious silence of Ronald Dworkin, one of the great legal theorists, essentially ignored the administrative state , so thoroughly that one suspects it had to be a case of willful blindness. Reading Dworkin's corpus one would hardly know that the administrative state existed.
8. Dworkin knew a mortal threat to law's empire when he saw one but elected to remain silent, hoping the danger would somehow pass. "Courts are the capitals of law's empire, and judges are its princes."
9. But the administrative state threatens law's imperial sway. It threatens to relegate courts and judges to a lower status, as marginal officials who are stationed in the outlying provinces and are charged with patrolling the very outermost boundaries of executive authority, but who are no longer central actors—no longer the guardians of principle.
10. Margaret Allars, an Australian law professor, argues that the deference principal cannot be squared with Dworkin's "law as integrity", which presupposes that judges can find a single right answer even in hard cases.
11. By and large courts have become marginal actors highly deferential to the administrative state, with occasional exceptions that are more salient than consequential.
12. The arc of administrative law and judicial review has bent toward deference at least since 1932.
13. The long-term trend of judicial deference to agency legal interpretations that predates *Chevron* by many decades and which persist in de facto form even if *Chevron* were overruled de jure.
14. The tension is that the classical system of separated powers if it were abolished would in all probability be created again, in a kind of eternal recurrence.[32]
15. As midwife , legal scholars can help to "shorten and lessen the birth-pangs' as the administrative state is born from the womb of law.

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[31] "[T] he arc of the moral universe is long but it bends toward justice." Dr. Martin Luther Kings, Jr. Speech given at the National Cathedral , March 31, 1968.

[32] "There is no question of returning to the pre-1968 situation, if only for the reason that the pre-1968 situation include the conditions that led to 1968." Valery Giscard d'Estaing

16. After all, no one has ever drawn clear and crisp distinctions among fact-finding, law-interpretation, and policy-making.
17. Federal courts now also defer heavily to administrative agencies on questions of law, in virtue of the 1984 decision in *Chevron.*
18. The demise of de novo judicial review of legal questions, which was an unquestionable element of the judicial power, is papered over by the legal fiction that Congress itself generally intends to delegate law-interpreting power to agencies.
19. The delegation fiction is modern administrative law's equivalent to the fiction that the Queen-in-Parliament still rules England—although she is bound always to act on the advice of her ministers.
20. The "major questions" canon is invoked episodically and unpredictably, and so far in a mere handful of cases.
21. King v. Burwell was of course merely the latest by-product of a titanic partisan struggle the Affordable Care Act, one that has resonated through the agencies and courts for years now. Great case—int the sense of cases with maximum political salience—make bad law.
22. So far, however, there is no indication whatsoever that the Court as a body has any interest in overruling *Chevron.*
23. Judicial deference to administrative interpretations of law, in various forms and with various weights, preceded *Chevron* by decades, in a kind of twilight between de jure and de facto ; the case law was inconsistent, but deference was always one major stand.
24. The only civil cases that must be committed exclusively to Article III courts exercising the "judicial power of the United States" are pure common-law claims between private parties A and B, claims that are not ancillary to an administrative cause of action in the case.
25. Agencies' power to determine their own jurisdiction would make agencies "judges in their own cause"—so the thinking ran.
26. The administrative state has at least five features that cannot be squared with the original Constitution: (1) the vastly increased scope of federal governmental powers under Article I, particularly the Commerce Clause; (2) massive delegation from Congress to the President and bureaucracy, amounting to de facto transfer of legislative power to nonlegislative officials; (3) the creation of independent agencies, which is said to be inconsistent with the "unitary executive" created by Article II; (4) the vesting of adjudicative power in executive agencies, subject only to deferential review by Article III judges; (5) and the combination of legislative (rulemaking), executive, and adjudicative functions in administrative agencies.
27. The institutional scheme of 1789, in other words, created the means of its own supersession.
28. But at a minimum, there is no evidence-based reason to think that the arbitrariness review of the APA creates a strong check on agencies.

29. Some critics never come to grips with the problem of abnegation, the brute fact that everything they deem inconsistent with Constitution if 1789 emerged through and by means of the very Constitution, not despite it.

Ratio Decidendi[33]

It would certainly appear that a decision in the two herring boat cases will not have been handed down by the United States Supreme Court at the time of the instant presentation. Prognostication in the field of Supreme Court of the rendition of decisions is an uncertain exercise at best. The presenter's father was fond of repeating the following event occasioned by his clients: "Mr. Ingber are you sure?" Response: "The Supreme Court splits five to four and you seek some degree of certainly." In a fine judicial biography, Super Chief, by the aforementioned Professor Bernard Schwartz, the following judicial truism was revealed: In reading an entertaining book of considerable legal scholarship by Professor Bernard Schwartz, *Super Chief Earl Warren and His Supreme Court-A Judicial Biography* (New York: New York University Press 1983), the author first became aware of Justice Robert Jackson's pithy description of the Supreme Court's role in the legal hierarchy: "However, reversal by a higher court is not proof that justice is thereby better done. There is no doubt that if there were a super-Supreme Court, a substantial proportion of our reversals of state courts would also be reversed. *We are not final because we are infallible, but we are infallible only because we are final.*" (Emphasis added) *Brown v. Allen,* 344 U.S. 443, 540 (1953).

So time to plunge into the currently unknown judicial waters. At first I was inclined to favor sustaining the 1984 *Chevron* decision recognizing that the overruling of precedence speaks more strongly in the continual context where Congress lacks the power to change the law. But upon reading the comprehensive books of Professors Merrill, Hamburger, and Vermeule and the considerable scholarship contained in innumerable law review articles.

The administrative state is here to say. Textualist might argue that nowhere in the words of the constitution is one able to find a possibility for the creation of a fourth branch of government. Being neither an originalist nor a textualist, although I am more inclined on occasion to side with the latter, I believe in a constitution that the founding fathers, a group of wise and experienced lawyers, believe could only survives centuries of application if that document have the capacity of adapt to changes wrought by a future that could hardly be envisioned.

I am not particular persuaded by the politically accountable argument. The notion that the reasonable statutory interpretation of an administrative agency could be changed to another

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[33] Black's Law Dictionary: [Latin "the reason for deciding"] 1. The principle or rule of law on which a court's decision is founded <many poorly written judicial opinions do not contain a clearly ascertainable ratio decidendi>. 2. The rule of law on which a later court thinks that a previous court founded its decision; a general rule without which a case must have been decided otherwise <this opinion recognizes the Supreme Court's ratio decidendi in the school desegregation cases>

reasonable interpretation forthcoming from a new politically victorious administration that seeks to provide a particularly persuasive element. I understand the rationale for such a position as it is based that the administrative agency is performing a legislative function that is surely dependent on the popular will of the electorate. But the administrative agency is also performing a judicial like function of statutory interpretation that should be dependent on more stable and continuing considerations. After all, the entire Article III function is carried out by a branch that was not meant to politically sensitive given the lifetime appointment and salary restrictions applicable to all federal judges.

Modern society, scientifically, technologically, and economically, requires the expertise and experience of administrators that are thoroughly familiar with the terribly complex statutes assigned to their daily administration. District court and appellate court judges assigned to cases interpreting complex statutory provisions lack the kind of statutory familiarity that the interpretative process calls forth. There is no need for compelled and controlled deference. The elements of Skidmore persuasiveness so accurately described by Associate Justice Jackson. Rigid deference by a non-judicial branch seems to inflexible to me and defies Marbury's direction that the judicial department is entrusted with the sacred task of telling the citizenry "what the law is".

From a scorecard perspective, I believe that Justices Thomas, Gorsuch, Kavanaugh, and Alito have previously expressed their views. Presumably, the liberal side of Jackson Brown, Kagan, and Sotomayor will vote to after the two lower appellate court decisions. Accordingly, it is up to Chief Justice Roberts and Associate Justice Amy Coney Barrett to decide which side shall prevail.

CHAPTER 6

PARTNERSHIP LIABILITIES

§ 1. Overview

Section 752 maintains parity between inside and outside basis by coordinating adjustments to the partners' outside bases with increases and decreases in partnership liabilities. The linkage between inside and outside basis is especially important in ensuring that items of deduction attributable to partnership liabilities flow through to the same partners who have outside basis reflecting the underlying liabilities. A partner who is allocated a deduction attributable to a partnership liability generally must be allocated a corresponding share of the liability. A partner's share of partnership liabilities is also important for purposes of determining gain or loss upon sale of his partnership interest under § 741 and the treatment of partnership distributions under § 731. See Chapters 8 and 9.

The former § 752 regulations (pre-1988) allocated partnership liabilities in a relatively straightforward manner. Recourse liabilities were generally shared by general partners in accordance with their loss-sharing ratios, while nonrecourse liabilities were shared by all partners, general and limited, in accordance with their profit-sharing ratios. Former

Reg. § 1.752–1(e). While the former liability-sharing rules were easily stated, they sometimes invited manipulation and gave rise to uncertainty in the case of complex commercial arrangements. In particular, the former regulations failed to resolve problems arising from side agreements requiring limited partners to satisfy partnership liabilities. See Raphan (1985). The current § 752 regulations reflect the Treasury's response to a 1984 congressional mandate to revise the liability-sharing rules "to ensure that the partner receiving basis with respect to a partnership liability ... bears the economic risk of loss with respect to such liabilities."

The § 752 regulations coordinate the liability-sharing rules with the economic effect analysis developed in the § 704(b) regulations. The sharing of recourse liabilities is determined by identifying which partners would bear the economic risk of loss based on the consequences of a "constructive liquidation"—a hypothetical event in which all partnership assets become worthless and the partnership liquidates. While the regulations are phrased in terms of "economic risk of loss" (a defined term), they focus primarily on the partners' sharing of the ultimate legal liability for the partnership's obligations. Generally, the allocation of economic risk of loss can be determined by answering the question: If the partnership defaulted on its obligations, to what extent (if any) would a partner be obligated to pay the liability from personal funds, without any right to reimbursement? If no partner would bear the economic risk of loss, the liability is classified as nonrecourse. Nonrecourse liabilities are allocated according to flexible rules based on the manner in which the partners share the profits that would presumably be used to repay such liabilities.

§ 2. Definition of Liability and Assumption

(a) Definition. Under § 752, a liability affects outside basis only to the extent that it creates or increases the basis of property (including cash) or gives rise to a current deduction or a nondeductible noncapital expenditure (e.g., a fine). Reg. § 1.752–1(a)(4)(i) (liability defined); Rev. Rul. 88–77; Rev. Rul. 95–26 (short sale of securities). This treatment generally preserves parity between aggregate inside and outside basis. For example, unpaid expenses and accounts payable of cash-basis taxpayers are not treated as liabilities for purposes of § 752, because these obligations are not deductible until paid. See Chapter 5.

The regulations specifically address an assumption of fixed or contingent payment obligations that are not liabilities as defined in Reg. § 1.752–1(a)(4)(i), including environmental and tort obligations. See Reg. § 1.752–1(a)(4)(ii), –7. Under these special rules, a partnership's assumption of a partner's "non-§ 752 liabilities" (i.e., liabilities that have not yet given rise to a deduction or tax basis) generally does not trigger an immediate downward adjustment to outside basis. If the partnership satisfies the liability while the partner remains in the partnership, the § 704(c) built-in loss attributable to payment of the liability is allocated to the part-

ner, reducing outside basis. If certain events that separate the partner from the liability occur (e.g., a transfer of the partner's interest) before the partnership satisfies the liability, outside basis is reduced immediately but the partner's deduction for the built-in loss is deferred until the time of economic performance (i.e., satisfaction of the liability) by the partnership. The rules governing non-§ 752 liabilities are aimed at tax shelters that sought to create an artificial loss on sale of a partnership interest by not reducing outside basis for contingent obligations that arguably fell outside § 752. Like § 358(h) in the corporate context, the special basis-reduction rules do not apply if the trade or business associated with the non-§ 752 liability is transferred to the partnership.

(b) Whose Liability. The § 752 regulations provide that a person is generally treated as "assuming" a liability only to the extent that he becomes subject to personal liability with respect to such liability. The assumption will be respected only if the assuming partner is directly liable to the creditor and no other partner (or related person) would be treated as bearing the economic risk of loss under the § 752 regulations. Reg. § 1.752–1(d). For example, a limited partner is not treated as assuming a partnership liability if he is only indirectly liable to a creditor. The general rules concerning assumptions do not apply to contributions or distributions of property subject to liabilities. Under § 752(c), the transferee is treated as assuming such liabilities, subject to the fair-market-value limitation, even though no personal liability exists. § 752(c); Reg. § 1.752–1(e).

§ 3. Recourse Liabilities

(a) Economic Risk of Loss. A partnership liability is recourse to the extent that any partner bears the economic risk of loss with respect to such liability. Reg. § 1.752–1(a)(1). If a liability is part recourse and part nonrecourse, the regulations bifurcate the liability. Reg. § 1.752–1(i); see Reg. § 1.752–2(f), Ex. 5. A partner's share of partnership recourse liabilities equals the portion of such liabilities for which he bears the economic risk of loss. Reg. § 1.752–2(a). In general, a partner bears the economic risk of loss with respect to a partnership liability to the extent that the partner (or a related person) would be obligated to make a net payment or a net contribution with respect to such liability if the partnership were constructively liquidated. Reg. § 1.752–2(b)(1).

In effect, a partner's economic risk of loss is measured by his ultimate responsibility to pay the creditor or to contribute additional funds to the partnership (after determining the consequences of the constructive liquidation). In sorting out the partners' obligations, the regulations first determine a partner's gross payment or contribution obligation and then reduce this amount by any reimbursement to which the partner (or a related person) would be entitled as a result of the payment or contribution. Reg. § 1.752–2(b)(5). Except in abusive situations, partners (or related persons) are

generally assumed to discharge their obligations, regardless of net worth. Reg. § 1.752–2(b)(6) (deemed-satisfaction rule).

(b) Constructive Liquidation. The regulations trace the economic risk of loss by reference to a hypothetical liquidation in which the following events are deemed to occur: (i) the partnership's assets (including cash) become worthless, (ii) the partnership's liabilities become due and payable in full, (iii) the partnership disposes of its assets in a *fully taxable exchange for no consideration (other than relief from limited liabilities), and (iv) the partnership allocates its items of income, gain, loss,* deduction and credit among the partners and liquidates. Reg. § 1.752–2(b)(1).

In the constructive liquidation, the partnership is treated as realizing the amount of any liability for which "the creditor's right to repayment ... is limited solely to one or more assets of the partnership." Reg. § 1.752–2(b)(2)(i). This category of "limited liabilities" includes "true" nonrecourse debt which would be extinguished by the deemed transfer of the partnership's assets. See Reg. § 1.1001–1; Tufts (1983). The constructive liquidation is treated as a foreclosure of the property subject to such debt, giving rise to gain or loss equal to the difference between the amount of the debt extinguished and the tax basis (or book value, if different) of the securing property. If tax basis and book value differ, the consequences of the constructive liquidation are determined by reference to the book value of the partnership property. Such a

book/tax disparity may arise whenever property is contributed to the partnership subject to § 704(c) or is subsequently revalued.

Example (1): A partnership purchases equipment for $250 cash and a nonrecourse purchase-money note of $750. Upon a constructive liquidation, the partnership would be treated as transferring the equipment (deemed to be worthless) for an amount equal to the nonrecourse liability, triggering a loss of $250 ($1,000 basis less $750 amount realized). If the basis of the equipment were less than the amount of the debt (e.g., because of depreciation deductions), the partnership would recognize *Tufts* gain on the constructive liquidation. For example, if the constructive liquidation occurred when the equipment had a basis of $300 and the debt remained $750, the partnership would recognize a gain of $450 ($750 amount realized less $300 basis).

With respect to its remaining property, the partnership recognizes a loss on the deemed disposition equal to the tax basis (or book value, if different) of such property, triggering a corresponding reduction in the partners' capital accounts. The aggregate deficit in the partners' book capital accounts immediately after the constructive liquidation will generally equal the amount of the partnership's recourse liabilities. The constructive liquidation is deemed to occur whenever it is necessary for tax purposes to determine the partners' shares of partnership liabilities and outside basis. Reg. § 1.752–4(d).

Example (2): A and B each contribute $5,000 to the AB general partnership in exchange for equal partnership interests. The partnership maintains capital accounts in accordance with the § 704(b) regulations, and each partner is obligated to restore any deficit in his capital account. The partnership purchases a building (worth $100,000) for $10,000 cash and a $90,000 recourse purchase-money note. Upon a constructive liquidation, the partnership would realize a loss of $100,000 (i.e., the amount realized would not include the $90,000 recourse liability because that liability is not discharged as a result of the transfer). The loss would be allocated $50,000 to A and $50,000 to B as equal partners, and each partner would have a capital account deficit of $45,000 ($5,000 contribution less $50,000 loss). Accordingly, each partner would have an obligation to contribute $45,000 to the partnership to pay the recourse liability.

Example (3): During its first year, the AB general partnership in the preceding example has operating income of $150,000, operating expenses of $110,000 and depreciation deductions of $20,000. The partnership uses its net cash flow of $40,000 to repay a portion of the $90,000 debt, reducing the principal amount to $50,000. Upon a constructive liquidation at the end of the year, the partnership would recognize a loss of $80,000 (i.e., the adjusted basis of the building). The partnership's total losses of $60,000 ($20,000 net taxable income decreased by $80,000 constructive loss) would produce a deficit of $25,000 in each partner's capital account ($5,000 contribution less $30,000 loss). Accordingly, each partner would have an obligation to contribute $25,000 to the partnership to pay the recourse liability. In the example, the partners' liability-sharing ratio remains 50/50 with respect to the outstanding debt, since the partners share all items of income, gain, loss and deduction equally. If the partners' sharing ratios are more complex, however, the allocation of the partnership liability may change over time.

(c) Direct Payment Obligations. A partner also bears the economic risk of loss to the extent of any obligation to make a direct payment to a creditor (or to reimburse another partner for such a payment). Payment obligations running directly to the creditor include guarantees, assumptions, indemnities and similar arrangements. Because the regulations focus on ultimate responsibility for a partnership liability rather than formal structure, it is important to take account of any collateral arrangement that affects a partner's economic risk of loss.

If a limited partner guarantees a recourse liability of the partnership, the guarantee normally does not shift the basis for the liability away from the general partner. See Reg. § 1.752–2(f), Ex. 3 (deemed satisfaction by general partner). If the limited partner were required to pay the obligation, he would be subrogated to the lender's rights against the partnership and would accordingly be entitled to reimbursement from the general partner. Unless he waived his right of subrogation, the limited partner

would not be obligated to make a net payment. See Reg. § 1.752–2(f), Ex. 4.

By contrast, a limited partner who guarantees a nonrecourse debt should generally be allocated basis up to the amount of the guarantee. See Reg. § 1.752–2(f), Ex. 5. In effect, the regulations classify a nonrecourse debt as a recourse liability (a defined term) if one of the partners bears the economic risk of loss, even though the partnership has no personal liability. The partner-guarantor is personally obligated to pay the creditor under the guarantee, and has no right to reimbursement from the partnership or the other partners. Reg. § 1.752–1(a)(1),–2(b)(1).

Under an indemnity agreement, one partner (the "indemnitor") may be obligated (i) to satisfy the liability of another partner (the "indemnitee") to a third-party creditor or (ii) to reimburse the indemnitee for payment of the underlying liability. An indemnity agreement may be enforceable directly by the creditor (e.g., as a third-party beneficiary under applicable state law). An indemnitor generally becomes ultimately liable for payment to the extent of the indemnity. For example, if a limited partner agrees to indemnify the general partner for 50% of any payment to the creditor, each partner is allocated 50% of the liability. The term "indemnity" may also be used to describe a partner's agreement to hold a creditor harmless (rather than to indemnify the obligor). If the creditor can proceed against the indemnitor only in the event that it cannot recover from the general partner, however,

the indemnity may be ineffective to shift basis for the liability. On a constructive liquidation, the general partner is presumed to discharge his obligation to satisfy partnership liabilities. Reg. § 1.752–2(b)(6); but cf. Reg. §§ 1.752–2(j) (anti-abuse rules),–2(k) (disregarded entities).

(d) Disproportionate Loss Sharing. Generally, the regulations seek to minimize the effect of the § 704(d) limitation on outside basis by coordinating the § 704(b) loss-sharing rules and the § 752 liability-sharing rules. The allocation of losses is first determined under § 704(b) and the corresponding liabilities are then assigned under § 752 to the partners who were allocated a share of losses. This treatment reflects a policy decision that § 704(d) should not impose additional hurdles for loss allocations that withstand scrutiny under § 704(b). If the partners share losses disproportionately to their capital contributions, however, a deficit restoration obligation may produce unexpected results. See Reg. § 1.752–2(f), Ex. 1–2.

Example (4): A and B contribute $1,500 and $500, respectively, to a general partnership and agree to share profits and losses equally. The partnership maintains capital accounts in accordance with the § 704(b) regulations, and each partner is obligated to restore any deficit in her capital account. The partnership purchases land for $2,000 cash and a $1,000 recourse purchase-money note. Upon a constructive liquidation, the land would be presumed to be worthless and the partnership would realize a loss of $3,000. The loss would be allocated $1,500 to

A and $1,500 to B, in accordance with the loss-sharing ratio under the partnership agreement. A's capital account would be reduced to zero ($1,500 contribution less $1,500 loss); B would have a capital account deficit of $1,000 ($500 contribution less $1,500 loss), and would be obligated to contribute $1,000 to the partnership. Because B bears the economic risk of loss, the $1,000 liability is allocated entirely to B, increasing B's initial outside basis from $500 to $1,500; A's outside basis remains $1,500.

In effect, the regulations allocate a disproportionate share of recourse liabilities to the partner with the lower capital account balance immediately before the constructive liquidation. As a result, in the above example each partner has sufficient outside basis to absorb her share of losses. If A and B had instead made equal capital contributions of $1,000, each partner would bear the economic risk of loss for $500 of the $1,000 liability, and would again have an outside basis of $1,500 ($1,000 contribution plus $500 of partnership liabilities) sufficient to absorb her share of losses.

Example (5): A and B each contribute $500 cash to a general partnership. Under the partnership agreement, profits and losses are allocated 40% to A and 60% to B. The partnership maintains capital accounts in accordance with the § 704(b) regulations, and each partner is obligated to restore any deficit in her capital account. The partnership purchases land for $1,000 cash and a $200 recourse purchase-money note. Upon a constructive liquidation, the $1,200 loss would be allocated 40% to A ($480) and 60% to B ($720), leaving A with a capital account balance of $20 ($500 contribution less $480 loss) and B with a capital account deficit of $220 ($500 contribution less $720 loss). B would accordingly be obligated to contribute $220 to the partnership, while A would be entitled to a liquidating distribution of $20. B's economic risk of loss for the liability would be limited to $200, determined by multiplying B's net contribution obligation ($220) by the partnership's recourse liability ($200), divided by the partners' total net contribution obligations ($220). B's initial outside basis would be $700 ($500 contribution plus $200 of partnership liabilities). B's obligation to contribute an additional $20 to repay A's positive capital account balance is not treated as a partnership liability in determining B's outside basis. As a result, the § 704(d) limitation on losses in excess of outside basis may suspend $20 of B's losses. In effect, B has "borrowed" $20 from A but does not receive a corresponding increase in her outside basis until she makes an additional contribution.

(e) Partner Loans. The regulations treat a recourse loan from a partner (or a related person) in the same manner as a loan from a third-party creditor. If, however, the loan would otherwise be nonrecourse (e.g., because no other partner has guaranteed or assumed the liability), the economic risk of loss is assigned to the partner who makes the loan (or is related to the lender). Reg. § 1.752–2(c)(1). The partner-loan rule is intended to prevent

other partners from claiming basis for a nonrecourse liability owed to a partner (or related party). For purposes of the partner-loan rule, a partner and another person are related if they bear a relationship specified in § 267(b) or § 707(b)(1), with certain modifications. Reg. § 1.752-4(b)(1).

The partner-loan rule is subject to a de minimis exception if (i) the loan constitutes "qualified nonrecourse financing" within the meaning of § 465(b)(6) (but not limited to activities involving the holding of real property) and (ii) the lending partner (and related persons) possesses an interest of 10% or less in each item of partnership income, gain, loss deduction, or credit for each year in which the loan is outstanding. Reg. § 1.752-2(d)(1). The de minimis rule would apply, for example, to a loan from an institutional lender who is also a 10% partner. The lender's status as a partner would be ignored, and the basis for the loan would be allocated under the nonrecourse rules.

(f) Pledge of Property as Security. If a partner pledges his own separate property (other than his partnership interest) as security for a partnership liability, the partner is treated as bearing the economic risk of loss to the extent of the net fair market value of such property. Reg. § 1.752-2(h)(1); Prop. Reg. § 1.752-2(h)(3). A similar rule applies if a partner contributes property ("contributed security") to a partnership which uses such property solely to secure a partnership liability. Reg. § 1.752-2(h)(2). Upon a constructive liquidation, contributed security is excluded from the

general rule that all partnership assets are deemed to be worthless, and the contributed security is deemed to be transferred to the creditor, to the extent of its value, in full or partial satisfaction of the secured liability. Reg. § 1.752-2(b)(1)(ii). For purposes of § 752, the value of pledged property is limited to its net fair market value determined at the time of the pledge or contribution, taking into account any non-partnership liabilities secured by the pledged property. Prop. Reg. § 1.752-2(h)(3).

(g) Disregarded Entities. Proposed regulations under § 752 clarify when the owner of a disregarded entity will be treated as bearing the economic risk of loss for a partnership liability based on an obligation of the disregarded entity. Prop. Reg. § 1.752-2(k). Even though a disregarded entity such as a single-member LLC may be treated as a partner under state law, the entity's owner is treated as the partner for federal tax purposes. Because a disregarded entity and its owner are treated as a single entity for tax purposes, the owner might be presumed to discharge any of the disregarded entity's obligations to contribute to the partnership or pay creditors. Based on state-law limitations on personal liability, however, the owner may have no obligation to satisfy the disregarded entity's debts. In determining the owner's economic risk of loss for the disregarded entity's obligations, these state-law limitations on liability must be taken into account. In general, the disregarded entity's owner is deemed to bear the economic risk of loss only to the extent of the disregarded entity's net value that

could be used to satisfy the liability. Prop. Reg. § 1.752–2(k)(1). If the disregarded entity has no significant assets (other than its interest in the partnership, if any), the owner bears no economic risk of loss.

Example (6): X, an LLC owned entirely by A, is classified as a disregarded entity under the § 7701 regulations. In 2006, X becomes the sole general partner of a limited partnership which borrows $75,000 to purchase land; the $75,000 debt is secured by the land and is also a general obligation of the partnership. The partnership agreement provides that only X is required to restore any deficit in its capital account. At the end of 2006, when the partners' shares of partnership liabilities are determined, X has no assets other than its partnership interest. Because X is a disregarded entity, X's owner A is treated as the general partner for federal tax purposes. For purposes of the constructive liquidation, A is treated as bearing the economic risk of loss for the partnership's $75,000 liability only to the extent of X's net value (zero). Since neither A nor any other partner bears any economic risk of loss, the $75,000 debt is classified as a nonrecourse obligation under § 752 and is allocated among all of the partners under the rules for nonrecourse liabilities. See Prop. Reg. § 1.752–2(k)(6), Ex. 1.

The proposed regulations define net value as the fair market value of all of the disregarded entity's assets that could be reached by creditors (including required contributions from the disregarded entity's owner but excluding the value of any partnership

interest held by the disregarded entity) less certain other obligations of the disregarded entity of equal or higher priority than its payment obligation to the partnership. Prop. Reg. § 1.752–2(k)(2). Once the net value of the disregarded entity has been determined for purposes of allocating liabilities among partners, net value is generally not redetermined unless the disregarded entity's other obligations change or there are significant contributions to or distributions from the disregarded entity. Id. An anti-abuse rule guards against anticipated reductions in net value that are part of a plan with a principal purpose of inflating a partner's economic risk of loss. Prop. Reg. § 1.752–2(k)(3). The owner of a disregarded entity must provide timely information to the partnership concerning the disregarded entity's tax classification and its net value. Prop. Reg. § 1.752–2(k)(5).

Example (7): The facts are the same as in Example (6), above, except that A contributes $25,000 cash to X at the end of 2007; the principal amount of the partnership debt remains unchanged. Because of the contribution and revaluation, X has a net value of $25,000 at the end of 2007. Thus, A would be deemed to bear the economic risk of loss for $25,000 of the partnership's $75,000 debt upon a constructive liquidation. Accordingly, this portion of the liability would be classified as a recourse liability allocable solely to A, and the remaining $50,000 of the liability would continued to be classified as a nonrecourse liability. See Prop. Reg. § 1.752–2(k)(6), Ex. 2. The result should be the

same if, instead of contributing an additional $25,000 to X, A individually agrees at the end of 2007 to restore any capital account deficit up to $25,000. As a result of the limited deficit restoration obligation, A should be treated independently as bearing the economic risk of loss for $25,000 of the partnership's liability; the special rule applicable to obligations of a disregarded entity would not apply. See Prop. Reg. § 1.752–2(k)(1) (last sentence).

(h) Time Value of Money. The regulations apply time-value-of-money concepts to deferred obligations. Generally, a deferred obligation is taken into account at its outstanding principal amount only if the obligation bears adequate interest; otherwise, only the discounted present value of the obligation (determined under the rules of § 1274(b)) is taken into account. Reg. § 1.752–2(g)(2). If a partner contributes his own promissory note (other than a readily tradeable note) to a partnership, the contributed note is not reflected in his capital account upon contribution. Instead, the promissory note is treated as an additional contribution obligation and may increase the partner's outside basis under § 752 to the extent of the partner's economic risk of loss.

(i) Anti-Abuse Rules. The § 752 regulations contain anti-abuse rules intended to reinforce the allocation of recourse liabilities based on the economic risk of loss. Applying general substance-over-form principles, the Service can look behind illusory obligations intended to create the appearance of

economic risk of loss and treat other arrangements in accordance with their economic effect. Reg. § 1.752–2(j)(1). It is not entirely clear how the general anti-abuse rules under § 701 should be coordinated with the § 752 rules for allocating partnership liabilities. Despite the artificiality of the economic risk concept, the partners' arrangement for sharing liabilities under § 752 presumably reflects the "intent of Subchapter K," as articulated by the § 701 regulations. Thus, transactions structured to take advantage of the liberal § 752 rules should generally not be considered abusive under § 701 even if comparable treatment would not be available outside Subchapter K. See Reg. § 1.701–2(d), Ex. 4 (use of partnership to avoid gain recognition under § 351(c) for liabilities in excess of basis) and Ex. 6 (valid allocation of nonrecourse liabilities).

§ 4. Nonrecourse Liabilities

(a) General. A partnership liability is nonrecourse to the extent that no partner bears the economic risk of loss for that liability. Reg. § 1.752–1(a)(2). Under the § 752 regulations, nonrecourse liabilities are allocated in three tiers. The first two "priority" tiers consist of (i) a partner's share of "partnership minimum gain" as determined under the § 704(b) regulations concerning allocation of nonrecourse deductions and (ii) the amount of taxable gain that would be allocated to a partner under § 704(c) principles ("§ 704(c) minimum gain") if the partnership disposed of all property subject to

nonrecourse liabilities in a taxable transaction in full satisfaction of such liabilities and for no other consideration. Reg. § 1.752–3(a). The third tier consists of "excess" nonrecourse liabilities, i.e., the residual category left after initially allocating the partnership's nonrecourse liabilities to the two priority tiers. A partner's share of nonrecourse liabilities equals the sum of his shares of partnership minimum gain, § 704(c) minimum gain and excess nonrecourse liabilities.

In accordance with the *Crane* rule, the regulations include nonrecourse liabilities in the partnership's inside basis and the partners' outside bases. The underlying theory is that a partner who receives a disproportionate allocation of nonrecourse deductions should also receive a corresponding share of the *Crane* basis generated by the nonrecourse liability. In other words, the allocation of nonrecourse liabilities follows the allocation of nonrecourse deductions, i.e., "liabilities follow losses." The mechanism for accomplishing this result is relatively straightforward: whenever a partner is allocated a nonrecourse deduction, he is also allocated the *Crane* basis that generated the deduction. The allocation of nonrecourse liabilities is equal to the increase in the partner's share of partnership minimum gain attributable to the corresponding allocation of nonrecourse deductions.

Nonrecourse liabilities up to the amount of the partnership's basis in the underlying property (i.e., the portion which has not yet generated nonrecourse deductions) constitute excess nonrecourse liabilities which are allocated in accordance with the partners' overall profit-sharing ratios. The underlying assumption is that partnership profits will be used to repay the liability. The regulations also permit the partners to allocate excess nonrecourse liabilities by agreement in any manner that is "reasonably consistent with allocations (which have substantial economic effect under the § 704(b) regulations) of some significant item of partnership income or gain." Reg. § 1.752–3(a)(3). Alternatively, excess nonrecourse liabilities may be allocated in the manner in which it is "reasonably expected" that the corresponding nonrecourse deductions will be allocated. The method of allocating excess nonrecourse liabilities may vary from year to year.

Example (8): A and B each contribute $50,000 cash to the AB general partnership which purchases a building (worth $1,000,000) for $100,000 cash and a $900,000 nonrecourse note. The partnership agreement complies with all of the requirements under the § 704(b) regulations. Under the partnership agreement, all items of income, gain, loss and deduction are allocated equally. Immediately after formation of the partnership, the partners share the excess nonrecourse liability equally because they have equal interests in partnership profits. See Reg. § 1.752–3(b), Ex. 1. Accordingly, A and B each have an outside basis of $500,000 ($50,000 contribution plus $450,000 share of excess nonrecourse liabilities).

During Year 1, the partnership's operating income equals its operating expenses; the partnership

also has $200,000 of depreciation deductions. At the end of Year 1, each partner has a $50,000 share of the partnership minimum gain of $100,000 (i.e., the excess of the $900,000 liability over the $800,000 basis of the building). Accordingly, A and B continue to share the nonrecourse liability equally; each partner is allocated $50,000 of the nonrecourse liability to match her share of partnership minimum gain, and the $800,000 residual nonrecourse liability is allocated $400,000 each to A and B. Each partner has an outside basis of $400,000 at the end of Year 1 ($50,000 contribution plus $450,000 share of liabilities less $100,000 share of loss).

Example (9): The facts are the same as in Example (8), above, except that A contributes no capital and B contributes $100,000; the partnership agreement validly allocates all depreciation deductions to B. If the partners share nonrecourse liabilities 50:50 (i.e., in accordance with their overall profit-sharing ratios), the partners' initial outside bases will be $450,000 (A) and $550,000 (B). When the building is fully depreciated, B's share of partnership minimum gain will be $900,000; the first priority tier (partnership minimum gain) will thus absorb the entire liability. Because A is allocated none of the nonrecourse deductions, her share of "excess" nonrecourse liabilities will shift to B as the property is depreciated, triggering annual recalculation of the partners' outside bases.

The regulations offer a much simpler alternative that makes it unnecessary to recalculate the partners' shares of liabilities each year. Under the regu-

lations, the partners may agree to allocate excess nonrecourse liabilities in the manner in which it is reasonably expected that the corresponding nonrecourse deductions will be allocated. In Example (9), above, if the liability is allocated in accordance with expected nonrecourse deductions, B's share of the liability immediately after formation of the partnership is $900,000. Thus, A and B have initial outside bases of zero and $1,000,000, respectively. See Reg. § 1.752–3(b), Ex. 2.

If a partner receives a distribution of nonrecourse liability proceeds, the distribution carries out a share of partnership minimum gain for purposes of § 704(b). See Chapter 4. Under the § 752 liability-sharing rules, the distributee is allocated a portion of the nonrecourse liability equal to his share of the increase in partnership minimum gain attributable to the distribution. Since the increase in outside basis is deemed to occur immediately before the distribution, the distributee should not recognize gain under § 731 as a result of the distribution.

(b) Coordinating §§ 704(c) and 752. If appreciated property is contributed to a partnership, the built-in gain must be allocated to the contributing partner under § 704(c) principles. See Chapter 5. As discussed in Chapter 2, a partner who contributes property subject to a nonrecourse liability is allocated an amount of the liability at least equal to the § 704(c) minimum gain (i.e., the excess of the nonrecourse liability over the tax basis of the property). Reg. § 1.752–3(a)(2). This taxable gain is the minimum amount that would be allocated to the

contributing partner if the encumbered property were sold for no consideration other than relief of the nonrecourse liability. The method of allocating § 704(c) gain may affect the amount of nonrecourse liabilities allocated to the contributing partner. See Rev. Rul. 95–41.

The partnership's excess nonrecourse liabilities—the residual amount left after allocating nonrecourse liabilities under the first two priority tiers corresponding to partnership minimum gain and § 704(c) minimum gain—must generally be allocated in accordance with the partners' overall profit-sharing ratios (or the manner in which the partners reasonably expect to allocate nonrecourse deductions). Reg. § 1.752–3(a)(3). The regulations permit a partnership to allocate excess nonrecourse liabilities first based on the partners' remaining shares of § 704(c) gain after taking into account § 704(c) minimum gain. In effect, a partner who contributes property with built-in gain subject to a nonrecourse liability may be allocated the entire nonrecourse liability to the extent that it does not exceed the total built-in gain, i.e., the § 704(c) minimum gain (second tier) and the remaining § 704(c) gain (third tier). This method of allocating nonrecourse liabilities minimizes any shift of nonrecourse liabilities away from the contributing partner as a result of the contribution.

Example (10): A contributes property with a basis of $4,000 and a fair market value of $10,000, subject to a nonrecourse liability of $6,000, to the equal AB partnership. Since the total nonrecourse liability

($6,000) does not exceed the total book value of the contributed property ($10,000), there is no partnership minimum gain. Thus, no portion of the nonrecourse liability is allocated under the first tier. Under the second tier, A must be allocated $2,000 of the nonrecourse liability corresponding to the § 704(c) minimum gain ($6,000 nonrecourse liability less $4,000 basis). Under the third tier, the excess liability ($4,000) may be allocated in accordance with the partner's overall profit-sharing ratios. Since the excess liability does not exceed the remaining § 704(c) gain of $4,000 ($6,000 built-in gain less $2,000 § 704(c) minimum gain), the partners may agree instead to allocate the entire $4,000 excess liability to A. Thus, A's share of the nonrecourse liability would be $6,000 ($2,000 under the second tier and $4,000 under the third tier) and A's net relief of liabilities would be zero. A's outside basis would be $4,000 ($4,000 initial basis less $6,000 liabilities relieved plus $6,000 share of partnership liabilities).

If A's basis in the contributed property were instead $4,500, A's total § 704(c) gain would be only $5,500, or $500 less than the nonrecourse liability of $6,000. Accordingly, A could be allocated up to $5,500 of the liability on a priority basis ($1,500 under the second tier and $4,000 under the third tier). Since A and B share residual partnership profits equally, they would each be allocated $250 of the remaining liability. Thus, A would be allocated $5,750 of the $6,000 nonrecourse liability ($1,500 under the second tier and $4,250 under the

third tier). A's outside basis would be $4,250 ($4,500 initial basis less $6,000 liabilities relieved plus $5,750 share of partnership liabilities).

If a partnership holds assets subject to a single nonrecourse liability, the liability may be allocated among the assets in any reasonable manner. Reg. § 1.752–3(b). This situation may arise, for example, when a partnership holds assets subject to several discrete nonrecourse liabilities and refinances the total indebtedness with a single nonrecourse liability. It may also occur if an LLC classified as a partnership incurs a liability that is a general obligation of the LLC or is secured by all of the LLC's assets; even though such a liability is recourse to the LLC, it is nevertheless classified as a nonrecourse liability under § 752 because no partner bears the economic risk of loss for the liability. See Chapter 4. An allocation is considered reasonable provided that the total liabilities allocated to a particular asset do not exceed its fair market value when the nonrecourse liability is incurred. For example, a single nonrecourse liability may be allocated among different assets in proportion to their relative fair market values.

The portion of the nonrecourse liability allocated to a particular asset is then treated as a separate liability for purposes of determining § 704(c) minimum gain attributable to that asset. See Reg. § 1.752–3(a)(2). Once a liability has been allocated among particular assets, the partnership may generally not change the method of allocating the liability while any portion of the liability is still outstanding. If a particular asset is no longer subject to the liability, e.g., because the partnership disposes of the asset, the portion of the liability formerly allocated to that asset must be reallocated among the partnership's remaining assets, subject to the fair-market-value limitation. Any reduction in the outstanding balance must be allocated among the partnership's assets in the same proportion that the liability was originally allocated.

Example (11): In exchange for equal partnership interests in the newly-formed AB partnership, A contributes $50 cash and B contributes two assets: X (with a basis of $30 and a value of $60, subject to a nonrecourse liability of $40) and Y (with a basis of $30 and a value of $90, subject to a nonrecourse liability of $60). Immediately after formation of the partnership, the partnership refinances the separate liabilities encumbering X and Y with a single nonrecourse liability of $100. The partnership agrees to allocate the nonrecourse liability equally between the two assets ($50 each). There is no partnership minimum gain, i.e., the total nonrecourse liability ($100) does not exceed the total book value of the encumbered property ($150). Since each asset is treated as subject to a separate liability, there is $20 of § 704(c) minimum gain attributable to each asset ($50 nonrecourse liability less $30 basis). Thus, $40 of the nonrecourse liability must be allocated to B under the second tier for sharing nonrecourse liabilities. Reg. § 1.752–3(a)(2). The remaining $60 of the nonrecourse liability is an excess liability allocated under the third tier.

Reg. § 1.752–3(a)(3). The partnership agrees to allocate the excess liability first to the partners to the extent of their remaining shares of § 704(c) gain and then equally based on their equal interests in partnership profits. B's remaining share of § 704(c) gain is $50, i.e., the total § 704(c) gain of $90 ($150 total value of X and Y less $60 total basis) less the $40 of § 704(c) minimum gain previously taken into account under the second tier. Thus, B may be allocated $90 of the nonrecourse liability based on his share of § 704(c) minimum gain and remaining § 704(c) gain. The additional $10 of the nonrecourse liability must be allocated equally to A and B. Thus, the nonrecourse liability is allocated $5 to A and $95 to B. See Reg. § 1.752–3(c), Ex. 3.

If partnership property is revalued, the § 752 regulations allocate a portion of the partnership's nonrecourse liabilities to the existing partners equal to the § 704(c)-type gain arising from the revaluation. For example, assume that the equal AB partnership has depreciable property with a basis of zero and a fair market value of $450, subject to a nonrecourse liability of $150. If the partnership property is revalued in connection with admission of a new partner, the revaluation will eliminate any partnership minimum gain since the book value of the property ($450) exceeds the nonrecourse liability ($150). See Reg. § 1.704–2(d)(3). The revaluation creates § 704(c)-type gain of $150 ($150 liability less zero basis) allocable to the existing partners, thereby preventing a shift in liabilities. Thus, A and B would each be allocated $75 of the partnership's

nonrecourse liability (equal to their former share of the total partnership minimum gain of $150). See Reg. § 1.752–3(a)(2).

§ 5. Review Problem

A, B and C make the following contributions to the newly-formed ABC general partnership in exchange for their respective partnership interests. A contributes $90 cash, B contributes nonmarketable securities with a basis of $60 and a fair market value of $60, and C contributes land with a basis of $150 and a fair market value of $150. The partnership purchases equipment (worth $240) for $90 cash and a $150 purchase-money note. Under the partnership agreement, profits and losses are allocated 30% to A, 20% to B and 50% to C. The partnership agreement requires that capital accounts be maintained in accordance with the § 704(b) regulations and provides for restoration of deficit capital accounts; liquidating distributions will be in accordance with positive capital accounts. In each of the following situations, determine the proper allocation of the $150 liability immediately after formation of the partnership.

(a) The purchase-money note is a recourse obligation.

(b) Same as (a), above, except that the partners share profits and losses equally under the partnership agreement.

(c) Same as (a), above, except that the partnership is a limited partnership and B is the sole limited partner. B is not required to restore any

deficit in her capital account, but the partnership agreement otherwise satisfies the requirements of the alternate economic effect test.

(d) Same as (c), above, except that B has a deficit restoration obligation of $30.

(e) Same as (c), above, except that B guarantees $30 of the purchase-money note.

(f) Same as (c), above, except that the purchase-money note is a nonrecourse obligation secured only by the equipment. The partnership agreement contains a minimum gain chargeback provision and otherwise satisfies the requirements of the § 704(b) regulations.

(g) Same as (f), above, except that B guarantees $50 of the purchase-money note.

Answers: (a) Upon a constructive liquidation, the ABC partnership would realize a loss of $450, allocated in the ratio 30:20:50 under the partnership agreement. Accordingly, A's capital account would show a deficit of $45 ($90 original balance less $135 share of loss); B's capital account would show a deficit of $30 ($60 original balance less $90 share of loss); and C's capital account would show a deficit of $75 ($150 original balance less $225 share of loss). Since each partner would be obligated to restore the deficit in her capital account, the $150 recourse liability would be allocated $45 to A (30%), $30 to B (20%) and $75 to C (50%).

(b) Since the partners' loss-sharing ratio is disproportionate to their capital contributions, the sharing of the recourse liability will change. Upon

the constructive liquidation, A's capital account will show a deficit of $60 ($90 original balance less $150 share of loss) and B's a deficit of $90 ($60 original balance less $150 share of loss); C's capital account will be zero ($150 original balance less $150 share of loss). Accordingly, the $150 recourse liability will be allocated $60 to A and $90 to B.

(c) Since B is not obligated to restore any deficit in her capital account, an allocation of losses in excess of B's capital contribution would lack substantial economic effect under the § 704(b) regulations. Accordingly, the partnership agreement should provide that all taxable loss will be allocated to A and C once B's capital account is reduced to zero. In this event, the $150 recourse liability will be allocated $56.25 to A (3/8) and $93.75 to C (5/8); no portion of the liability will be allocated to B.

(d) Since B has a deficit restoration obligation of $30, the result will be the same as in (a), above.

(e) The result will generally be the same as in (c), above. Unless B waives the right of subrogation, B would be entitled to reimbursement if required to perform under the guarantee; thus, B would have no net payment obligation. See Reg. § 1.752–2(f), Ex. 4. Alternatively, if the creditor must first exhaust its rights against the partnership before proceeding against B, no payment obligation would arise because A and C would be deemed to satisfy the partnership's obligations. See Reg. § 1.752–2(f), Ex. 3. If B waives the right of subrogation, however, she may be deemed to have a $30 deficit restoration obligation. See Reg. § 1.704–1(b)(2)(ii)(h).

(f) Since the entire $150 liability is an excess nonrecourse liability, it will be allocated in accordance with the partners' overall profit-sharing ratio (30:20:50). Upon a constructive liquidation, the partnership would realize a loss of $300 ($450 basis less $150 amount realized), reducing the partners' capital accounts to zero but not giving rise to any deficit.

(g) The $150 liability is bifurcated into a nonrecourse liability ($100) and a recourse liability ($50). Reg. § 1.752–1(i). The nonrecourse liability of $100 is allocated in accordance with the partners' overall profit-sharing ratio (30:20:50). The $50 balance of the liability is a recourse liability allocated entirely to the partner-guarantor (B), assuming that such partner is not entitled to reimbursement from the partnership for any payments to the creditor. See Reg. § 1.752–2(f), Ex. 5. If B has a right to reimbursement from the other partners, however, B's economic risk of loss is limited to her *net* payment obligation. A reimbursement obligation might arise, for example, if A and C were allocated a share of the losses attributable to the $50 recourse liability and were obligated to restore their capital account deficits. If A and C (rather than B) guaranteed $50 of the $150 purchase-money note, B would not bear any economic risk of loss since she would have no obligation to restore any deficit in her capital account. Thus, the § 752 regulations effectively prevent limited partners from sharing nonrecourse debt guaranteed by general partners. See Raphan (1985).

CHAPTER 9

PARTNERSHIP DISTRIBUTIONS

§ 1. Overview

The rules governing current and liquidating distributions are intended generally to defer recognition of as much gain or loss as possible, both to the partnership and to the distributee partner. Section 731(b) provides that the partnership recognizes no gain or loss on a distribution of property (including cash) to a partner. The distributee, in turn, recognizes gain only to the extent that he receives a distribution of cash in excess of his basis in his partnership interest, and recognizes loss only on certain liquidating distributions. Any recognized gain or loss is treated as arising from the sale or exchange of the distributee's partnership interest. § 731(a). Finally, certain distributed property retains its ordinary income character in the distributee's hands. § 735.

The mechanism for preserving pre-distribution unrealized gain or loss in the distributed property depends upon whether the distributee's interest in the partnership continues or is completely liquidated. In a current distribution, the distributee generally takes a transferred basis in the distributed property equal to its pre-distribution basis in the

partnership's hands. § 732(a). Any unrealized gain or loss is preserved through appropriate adjustments to the basis of the distributee's partnership interest. § 733. By contrast, in a liquidating distribution the distributee takes an exchanged basis in the distributed property determined by reference to his pre-distribution basis in his partnership interest. Regardless of the tax consequences to the distributee, a distribution generally produces no adjustments in the basis of undistributed partnership property, unless the partnership files an election under § 754 (relating to optional basis adjustments). § 734. In certain liquidating distributions, a mandatory adjustment to the basis of undistributed property may be required to prevent duplication or transfer of losses. § 734(d) (substantial basis reduction).

Congress has added several provisions recently that limit the broad nonrecognition policy of § 731. For example, a distribution of § 704(c) property within seven years of the contribution triggers recognition of gain (or loss) under § 704(c)(1)(B). See Chapter 5. Furthermore, under § 737, a partner who receives a distribution of partnership property must generally recognize any remaining § 704(c) gain attributable to property contributed by him within seven years of the distribution. § 737. Section 737 serves as a backstop to § 704(c)(1)(B) and the disguised sale rules of § 707(a)(2)(B). Finally, distributions of marketable securities (and similar items) may be treated as distributions of money for certain purposes, thereby triggering potential recog-

nition of gain (but not loss). § 731(c). Any gain triggered under these provisions will result in appropriate basis adjustments.

This Chapter focuses initially on the application of §§ 731–737 to distributions that do not trigger § 751. Under § 751(b), a distribution that alters the distributee's proportionate share of unrealized receivables or substantially-appreciated inventory is treated in part as a sale or exchange of partnership property. Thus, § 751(b) may override nonrecognition treatment to prevent potential shifting of unrealized ordinary income among the partners. Finally, payments in liquidation of a retiring or deceased partner's interest in the partnership are subject to § 736, as discussed in Chapter 10.

§ 2. Current Distributions

(a) General. The regulations define a current distribution as any distribution which is not in liquidation of a partner's entire interest in the partnership. Reg. § 1.761–1(d). A current distribution may represent a partner's distributive share of the partnership's current earnings, a return of capital or a constructive distribution of cash under § 752 triggered by a decrease in his share of partnership liabilities. In certain cases, however, other statutory provisions may modify or preempt the normal distribution rules. For example, § 707 may treat a purported distribution as a disguised sale. See Chapter 7. Also, a transaction may be structured as a loan or a drawing against a partner's distributive share to avoid triggering gain on a

distribution of cash in excess of outside basis. See Chapter 3. Characterization as a loan (rather than a current distribution) is generally respected only if there is "an unconditional and legally enforceable obligation to repay a sum certain at a determinable date." Rev. Rul. 73–301.

(b) Gain Recognition and Basis. A current distribution triggers recognition of gain to the distributee partner to the extent that he receives cash in excess of his outside basis immediately before the distribution. § 731(a)(1). Under § 733, the distributee's outside basis is reduced (but not below zero) by the amount of cash distributed. Thus, gain is recognized only to the extent that the distributee's pre-distribution basis is insufficient to absorb the full amount of a cash distribution. Unless one of the statutory exceptions applies, current distributions of property other than cash never trigger recognition of gain or loss. To preserve any unrealized gain or loss when property is distributed in kind, the distributee generally takes the same basis in the distributed property (other than cash) as its adjusted basis in the partnership's hands immediately before the distribution. § 732(a)(1). Moreover, the distributee's outside basis is further reduced (after taking account of any cash distributed) by the basis in the distributee's hands of the property distributed in kind. § 733.

If the distributee's outside basis (after taking account of any cash distributed) is insufficient to absorb the full amount of the partnership's basis in the distributed property, only the remaining outside

basis is assigned to the property distributed in kind. § 732(a)(2). The distributee's outside basis is reduced to zero and the property distributed in kind takes a basis in the distributee's hands which, together with any cash distributed, does not exceed his pre-distribution basis in his partnership interest. Section 732(a)(2) ensures that the proper amount of gain (or loss) is preserved by limiting the basis of distributed property in the distributee's hands, and thus functions in a manner analogous to the recognition of gain upon a distribution of excess cash.

Example (1): Partner A has an outside basis of $50 in her partnership interest which has a fair market value of $100 (equal to A's share of the partnership assets). In exchange for 50% of her partnership interest, A receives a current distribution consisting of $15 cash and property having a basis of $25 in the partnership's hands and a fair market value of $35. Under § 732(a)(1), A takes a transferred basis of $25 in the distributed property, leaving A with a basis of $10 in her partnership. § 733. The $50 of unrealized gain inherent in A's former partnership interest ($100 fair market value less $50 basis) equals the aggregate unrealized appreciation in the distributed property ($35 fair market value less $25 basis) and in A's remaining partnership interest ($50 fair market value less $10 basis). See Reg. § 1.732–1(a), Ex. 1.

If A's pre-distribution outside basis were instead $20, the basis of the distributed property in A's hands would be limited to $5 (pre-distribution out-

side basis of $20 less $15 cash distributed) under § 732(a)(2), and the basis of A's partnership interest would be reduced to zero under § 733. Immediately after the distribution, A would have a potential gain of $30 in the distributed property ($35 fair market value less $5 basis) and $50 in her remaining partnership interest ($50 fair market value less zero basis). Thus, the unrealized gain of $80 inherent in A's partnership interest immediately before the distribution ($100 fair market value less $20 basis) would be preserved. See Reg. § 1.732–1(a), Ex. 2.

If A's pre-distribution outside basis were only $10, A would recognize a gain of $5 ($15 cash distribution less $10 outside basis), leaving A with a basis of zero both in the distributed property and in her remaining partnership interest. §§ 731(a)(1), 732(a)(2) and 733. The unrealized gain of $85 in these assets ($85 fair market value less zero basis) would equal the $90 of unrealized gain inherent in A's former partnership interest ($100 fair market value less $10 basis) less A's recognized gain of $5 on the distribution.

(c) Allocation of Basis. If the general transferred basis rule does not apply (i.e., because the distributee's outside basis, after reduction for any cash distributed, is less than the partnership's aggregate basis in the other distributed property), § 732(c) governs the allocation of basis among the properties distributed in kind. Before 1997, § 732(c) allocated any basis adjustments in proportion to the relative bases of the distributed assets. In 1997,

Congress amended § 732(c) to require basis adjustments to conform more closely to the fair market value of distributed assets. Current law preserves the priority allocation to "hot assets" under § 732(c), in order to maximize the distributee's basis in such assets and thereby minimize the ordinary income that they will generate. For this purpose, hot assets include unrealized receivables and inventory (whether or not substantially appreciated). See § 751(c), (d).

Under § 732(c), the distributee's remaining basis in his partnership interest (after reduction for any cash distributed) is allocated first to hot assets (up to their bases in the partnership's hands). § 732(c)(1)(A)(i). If the distributee's remaining basis is less than the partnership's total basis in distributed hot assets, the basis of these assets must be reduced to match the distributee's remaining basis. § 732(c)(1)(A)(ii). Any decrease is allocated first to distributed hot assets with unrealized depreciation in proportion to their unrealized depreciation (but not in excess of such amount) before the basis decrease; any remaining decrease is allocated to distributed hot assets in proportion to their adjusted bases (after taking into account any prior basis decrease). § 732(c)(3).

If the distributee partner has any remaining basis after the allocation to hot assets, such basis is allocated to other distributed assets (up to their bases in the partnership's hands). § 732(c)(1)(B). If the distributee's remaining basis is less than the partnership's total basis in other distributed property, the basis of such assets is decreased; the decrease is allocated first to non-hot assets in proportion to their unrealized depreciation (but not in excess of such amount) and then in proportion to their adjusted bases (after taking into account any prior basis decrease). § 732(c)(3).

Example (2): Partner A, whose outside basis is $15,000, receives a current distribution consisting of $4,000 cash, inventory worth $10,000 (basis of $8,000), capital asset X worth $1,000 (basis of $1,000), and capital asset Y worth $4,000 (basis of $5,000). A's outside basis ($15,000) is reduced by the amount of cash distributed ($4,000) and A's transferred basis in the inventory ($8,000). Assets X and Y are initially assigned a basis of $1,000 and $5,000, respectively. Since their aggregate basis to the partnership ($6,000) exceeds A's remaining outside basis ($3,000), the basis of X and Y must be decreased by $3,000. The basis decrease is allocated first to Y to the extent of Y's unrealized depreciation ($1,000), reducing Y's basis to $4,000; the remaining decrease ($2,000) is allocated $400 to X ($2,000 × $1,000/$5,000) and $1,600 to Y ($2,000 × $4,000/$5,000) in proportion to their bases (after taking into account the prior decrease in Y's basis). Accordingly, A takes a basis of $600 in X ($1,000 less $400 decrease) and $2,400 in Y ($5,000 less $2,600 decrease). See Reg. § 1.732–1(c)(4), Ex. 2.

§ 3. Liquidating Distributions

(a) General. The regulations define a "liquidation of a partner's interest" as the "termination

of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership." Reg. § 1.761–1(d). When a partner's interest is liquidated by a series of distributions, the liquidation is held open until the time of the final distribution. Id. The rules governing liquidating distributions apply to distributions in connection with a liquidation or termination of the partnership itself as well as the liquidation of a single partner's interest.

Despite their apparent similarities, liquidating distributions are treated differently from current distributions in several important respects. First, while § 731(a) generally prescribes nonrecognition treatment, it provides for recognition of loss as well as gain on certain liquidating distributions. § 731(a)(2). Second, the distributee takes an exchanged basis in the distributed assets (determined by reference to his basis in his partnership interest) which may be higher or lower than the pre-distribution basis of the assets in the hands of the partnership. § 732(b). The treatment of liquidating distributions generally reflects an entity approach, as contrasted with the aggregate approach applicable to current distributions.

(b) Gain or Loss Recognition. In a liquidating distribution, the distributee recognizes gain to the extent that any cash distributed exceeds his pre-distribution basis in his partnership interest. § 731(a)(1). No loss is recognized unless the distributee receives solely cash, "hot assets" (defined for this purpose as unrealized receivables and inventory regardless of whether the inventory is substantially appreciated), or a combination thereof. § 731(a)(2). The recognized loss, if any, is equal to the excess of the distributee's outside basis immediately before the distribution over the sum of any cash distributed and the basis in his hands of the distributed hot assets. Loss recognition is a corollary of § 732(c), which limits the basis of hot assets in the distributee's hands to their pre-distribution basis and thereby preserves any ordinary gain or loss inherent in those assets. On the other hand, a retiring partner may receive hot assets with a reduced basis and ultimately recognize a larger ordinary gain than if the partnership had sold the hot assets.

Example (3): Partnership AB has $200 cash and inventory with a basis of $100 and a fair market value of $200. Upon liquidation of AB, the partnership distributes equal shares of each asset to A and B, who have bases in their partnership interests of $100 and $200, respectively. B takes a basis of $50 in her share of the inventory and recognizes a capital loss of $50 ($200 outside basis less $100 cash and $50 basis assigned to the inventory). §§ 731(a)(2), 732(c) and 741. If B sells her share of the inventory for $100 within five years after the distribution, she will recognize $50 of ordinary income. § 735(a)(2). Even though B has no economic gain or loss on the transaction, she recognizes $50 of capital loss on the distribution and has $50 of ordinary income on the subsequent sale. Under § 732(b), A takes a basis of zero in the inventory,

and will realize $100 of ordinary income if she sells the inventory within five years after the distribution. The distribution of the inventory to A and B, followed by a sale within five years, thus triggers $50 more total ordinary income (and $50 more capital loss) than if the partnership had sold the inventory before liquidating.

(c) Basis Allocation. The basis allocation rules of § 732(c) apply to liquidating distributions in the same manner as to current distributions. In the case of liquidating distributions, however, the total basis to be allocated is independent of the partnership's pre-distribution basis in the distributed property; thus, the property may take a lower or (except in the case of hot assets) higher basis in the distributee's hands than it had in the partnership's hands. Any increase is allocated first to non-hot assets with unrealized appreciation in proportion to their unrealized appreciation (but not in excess of such amount); any remaining increase is allocated to non-hot assets in proportion to their relative fair market values.

Example (4): Partner A, whose outside basis is $110, receives a distribution of two capital assets (X and Y) in liquidation of her partnership interest. In the partnership's hands, X has a fair market value of $25 and a basis of $30, and Y has a fair market value of $50 and a basis of $10. A's outside basis is first allocated $30 to X and $10 to Y, equal to their bases in the partnership's hands. A's remaining outside basis ($70) is allocated $40 to Y (the only appreciated asset) to the extent of its unrealized

appreciation; the remainder ($30) is allocated $10 to X ($30 × $25/$75) and $20 to Y ($30 × $50/$75) in proportion to their relative fair market values. Thus, A takes a basis of $40 in X and $70 in Y. See Reg. § 1.732–1(c)(4), Ex. 1.

(d) Anti-Abuse Rules. The § 701 anti-abuse rules recognize that § 732(c) is intended to provide simplifying administrative rules and may thus produce basis distortions. If the ultimate tax consequences are clearly contemplated under § 732(c), however, the transaction will be respected for purposes of § 701. See Reg. § 1.701–2(d), Ex. 10–11 (reflecting the pre–1997 version of § 732(c)). In one example, a liquidating distribution shifts a portion of the distributee's outside basis from nondepreciable to depreciable assets, thereby producing a timing advantage; because the ultimate tax consequences are clearly contemplated, the transaction is deemed to satisfy the "proper-reflection-of-income" test. Id. (Ex. 10). In another example, the withdrawing partner takes an artificially high basis in an "insignificant" asset that she plans to sell and an artificially low basis in land that she plans to retain; thus, the § 732(c) allocation allows the distributee, in effect, to recover a portion of the cost of the land. Id. (Ex. 11). Upon formation of the partnership, the distributee's acquisition of the land and use of § 732(c) to produce basis distortions were part of an underlying plan. Accordingly, the § 732(c) allocation fails the "proper-reflection-of-income" test and the transaction may be recast to achieve results consistent with the intent of Subchapter K. Id.

§ 4. Treatment of Liabilities

A decrease in a partner's share of partnership liabilities is treated as a deemed distribution of cash under § 752(b), which may trigger recognition of gain to the distributee under § 731(a)(1). The deemed distribution is treated as an advance or draw up to the amount of the partner's distributive share of income for the taxable year. Rev. Rul. 94–4. Thus, the distributee's outside basis is increased by his distributive share of partnership income for the year before determining the consequences of the deemed distribution. See Reg. § 1.731–1(a)(1)(ii).

Example (5): The AB partnership has excess nonrecourse liabilities of $10,000, which are allocated equally to partners A and B. A, whose outside basis is $50,000, receives a cash distribution of $50,000 which reduces his interest in the partnership (and his share of partnership liabilities) from 50% to 20%. The reduction in A's share of partnership liabilities from $5,000 (50%) to $2,000 (20%) is treated as a deemed distribution of $3,000 cash to A. If A's distributive share of income for the year is at least $3,000, A will recognize no gain as a result of the § 752(b) deemed distribution. B's share of the partnership's liabilities increases from $5,000 (50%) to $8,000 (80%), triggering a corresponding increase in B's outside basis.

The rules for distributions of encumbered property mirror the rules for contributions of encumbered property discussed in Chapter 2. The distributee partner's basis in his partnership interest is (i) increased by the amount of liabilities to which the distributed property is subject, (ii) decreased by his share of the reduction in partnership liabilities, and (iii) decreased by the basis of the distributed property in his hands. §§ 705, 722, 733 and 752. Under § 752, any increases and decreases in the distributee's share of partnership liabilities are netted against each other. Reg. § 1.752–1(f). The distributee's basis in his partnership interest is first adjusted to reflect the net increase or decrease in liabilities before determining the basis of the distributed property. Rev. Rul. 79–205. These ordering rules are intended to defer recognition of gain or loss, especially if a distribution results in a net increase in a partner's share of partnership liabilities.

A partnership may enter into a § 1031 deferred like-kind exchange in which property subject to a liability (the "relinquished liability") is transferred in one taxable year and property subject to a liability (the "replacement liability") is received in the partnership's next taxable year. The Service has ruled that the relinquished and replacement liabilities are netted for purposes of § 752. Any net decrease is taken into account in the partnership's initial taxable year, while any net increase is taken into account in the subsequent taxable year. Rev. Rul. 2003–56.

§ 5. Distribution of Marketable Securities

(a) General. Section 731(c) generally treats a distribution of marketable securities (defined broadly) as a distribution of cash for purposes of

§§ 731(a)(1) and 737. Thus, a distribution of marketable securities may trigger recognition of gain (but not loss) under § 731(a)(1). The purpose of § 731(c) is to limit deferral of gain when the distributee receives liquid assets equivalent to cash. For example, assume a partnership purchases marketable securities worth $100 and distributes such securities to a partner with an outside basis of $40. If the partner received solely cash, he would recognize gain of $60 under § 731(a)(1). Section 731(c) achieves the same result by treating the distribution of securities as a distribution of cash, reduced by the distributee's share of any net appreciation in such securities. See § 731(c)(3)(B). Under the anti-abuse rules, the Service may recast a transaction as appropriate to achieve results consistent with the purpose of § 731(c). Reg. § 1.731–2(h).

(b) Basis Consequences. The distributee's basis in the distributed securities is determined under the normal distribution rules of § 732 and increased by any gain recognized under § 731(c). § 731(c)(4)(A); Reg. § 1.731–2(f)(1). Any basis increase is allocated among the distributed securities in proportion to their unrealized appreciation in the distributee's hands before such basis increase. § 731(c)(4)(B). Under § 733, the distributee's remaining outside basis is reduced by the basis assigned to the securities under § 732, determined as if no gain were recognized under § 731(c). § 731(c)(5). The special treatment of marketable securities affects only the tax treatment of the distributee partner, and is not taken into account in

determining inside basis adjustments under § 734(b). See Reg. § 1.731–2(f)(2).

Example (6): When A's 1/3 interest in the equal ABC partnership has a basis of $40 and a fair market value of $90, A receives a liquidating distribution of the partnership's only marketable security (X). X has a fair market value of $90 and a basis of $30 to the partnership. A is treated as receiving a cash distribution of $70 ($90 fair market value of X less $20 share of X's unrealized appreciation), triggering $30 of gain to A under § 731(a)(1). A takes a basis of $70 in X ($40 basis under § 732(b) increased by $30 gain recognized), preserving A's $20 share of unrealized appreciation in X and reducing A's outside basis to zero. If A instead received a current distribution, A would take a basis of $60 in X ($30 basis under § 732(a)(1) increased by $30 gain recognized); A's outside basis would be reduced to $10 ($40 less $30 basis allocated to X under § 732(a)(1)). See Reg. § 1.731–2(j), Ex. 5.

(c) Reduction for Net Unrealized Appreciation. Under § 731 (c)(3)(B), the amount treated as cash under § 731(c) is limited to the fair market value of the distributed securities, reduced by the distributee's share of the net appreciation in such securities. The distributee's share of net appreciation is equal to the excess of (i) the distributee's share of the net gain if all of the partnership's marketable securities were sold for fair market value immediately before the distribution, over (ii) the distributee's share of the net gain if all of the partnership's marketable securities were sold for

fair market value immediately after the distribution. § 731(c)(3)(B); Reg. § 1.731–2(b)(1), (2). The reduction in the amount treated as cash is intended to permit the distributee to continue to defer his share of the net appreciation inherent in the partnership's marketable securities.

Example (7): The facts are the same as in Example (6), above, except that the partnership also owns two other marketable securities (Y and Z) with an unrealized loss of $15 (Y) and an unrealized gain of $30 (Z). Accordingly, A would be allocated net gain of $25 if, immediately before the distribution, the partnership's securities were sold for their fair market value ($20 gain in X, $5 loss in Y, and $10 gain in Z). Following the liquidating distribution, A's share of the net gain inherent in the securities held by the partnership (Y and Z) is zero. The distribution results in a $25 decrease in A's share of the net gain inherent in the partnership's securities ($25 net gain before distribution less zero net gain after distribution). Thus, A is treated as receiving a cash distribution of $65 ($90 fair market value of X less $25 decrease in share of net gain). A recognizes $25 of gain ($65 less $40 outside basis) and takes a basis of $65 in X ($40 basis under § 732(b) increased by $25 gain recognized). See Reg. § 1.731–2(j), Ex. 2.

(d) Special Rules. Section 731(c) does not apply to distributions of marketable securities by an investment partnership to an "eligible" partner. § 731(c)(3)(A)(iii). Section 731(c) also provides exceptions for marketable securities distributed to a partner who previously contributed such securities

and for securities that were not marketable when acquired. § 731(c)(3)(A)(i)-(ii). Finally, § 731(c) applies only after giving effect to § 704(c)(1)(B); both §§ 704(c)(1)(B) and 731(c) take precedence over § 737. Reg. § 1.731–2(g); see § 10 below.

§ 6. Section 732(d) Election

Under certain circumstances, § 732(d) permits a distributee who acquired his partnership interest by purchase or bequest to treat assets distributed to him as having a pre-distribution basis in the partnership's hands equal to the basis such assets would have if a § 754 election had been in effect when the distributee acquired his partnership interest. The purpose of the § 732(d) election is to make available to the distributee, as nearly as possible, the same tax treatment as if he had been entitled to a § 743(b) adjustment when he acquired his interest. The § 732(d) election is available only if (i) the distributee acquired all or part of his partnership interest by "transfer," i.e., by sale or exchange or upon the death of a partner, (ii) the partnership did not have a § 754 election in effect at the time of the transfer, and (iii) the distribution occurs within two years after the original transfer. The election must accompany the transferee's tax return for (i) the year of the distribution if the distribution includes any depreciable property or (ii) in all other cases, the first taxable year in which the basis of the distributed property affects the distributee's income tax. Reg. § 1.732–1(d)(2). Unlike the § 754 election, the § 732(d) election has no effect on subsequent

transfers of a partnership interest and does not require the partnership's consent.

Example (8): D inherits the partnership interest of deceased partner C, at a time when the ABC partnership has the following balance sheet and no § 754 election in effect:

Assets	Basis	Value	Capital	Basis	Value
Cash	$3,000	$ 3,000	A	$2,000	$ 4,000
Inventory	3,000	9,000	B	2,000	4,000
Total	$6,000	$12,000	C	2,000	4,000
			Total	$6,000	$12,000

D takes her 1/3 partnership interest with an outside basis equal to fair market value ($4,000) under § 1014, and within two years D receives a liquidating distribution of her pro rata share of the partnership's cash and inventory. In the absence of a § 732(d) election, D would take a $1,000 basis in the inventory and recognize a $2,000 capital loss on the liquidating distribution ($4,000 outside basis less $1,000 cash less $1,000 basis allocated to the inventory). See §§ 731(a)(2), 732(c) and 741. If D then sold the inventory, she would recognize $2,000 of ordinary income under § 735, offsetting her $2,000 capital loss. If D instead makes the § 732(d) election, she will take a basis of $3,000 in her share of the inventory (D's $1,000 share of the common basis of the inventory plus the $2,000 upward adjustment to which D would have been entitled under § 743(b)). Thus, the § 732(d) election eliminates D's artificial loss on the liquidating distribution as well as the overstated gain on the

subsequent sale. If D had received any property other than cash and hot assets in liquidation of her interest, she would have reported no loss and any remaining basis in her partnership interest would have been allocated to such other property under § 732(c).

The application of § 732(d) may be mandatory (whether or not the distribution occurs within two years) if the fair market value of partnership property (other than money) exceeds 110% of its basis in the partnership's hands at the time the distributee acquires his partnership interest. § 732(d) (last sentence); see Reg. § 1.732–1(d)(4) (additional requirements). As indicated by the additional requirements in the regulations, mandatory application of § 732(d) is intended to prevent a shifting of basis from nondepreciable property to depreciable property in connection with a distribution. The 1997 changes in § 732(c) may lessen the need for mandatory § 732(d) basis allocations.

§ 7. Subsequent Dispositions of Distributed Property

Section 735 generally preserves the ordinary income character of distributed "hot assets" upon a subsequent disposition by the distributee. For this purpose, hot assets include unrealized receivables and inventory (whether or not substantially appreciated) but do not include § 1231 property (regardless of its holding period). The "taint" of ordinary gain or loss treatment is permanent for unrealized receivables, but lasts only five years for inventory if

the inventory becomes a capital asset in the distributee's hands. § 735(a). For purposes of the five-year rule, the distributee is not permitted to tack the partnership's holding period for distributed inventory. § 735(b). There is no need for unrealized receivables to include depreciation recapture for purposes of § 735(a)(1), because the potential ordinary income inherent in depreciated property is generally preserved through the recapture provisions themselves. §§ 751(c), 1245 and 1250. If the distributee disposes of property subject to § 735(a) in a nonrecognition transaction, the taint of ordinary income treatment generally applies to any "substituted basis property" resulting from the transaction. §§ 735(c)(2), 7701(a)(42)-(44).

Example (9): Partnership ABC distributes to partner A a parcel of land which constitutes inventory in the partnership's hands having a basis of $1,000 and a fair market value of $900. A takes a basis of $1,000 in the land, holds the land for investment purposes and then sells the land three years later when its value has increased to $1,200. Even though all of the appreciation occurred while A held the land, the entire gain of $200 is ordinary income to A under § 735(a)(2). Conversely, any loss realized by A on a sale of the land within five years would be treated as ordinary.

§ 8. Inside Basis Adjustments

(a) General. Section 734(a) provides that a distribution of property to a partner does not trigger an adjustment to the basis of any property remain-

ing in the partnership's hands after the distribution, unless (i) an election under § 754 is in effect with respect to the partnership or (ii) there is a substantial basis reduction as defined in § 734(d). Thus, the basis of the remaining partnership property is often unchanged as a result of a distribution, in accordance with an entity approach. Prior to 2004, inside basis adjustments were entirely elective rather than partially mandatory. Absent a § 754 election, a distribution of low-basis property to a partner whose interest is liquidated might leave the continuing partners with substantially less net built-in gain (or substantially higher net built-in loss) inside the partnership than before the distribution. Congress was concerned that certain tax-shelter transactions sought to exploit the electivity of basis adjustments to duplicate and transfer losses among partners in connection with distributions. Rather than make the § 754 election mandatory for all partnership distributions, Congress adopted a targeted approach aimed specifically at liquidating distributions in which there is substantial potential for duplication or transfer of losses.

If the partnership has a § 754 election in effect, § 734(b) requires that the basis of retained partnership property be adjusted if, as a result of a distribution, the distributee recognizes any gain or loss or takes a basis different from the partnership's basis in the property. Section 734(b)(1) requires upward adjustments to retained partnership property if the distributee recognizes gain or takes a basis in the distributed property lower than its basis in

the partnership's hands; § 734(b)(2) requires downward adjustments to retained partnership property if the distributee recognizes loss or takes a basis in the distributed property higher than its basis in the partnership's hands.

Absent a § 754 election, no adjustment to inside basis is generally required. An inside basis adjustment is mandatory only to the extent that a § 754 election (if one were in effect) would result in a net downward adjustment, under § 734(b)(2), to the partnership's remaining property in excess of $250,000. See § 734(d). In effect, this rule applies only to liquidating distributions, since a current distribution cannot give rise to a downward adjustment to inside basis. Congress exempted securitization partnerships from the mandatory adjustment rule. § 734(e). If the substantial basis reduction threshold is not satisfied or there is a net upward adjustment under § 734(b)(1), inside basis continues to be adjusted only if the partnership has a § 754 election in effect. Thus, Congress preserved electivity of basis adjustments in most situations in order to avoid excessive administrative burdens.

While § 734(b) determines the amount of any increase or decrease in the basis of partnership property, the allocation of the basis adjustment is governed by § 755. § 734(c). Unlike the § 743(b) adjustment (which affects only the transferee-partner's share of the partnership's basis in its property, as discussed in Chapter 8), the § 734(b) adjustment increases or decreases the common basis of partnership property and thus affects all of the

continuing partners (including the distributee, in the case of a current distribution).

(b) Recognized Gain or Loss. The § 734(b) adjustment avoids distortions of gain or loss that would otherwise arise under the general rule of § 734(a) if the basis of partnership property were not adjusted. If the partnership has a § 754 election in effect, the basis of partnership property is increased by the amount of any gain, and decreased by the amount of any loss, recognized by the distributee as the result of a current or liquidating distribution. § 734(b)(1)(A), (b)(2)(A). If the substantial basis reduction threshold is satisfied, the partnership must reduce the basis of retained partnership property even if no § 754 election is in effect. § 734(d).

Example (10): Partnership ABC distributes $200 cash to partner A in liquidation of his entire partnership interest. Immediately before the distribution, A had a basis of $100 in his partnership interest and the partnership's balance sheet was as follows:

	Basis	Value		Basis	Value
Assets			Capital		
Cash	$200	$200	A	$100	$200
Land	100	400	B	100	200
Total	$300	$600	C	100	200
			Total	$300	$600

As a result of the distribution, A recognizes gain of $100 ($200 cash distribution less $100 outside basis), equal to his 1/3 share of the unrealized appreciation in the land. If the partnership's basis in the

land is not adjusted and the land is sold for $400, the partnership will realize $300 of gain which will all flow through to the continuing partners (B and C). In effect, A's 1/3 share of the unrealized appreciation ($100) will be taxed twice, once to A on liquidation and again to the continuing partners (B and C) on sale of the land. The overstatement of gain should be only temporary, however, since the continuing partners will increase their outside bases to reflect the full amount of gain from sale of the land. If the § 754 election is in effect, however, § 734(b)(1)(A) increases the partnership's basis in the land by the amount of A's recognized gain ($100), thus reducing the partnership's gain on sale of the land to $200 and eliminating the temporary double taxation to B and C. See Reg. § 1.734-1(b)(1), Ex. 1. The post-distribution unrealized appreciation in the partnership's assets ($200) plus the gain recognized by A ($100) equals the pre-distribution unrealized appreciation in the partnership's assets ($300).

Example (11): Partnership DEF distributes $100 cash to partner D in liquidation of his entire partnership interest. Immediately before the distribution, D had a basis of $200 in his partnership interest, and the partnership's balance sheet was as follows:

	Basis	Value		Basis	Value
Assets			Capital		
Cash	$200	$200	D	$200	$100
Land	400	100	E	200	100
Total	$600	$300	F	200	100
			Total	$600	$300

As a result of the distribution, D recognizes a loss of $100 ($200 outside basis less $100 cash distribution) under § 731(a)(2). If the § 754 election is in effect, the partnership must decrease its basis in the land by $100 to reflect D's recognized loss, reducing the partnership's potential loss on sale of the land to $200 ($300 basis less $100 fair market value) in the partnership's hands. See Reg. § 1.734-1(b)(2), Ex. 1. The post-distribution unrealized loss in the partnership's assets ($200) plus D's recognized loss ($100) is equal to the pre-distribution unrealized loss in the partnership's assets ($300). By reducing the partnership's basis in its remaining property, the § 734(b) adjustment eliminates the potential double-counting of D's share of pre-distribution unrealized loss. Inside basis is not reduced, however, unless the partnership has a § 754 election in effect (or the § 734(d) substantial basis reduction threshold is satisfied).

If the distributee recognizes gain on the distribution (or takes a reduced basis in the distributed property), inside basis adjustments are optional. Since the corresponding adjustment to inside basis would be a net increase rather than a net decrease, mandatory adjustments are not required. In this context, Congress apparently viewed the failure to make a § 754 election as harmless, at least from the government's perspective. Notwithstanding the administrative burden, the continuing partners may be expected to make a § 754 election to step up inside basis to reflect gain previously taxed to the

distributee when such recognized gain is sufficiently great. By contrast, the continuing partners would be disadvantaged by a § 754 election whenever the adjustment to inside basis is a net decrease.

A downward adjustment to inside basis results only if (i) the distributee partner recognizes a loss under § 731(a)(2) or (ii) takes a basis in distributed property, under § 732(b), in excess of its basis in the partnership's hands prior to distribution. § 734(b)(2). Even in these circumstances, a reduction in inside basis is mandatory only if the distributee recognizes a loss (or takes an increased basis in the distributed property) so that the substantial basis reduction threshold of $250,000 is satisfied. § 734(d). Because the distributee can recognize loss or take an inflated basis only in connection with a liquidating distribution, current distributions never trigger the mandatory adjustment rule. Indeed, many liquidating distributions will also fall outside the rule because of the substantial basis reduction threshold.

(c) Shifts in the Basis of Distributed Property. The basis adjustment rules of § 734(b) also apply when a distributee receives distributed property and takes a basis different from the partnership's pre-distribution basis. These adjustments are intended to preserve the aggregate unrealized gain or loss inherent in the partnership assets (both distributed and retained). If the partnership has a § 754 election in effect, the partnership must increase its basis in retained partnership property to the extent that the basis of the distributed property

in the distributee's hands is reduced under § 732(a)(2) or § 732(b); conversely, the partnership must reduce its basis in retained partnership property to the extent that the distributee takes an inflated basis in the distributed property under § 732(b). § 734(b)(1)(B), (b)(2)(B). If the distributee's basis in distributed property is inflated by more than $250,000, the basis of the partnership's remaining property must be correspondingly reduced even if no § 754 election is in effect. § 734(d).

Example (12): Partnership GHI distributes Land #1 to partner G in liquidation of her entire partnership interest. Immediately before the distribution, G had a basis of $500 in her partnership interest, and the partnership's balance sheet was as follows:

	Basis	Value		Basis	Value
Assets			Capital		
Cash	$ 600	$ 600	G	$ 500	$ 600
Land #1	600	600	H	500	600
Land #2	300	600	I	500	600
Total	$1,500	$1,800	Total	$1,500	$1,800

Under § 732(b), G takes a basis in Land #1 equal to her pre-distribution basis in her partnership interest ($500), which is less than the partnership's pre-distribution basis ($600). If the partnership has a § 754 election in effect, the $100 difference is added to the partnership's basis in its remaining property, increasing the basis of Land #2 to $400. See Reg. § 1.734–1(b)(1), Ex. 2. Giving effect to the § 734(b) adjustment, the partnership would realize a gain of $200 on a sale of Land #2 ($600 fair

market value less $400 basis), while G would realize a gain of $100 ($600 fair market value less $500 basis) on a sale of Land #1. The aggregate unrealized appreciation in the partnership's assets (both distributed and retained) is thus $300 both before and after the distribution.

In the preceding example, assume instead that G receives Land #2 in liquidation of her partnership interest. Under § 732(b), G's basis in Land #2 would be $500, or $200 more than the partnership's pre-distribution basis. If G sold Land #2, she would recognize only $100 of gain ($600 fair market value less $500 basis). Moreover, in the absence of a downward adjustment of $200 to the partnership's basis in Land #1, that asset could be sold with no realized gain, thereby deferring the continuing partners' share of the partnership's pre-distribution unrealized appreciation ($200) until sale or liquidation of their partnership interests. In order to eliminate these distortions, the basis of Land #1 must be adjusted downward to $400. See Reg. § 1.755–1(c)(2)(ii).

If the distributee's basis in distributed property is inflated by more than $250,000, the adjustment to inside basis is mandatory rather than elective. For purposes of § 734(d), a substantial basis reduction is defined as the sum of the amounts described in § 732(b)(2), i.e., the amount of any loss recognized and the amount of any basis inflation. Without a corresponding reduction to inside basis following a liquidating distribution, both loss recognition and basis inflation in distributed property present a

similar possibility of duplication or shifting of losses among partners. By contrast, nonliquidating distributions cannot trigger mandatory adjustments, since they do not give rise to the requisite loss recognition or basis inflation.

The 2004 legislative history provides an example illustrating the mandatory § 734(b) adjustment. In the example, A and B each contribute $2.5x and C contributes $5x to a newly-formed partnership; the partnership uses the cash to purchase LMN stock for $3x and XYZ stock for $7x. When the value of each stock has declined to $1x and no § 754 election is in effect, the partnership distributes the LMN stock to C in liquidation of C's partnership interest. C takes a basis of $5x in the LMN stock equal to C's outside basis. Thus, C would recognize a $4x loss if the LMN stock were sold immediately.

Under amended § 734(a), the partnership is required to reduce the basis of the retained XYZ stock, since the distribution satisfies the substantial basis reduction threshold of § 734(d). In C's hands, the basis of the LMN stock is inflated by $2x, the excess of C's outside basis ($5x) over the partnership's pre-distribution basis ($3x). Accordingly, the partnership must reduce the basis of the retained XYZ stock (worth $1x) from $7x to $5x, leaving A and B each with post-distribution inside loss ($4x) equal to their pre-distribution share of inside loss. In the absence of the mandatory § 734(b) adjustment, A and B would be left with a $6x inside loss, or $2x more than their pre-distribution share of inside loss. Thus, the mandatory adjustment en-

sures that a distribution of low-basis property to a departing partner (C) will not leave the continuing partners (A and B) with higher net built-in loss (or less net built-in gain) inside the partnership than before distribution.

(d) Basis Allocation. The regulations under § 755, which also govern § 743(b) adjustments, generally allocate § 734(b) adjustments in a manner that preserves the character and proportionate amount of unrealized appreciation (or depreciation) within separate classes of partnership property. Under § 755, partnership property is first divided into two classes of property, consisting of capital assets, including § 1231(b) property ("capital assets"), and any other partnership property ("ordinary assets"). Second, the § 734(b) adjustment is allocated (i) to property of the same class as the distributed property if the adjustment results from an increase or decrease in the basis of distributed property or (ii) entirely to capital assets if the adjustment results from recognition of gain or loss by the distributee. Reg. § 1.755–1(c)(1). Third, the § 734(b) adjustment is allocated to specific assets within the appropriate class based generally on the difference between the basis and fair market value of such property. § 755(a)(1). Adjustments may also be required that increase the disparity between the basis and fair market value of particular assets.

Any increase is allocated first among assets of the required character in proportion to their unrealized

appreciation (but not in excess of such amount); any remaining increase is allocated among assets of the required character in proportion to their relative fair market values. Reg. § 1.755–1(c)(2)(i). Any decrease is allocated first among assets of the required character in proportion to their unrealized depreciation (but not in excess of such amount); any remaining decrease is allocated among assets of the required character in proportion to their relative bases. Reg. § 1.755–1(c)(2)(ii). The basis of partnership assets of the required character may not be decreased below zero. Reg. § 1.755–1(c)(3). If the § 734(b) adjustment cannot be allocated to specific assets within a class (e.g., because the partnership has no retained property of that class or such property has insufficient basis to absorb the adjustment), it is held in abeyance until it can be allocated to subsequently-acquired property of the same class. § 755(b) (flush language); Reg. § 1.755–1(c)(4). If goodwill exists and is reflected in the value of the distributed property, a portion of the basis adjustment must be allocated to the partnership's goodwill. Reg. § 1.755–1(a)(4)(iii),–1(a)(6), Ex. 5.

Example (13): Immediately before partner A receives a liquidating distribution consisting of $100 cash, ordinary asset O and capital asset R, partnership ABC has the following balance sheet:

Assets	Basis	Value	Unrealized Appreciation/ (Depreciation)
Cash	$ 300	$ 300	$ 0
Ordinary Assets			
M	50	200	150
N	100	200	100
O	150	200	50
Total	$ 300	$ 600	$300
Capital Assets			
P	$ 100	$ 400	$300
Q	200	400	200
R	300	400	100
Total	$ 600	$1,200	$600
Capital			
A	$ 400	$700	$300
B	400	700	300
C	400	700	300
Total	$1,200	$2,100	$900

Under § 732(b) and (c), A takes a basis of $150 in capital asset R ($400 outside basis less $100 cash less $150 basis in ordinary asset O), which is $150 less than the partnership's basis ($300). Under §§ 734(b) and 755, the basis of the partnership's remaining capital assets is increased by $150. Reg. § 1.755–1(c)(1)(i). The basis increase is allocated $90 to capital asset P ($150 x $300/$500) and $60 to capital asset Q ($150 x $200/$500), in proportion to the relative unrealized appreciation of those assets in the partnership's hands. Reg. § 1.755–1(c)(2)(i). Immediately after the distribution, the partnership's balance sheet is as follows:

Assets	Basis	Value	Unrealized Appreciation/ (Depreciation)
Cash	$ 200	$ 200	$ 0
Ordinary Assets			
M	$ 50	$ 200	$ 150
N	100	200	100
Total	$ 150	$ 400	$ 250
Capital Assets			
P	$ 190	$ 400	$ 210
Q	260	400	140
Total	$450	$ 800	$350
Capital			
B	$400	$700	$300
C	400	700	300
Total	$800	$1,400	$600

The general effect of the § 734(b) allocation is thus to reallocate basis among the capital assets (the class of assets which received a different basis in A's hands), while leaving the basis of the ordinary income assets unchanged. After the § 734(b) adjustment, the partnership's total inside basis ($800) is equal to the total outside basis of the continuing partners (B and C), preserving their share of pre-distribution unrealized appreciation.

If a partner's outside basis differs from his share of the partnership's common basis, § 734(b) does not work well. For instance, in Example (13), assume that A purchased his partnership interest several years ago for $700 when the partnership did not have a § 754 election in effect. Upon a liquidating distribution, the basis of capital asset R would be stepped up to $450 in A's hands ($700 outside basis less $100 cash less $150 basis in ordinary

asset O). Under §§ 734(b) and 755, the adjustment to the partnership's retained capital assets would be a $150 *decrease* (rather than a $150 increase), which would be allocated $50 to capital asset P ($150 × $100/$300) and $100 to capital asset Q ($150 × $200/$300) in proportion to their relative bases. The result is particularly harsh to the continuing partners (B and C) because it leaves them with too little inside basis ($500) in comparison to their outside bases ($800). This defect could be remedied if the § 734(b) adjustment were determined by reference to the distributee's share of inside basis rather than his actual outside basis, in a manner similar to the § 743(b) adjustment.

(e) No Basis Reduction of Corporate Partner's Stock. Under § 755(c)(1), the partnership is prohibited from allocating any portion of a downward § 734(b) adjustment to stock of a corporation that is (or is related to) a partner in the partnership. This provision is aimed at certain tax-shelter abuses that sought to take advantage of the interaction between the partnership basis adjustment rules and § 1032, which protects a corporation from recognizing gain upon a disposition of its own stock (including stock held through a partnership). In these tax-shelter transactions, the distributee partner would claim a loss on liquidation of its partnership interest (or take an inflated basis in distributed assets). If a § 754 election were in effect, the partnership's basis in retained corporate stock was correspondingly reduced as a result of the downward § 734(b) abutment. Because § 1032 potentially eliminated any adverse tax consequences upon a later disposition of the partnership's retained corporate stock, however, taxpayers could apparently duplicate tax losses at no economic cost.

Under current law, the amount of the § 734(b) adjustment allocable to corporate stock but for the prohibition of § 755(c)(1) must instead be allocated to the partnership's other retained property. Once the basis of such other property has been reduced to zero, the partnership recognizes gain to the extent of any prevented downward adjustment. § 755(c)(2). The basis allocation rule of § 755(c) is intended to backstop § 732(f), which reduces the basis of corporate assets upon certain distributions of stock to a corporate partner.

Example (14): The XYZ partnership distributes cash in liquidation of partner Z's partnership interest and Z recognizes a $100,000 loss under § 731(a)(2). Following the distribution, the partnership's assets consist of land and stock of corporate partner Y; each asset has a basis $75,000 and proportionate built-in loss. The partnership has a § 754 election in effect, triggering a downward § 734(b) adjustment of $100,000 that, but for § 755(c)(1), would be allocable equally to the land and corporate stock. Because 755(c) prevents the partnership from reducing the basis of the retained corporate stock, the § 734(b) adjustment is instead allocated entirely to the land. Accordingly, the basis of the land is reduced to zero and the partnership recognizes gain of $25,000. See § 755(c)(2).

(f) Anti-Abuse Rule. While the elective feature of § 754 can be defended on grounds of administra-

tive convenience, Congress clearly recognized that the absence of mandatory basis adjustments might give rise to distortions between the partnership's inside basis and the partners' outside bases. The § 701 anti-abuse regulations apply a facts-and-circumstances test to determine whether the tax consequences flowing from the failure to make a § 754 election run afoul of the "proper-reflection-of-income" test. In one example, a withdrawing partner receives a distribution of assets with a higher basis in the partner's hands than in the partnership's hands; by failing to make a § 754 election, the partnership retains an artificially high basis in its remaining assets. Reg. § 1.701-2(d), Ex. 9. Nevertheless, the § 701 regulations conclude that the transaction should be respected, since the partnership was formed for a bona fide purpose and the ultimate tax consequences are clearly contemplated by § 754. In another example involving duplication of a built-in loss in contributed property, the § 701 regulations conclude that Congress did not contemplate the elective feature of § 754 with respect to partnerships formed for a tax-avoidance purpose. Reg. § 1.701-2(d), Ex. 8.

Under current law, a downward adjustment to the basis of retained partnership assets is mandatory if the amount of the basis reduction under § 734(b)(2) exceeds $250,000. § 734(d). Thus, the benefit of avoiding a § 754 election has been eliminated in the situation that was most likely to trigger the anti-abuse rule under prior law. Current law also eliminates a partnership's ability to preserve built-in loss inherent in contributed property by failing to make a § 754 election when the contributing partner's interest is liquidated (or sold). Under § 704(c)(1)(C), a built-in loss may be allocated only to the contributing partner and does not carry over to the continuing partners (or purchasing partner) when the contributing partner exits the partnership.

§ 9. Effect on Capital Accounts

(a) General. Distributions reduce the distributee partner's book capital account by the amount of money and the fair market value of property (net of liabilities which the distributee assumes or takes subject to). Reg. § 1.704-1(b)(2)(iv)(b)(4)-(5). Prior to the distribution, the partners' book capital accounts must first be adjusted to reflect the manner in which any unrealized income, gain, loss or deduction inherent in the property (and not previously reflected in the capital accounts) would be shared by the partners if the partnership sold the property for its fair market value on the date of the distribution (the "deemed sale adjustment"). Reg. § 1.704-1(b)(2)(iv)(e)(1). Although an in-kind distribution of property is generally nontaxable to the partnership, the capital account adjustments are necessary to balance the partnership's books and prevent economic distortions. The effect of a distribution on the partnership's balance sheet is to reduce both the left-hand side (showing assets) and the right-hand side (showing liabilities above and partners'

capital below) by an amount equal to the gross fair market value of the distributed property.

Example (15): A and B each contribute $9,000 cash to the equal AB partnership, which uses the cash to purchase nonmarketable securities for $18,000. When the securities have appreciated in value to $48,000, C is admitted as a 1/3 partner in exchange for a cash contribution of $24,000. In accordance with § 704(c) principles, the partnership agreement allocates the $30,000 of pre-admission unrealized appreciation in the securities entirely to A and B ($15,000 each), with any post-admission gain or loss to be shared equally by A, B and C. Subsequently, when the securities are worth $75,000, the partnership distributes them pro rata to the partners. Immediately before the distribution, the partners' capital accounts must be adjusted to reflect the allocation of taxable gain ($57,000) that would have occurred if the securities had been sold for $75,000. After the deemed sale adjustment, the book value of the securities is equal to their fair market value. Each partner's capital account is then reduced by his share of the fair market value of the securities ($25,000):

	Capital Accounts		
	A	B	C
Initial balance	$ 9,000	$ 9,000	$24,000
Deemed sale adjustment	24,000	24,000	9,000
Less: distribution	(25,000)	(25,000)	(25,000)
Balance after distribution	$ 8,000	$ 8,000	$ 8,000

After the distribution, the partnership's books remain in balance. See Reg. § 1.704–1(b)(5), Ex. 14(v).

(b) Optional Revaluation. In lieu of a deemed sale adjustment, the partnership may elect to revalue the partners' capital accounts in connection with a distribution of money or other property. Reg. § 1.704–1(b)(2)(iv)(f)(5)(ii). An optional revaluation may appear more burdensome than a deemed sale adjustment because it requires an appraisal of all the partnership's assets (rather than only the distributed asset). This burden is often more than offset, however, by the usefulness of an optional revaluation in preventing inadvertent capital shifts and other distortions in the partners' economic arrangements. In order to comply with the § 704(b) regulations, the rules governing restatement of capital accounts must be followed. See Chapter 4. If partnership property is booked up, the partners' capital accounts are not adjusted separately for any § 734(b) adjustment, since the basis adjustment is already reflected in the fair market value of the partnership property. In the absence of an optional revaluation, the § 704(b) regulations provide guidance in allocating the § 734(b) adjustment among the partners' capital accounts. Reg. § 1.704–1(b)(2)(iv)(m)(4).

Example (16): A, B and C each contribute $300 cash to the equal ABC general partnership, which retains $300 cash and purchases two parcels of land (Parcel #1 and Parcel #2) for $360 and $240,

respectively. When Parcel #2 has increased in value to $540, the partnership distributes Parcel #1 (still worth $360) to A in a current distribution. If the partnership elects to revalue its property in connection with the distribution, the partners' capital accounts immediately after the distribution will be as follows:

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Initial balance	$300	$300	$300	$300	$300	$300
Bookup adjustment		100		100		100
Less: distribution	(300)	(360)				
Balance after distribution	$ 0	$ 40	$300	$400	$300	$400

The bookup adjustment reflects the $300 of unrealized appreciation in Parcel #2 (which the partnership continues to hold). The distribution reduces A's book capital account by the fair market value of Parcel #1 ($360) and her tax capital account by the tax basis of Parcel #1 in A's hands ($300). Because the basis of Parcel #1 is stepped down in A's hands, the partnership is entitled to a positive § 734(b) adjustment of $60 to the basis of Parcel #2 (assuming a § 754 election is in effect). Accordingly, the partnership's common basis in Parcel #2 is increased to $300 ($240 cost basis plus $60 § 734(b) adjustment).

On a subsequent sale of Parcel #2 for $540, the partnership would have no book gain but would recognize a tax gain of $240 ($540 less $300 tax basis). Without a special allocation, the partners would share the tax gain equally ($80 each) in proportion to their pre-distribution 1/3 interests.

Thus, B and C would be taxed on only $160 of their total pre-distribution share of appreciation ($200 built-in gain less $40 share of § 734(b) adjustment), shifting a portion of the built-in gain to A. By analogy to § 704(c), however, the partnership should be permitted to specially allocate the benefit of the $60 § 734(b) adjustment entirely to A, who has a $60 potential gain outside the partnership. Accordingly, the taxable gain should be allocated $40 to A and $100 to each of B and C, restoring book/tax parity to their capital accounts:

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Initial balance	$ 0	$40	$300	$400	$300	$400
Gain on sale	40	0	100	0	100	0
Ending balance	$40	$40	$400	$400	$400	$400

On liquidation of the partnership, A would receive $40 and B and C would each receive $400. The economic result is appropriate since A receives property (Parcel #1 worth $360 and $40 cash) equal in value to her 1/3 share of partnership assets before the distribution. A's pre-distribution share of appreciation ($100) is also recognized or preserved ($40 gain on sale of Parcel #2 and $60 potential gain on Parcel #1).

§ 10. Distributions to Contributing Partners: § 737

(a) General. Section 737(a) may require recognition of gain (but not loss) to a contributing partner who receives a distribution of property (other than money) within seven years after contributing

respectively. When Parcel #2 has increased in value to $540, the partnership distributes Parcel #1 (still worth $360) to A in a current distribution. If the partnership elects to revalue its property in connection with the distribution, the partners' capital accounts immediately after the distribution will be as follows:

	A		B		C	
	Tax	Book	Tax	Book	Tax	Book
Initial balance	$300	$300	$300	$300	$300	$300
Bookup adjustment		100		100		100
Less: distribution	(300)	(360)				
Balance after distribution	$ 0	$ 40	$300	$400	$300	$400

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Partnership Taxation

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2. Crane v. Commissioner of Internal Revenue, 67 S.Ct. 1047 (1947)
3. Commissioner of Interna Revenue v. Tufts, 103 S.Ct. 1826 (1983)
4. I.R.C. Sec/ 704—Partner's distributive share
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Chapter 5

OPERATION OF A PARTNERSHIP: ALLOCATION OF PARTNERSHIP INCOME AND LOSSES

§ 5.01 INTRODUCTION

As you have learned, a partnership is a flow-through entity. Income and deductions are passed through to the partners. A mechanism needs to exist, therefore, for determining what each partner's allocable share of partnership income and deductions are. I.R.C. § 704(b) and its Regulations generally allow partners a great deal of flexibility in this regard. The allocations do not necessarily need to be in proportion to the underlying ownership of the partnership interests (as is the case with S corporations).[1] Someone who is otherwise a 50% partner could be allocated 90% of depreciation deductions, for example. Or, all losses could initially be allocated to the "money partners," with subsequent income allocated to them to the same extent as losses were, and then income allocated 50% to the money partners and 50% to the promoters. (This is sometimes called a "flip;" flips are quite common.)

I.R.C. § 704(b) provides that a partner's "distributive share of income, gain, loss, and deduction, or credit . . . shall be determined in accordance with the partner's interest in the partnership . . . if" the partnership agreement does not provide for how a distributive share will be allocated *or* if the allocations do not have substantial economic effect. Thus, if an allocation *does* have substantial economic effect, it need not be in accordance with a partner's interest in the partnership. As we will learn, a partner's interest in the partnership is determined under a fairly nonspecific facts and circumstances test. The Regulations provide detailed and specific rules as to when allocations have substantial economic effect. These substantial economic effect rules provide a safe harbor. If the partnership agreement complies with the rules, the partnership knows the transaction will be safe. Practitioners will endeavor to comply with them if possible. It used to be that practitioners viewed compliance with the substantial economic effect rules as being virtually mandatory, but in recent years practitioners have been increasingly willing to take their chances under the far vaguer "interest in the partnership" facts and circumstances test.

The partnership allocations rules have been called "a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject."[2] Unfortunately, this is not an exaggeration. Trusting that you have the time, talent, and determination, we will proceed.

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[1] *See* I.R.C. § 1377(a). Since partners can have varying interests in capital and profits, determining what the underlying ownership interest is may not be an easy task.

[2] Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545 (1986).

§ 5.02 CAPITAL ACCOUNTS

For an allocation to have substantial economic effect under the safe harbor, the capital accounts must be maintained in accordance with the rules in the Regulations.[3] As the name of the substantial economic effect test suggests, an allocation will meet the test if it has a genuine after-tax, economic effect on the partner to whom the allocation is made. The rules for maintaining the capital accounts help to fulfill this task. As the concern here is with the economic rather than tax impacts, the rules for keeping capital accounts are quite different than the rules for computing tax basis.

Under the Regulations, a partner's capital account is increased by:

1. The amount of money contributed to the partnership.
2. The fair market value of property contributed to the partnership (net of liabilities secured by the property that the partnership is considered to assume or take subject to under I.R.C. § 752).[4]
3. Allocations of partnership income and gain, including tax-exempt income.

A partner's capital account is decreased by:

1. The amount of money distributed to the partner.
2. The fair market value of property distributed to the partner (net of liabilities secured by the property that the partner is considered to assume or take subject to under I.R.C. § 752).
3. Allocations of expenditures of the partnership that can neither be capitalized nor deducted in computing taxable income.
4. Allocations of partnership loss and deduction.

Note that unlike the adjusted basis in the partnership interest, a partner's capital account does not include that partner's share of liabilities. If the partnership has liabilities, a partner's basis often will exceed his capital account balance.[5] Since, subject to the at risk and passive loss rules, a partner may receive loss allocations up to his basis in the partnership interest, a partner may have a positive tax basis and a negative capital account.

Many practitioners choose to comply with the capital account rules not by inserting a lengthy explanation into the partnership agreement, but instead by simply providing that the capital accounts will be maintained as specified in the relevant regulation. This latter approach has the advantage that if the rules for keeping capital accounts change, there is no need to amend the partnership agreement.

[3] Treas. Reg. § 1.704-1(b)(2)(iv)(a).

[4] The fair market value assigned to property will be regarded as correct provided that (1) such value is reasonably agreed to among the partners in arm's length negotiations and (2) the partners have sufficiently adverse interests. *See* Treas. Reg. § 1.704-1(b)(2)(iv)(h).

[5] This is not inevitably the case, however. For example, if the partner contributes property to a partnership with a fair market value that greatly exceeds its basis, the capital account may exceed the tax basis of the partnership interest even after factoring in liabilities.

As we will discuss in more detail later in this Chapter, particular in § 5.05, the partnership also maintains "book" accounts for the properties it holds. For example, if a partner contributes property with a tax basis of $7,000 and a fair market value of $10,000, the partnership's tax basis in that property under I.R.C. § 723 will be $7,000 (*see* Chapter 2). However, the partnership's book value will be the full fair market value of $10,000. If a partnership makes a distribution of property for which the fair market value differs from its book basis, for capital account purposes the partnership recognizes the inherent gain or loss and allocates the gain or loss to the partners. This gain or loss is recognized for capital account purposes only. There may not be any corresponding *taxable* gain or loss. For example, assume a partnership has two equal partners A and B and holds a property with a fair market value of $20,000 and a book basis of $15,000 (ignore the tax basis and any possible tax consequences for now). It distributes the property to A. Recall that A's capital account will be reduced for the full fair market value of the property, that is, $20,000. To enable to capital accounts to properly do their job, that is to reflect the economics of the partners' investments, the partners' capital accounts must be adjusted for the gain inherent in the distributed property. Accordingly, *for capital account purposes* (nothing need occur for tax purposes), the partnership recognizes the $5,000 of gain inherent in the property and allocates $2,500 of the gain to each partner's capital account. Thus, A's capital account will be increased by $2,500 and then decreased by $20,000.[6]

§ 5.03 SUBSTANTIAL ECONOMIC EFFECT RULES

A. Introduction

As we mentioned above, the Regulations contain a safe harbor. An allocation that has substantial economic effect will be allowed under I.R.C. § 704(b). There are two parts to the test. First, the allocation must have economic effect. The Regulations provide a largely mechanical test for determining whether or not an allocation has economic effect. Second, because it is possible to manipulate the economic effect test, the Regulations also provide that the economic effect of an allocation must be substantial. Generally, the economic effect of an allocation will be substantial if on an after tax, present value basis, a partner's economic investment in the partnership is either enhanced or diminished as a consequence of the allocation.

B. Economic Effect Rules

1. "Regular" Rules

Partnerships have two options, the "regular" economic effect test and the "alternate" economic effect test. The regular test has three parts:

1. The partnership must keep capital accounts in accordance with the rules described above.

[6] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(e).

2. When an interest of a partner is liquidated, the partner must be paid any positive balance in his capital account.

3. If a partner has a deficit balance in his capital account, he must pay the deficit to the partnership by the end of the tax year in which his partnership interest is liquidated (or, if later, 90 days after liquidation). This last rule is sometimes called a "deficit restoration obligation" or "DRO."[7]

Assume, for example, that on January 1 of year 1 A and B invest $10,000 each in the AB partnership. The partnership purchases equipment for $20,000. The tax basis of the equipment is of course $20,000. In this case its "book" basis will also be $20,000. The equipment's book basis is generally equal to its fair market value on acquisition.[8] Assume that depreciation deductions are $5,000 per year and the partnership has no debt.[9] Further assume the partnership breaks even on its operations except for depreciation deductions, and thus that the partnership operates at a $5,000 loss per year. The partnership agreement allocates all of the depreciation deductions to A. At the beginning of year 1, A and B each has a capital account and a basis in their respective partnership interests of $10,000. As a result of the year 1 allocation, A's capital account and basis will be reduced to $5,000 and B's will remain the same. If the capital account were not adjusted as described, the partnership would be failing to keep capital accounts in accordance with the Regulations and thus would fail the economic effect rules. The basis of the equipment is reduced under I.R.C. § 1016 to $15,000. The Regulations assume that a property has a fair market value equal to its book value.[10] This can be important, as we will see.

Assume at the beginning of year 2 the equipment is sold and the partnership is liquidated. In order to comply with the economic effect rules, the partnership must pay to each partner the balance in the capital accounts. The equipment will be assumed to have a fair market value equal to its book basis, or $15,000. If that is indeed the case, the $15,000 proceeds from the sale would have to be distributed $5,000 to A and $10,000 to B. If, however, the partnership agreement provided that upon liquidation, all partnership funds must be distributed equally ($7,500 each), the allocation in year one would not have had economic effect. This is because A would not have borne the economic burden of the depreciation allocation, in other words, the allocation would not fully have had an economic effect on him. Since the equipment is assumed to have a fair market value equal to its book basis, it is assumed that it went down in economic value by the amount of the depreciation deduction or $5,000. For the allocation of the full amount of depreciation to A to have economic

[7] Treas. Reg. § 1.704-1(b)(2)(ii)(a)-(c).

[8] If a property's book and tax basis vary, as would occur upon the contribution of property with a tax basis that is different from its fair market value, a number of important rules can apply, including those of I.R.C. § 704(c).

[9] We are making this number up and completely ignoring the actual rules of I.R.C. § 168, including the mid-year convention and I.R.C. § 179.

[10] Treas. Reg. § 1.704-1(b)(2)(iii)(c).

effect, A's capital account must be reduced by that amount and A must be paid no more than the balance in the capital account on its liquidation, or $5,000. If A is paid more than that ($7,500 in the modified example), she did not bear the full economic burden of the allocation. She only bore $2,500 of that burden and B (since he is getting $7,500 instead of the capital account balance of $10,000) actually bore the burden of the other $2,500. Consequently, the Regulations would require that the allocation in year 1 be changed and each partner would be allocated $2,500 of depreciation, giving each a capital account balance of $7,500 which is distributed to each partner upon liquidation.[11] As you can see, the Regulations can trump the provision in the partnership agreement.

Now again assume that the partnership agreement provides that liquidation distributions will be made in accordance with capital account balances. Assume again that A and B each contribute $10,000 to the partnership and the partnership borrows $40,000 on a recourse basis with only interest due for the first five years of the note. Assume that under I.R.C. § 752 $20,000 of the liability is allocated to each partner. AB purchases equipment for $60,000. Assume the equipment generates depreciation deductions of $10,000 per year. A will therefore have a beginning tax basis in the partnership interest of $30,000 and a beginning capital account of $10,000. Now assume that in year 1 the partnership breaks even except for depreciation deductions on the equipment and allocates the entire $10,000 of that depreciation to A. A's basis is reduced to $20,000 and her capital account is reduced to zero. Now assume that A's interest in the partnership is liquidated on January 1 of year 2 with the partnership relieving A of any obligation on the partnership liabilities. In order to comply with the economic effect rules, on liquidation the partnership must pay the partner the amount of any positive balance in her capital account. In this example, however, the capital account is zero, and thus no payment need be made to A. Note that, generally, if the partnership is in compliance with the economic effect rules, after liquidation of a partner's interest, the partner's capital account will be zero. Can you see why? In the example, the partner's basis prior to liquidation is $20,000. No payment is made to her. What happens to the $20,000 share of the liability? The answer is that I.R.C. § 752(d) provides that a partner's amount realized on the disposition of a partnership interest includes any liabilities of which the partner is relieved. Thus, A's amount realized includes the $20,000 of liability relief. As A's amount realized is $20,000 and A's basis in the partnership interest is $20,000, there is no tax gain or loss to A on the liquidation.

Now let's take the example one step further. Assume that in year 2 A remains a partner in the partnership. The partnership again breaks even on partnership operations except for depreciation, and again allocates $10,000 of depreciation to A. A's basis is reduced to $10,000 and A's capital is reduced to a negative ($10,000). If A's partnership interest is liquidated on January 1 of year 3 with the partnership relieving A of any obligation on the partnership liabilities, A will be required to contribute $10,000 to the partnership to bring her capital account to zero. Without this requirement, A in effect would be

[11] Treas. Reg. § 1.704-1(b)(5), Ex. 1(i).

getting more out of the partnership than she put into it. She invested $10,000 initially plus was allocated a share of partnership liabilities. She received $20,000 in depreciation allocations and was relieved of any obligation on the partnership liabilities when her partnership interest was liquidated. To insure that the entire allocation of depreciation indeed has an "economic effect" on her, she needs to contribute $10,000 to the partnership. This will bring her capital account to zero. Her basis will be increased to $20,000. Under I.R.C. § 752(d), the amount realized will also be $20,000, for no gain or loss on the liquidation. If A had no obligation to restore a deficit capital account balance, the allocations to A would not have economic effect. How would the allocations in years 1 and 2 then have to be made? The answer can actually be fairly complex, as we will shortly see, but under these facts the year 2 depreciation allocation would have to be made to B, since it had an economic effect on him and not on A. Recall that B's capital account at the end of year 2 was $10,000. After two years of depreciation, the equipment has a book value and presumed fair market value of $40,000. The debt is $40,000, so if the property were sold for $40,000, there are no proceeds left to pay B. If A had to contribute $10,000 to the partnership, her deficit capital account balance, that amount could have been paid to B. But if A has no such obligation, it means that B and not A bore the economic burden of the allocation of depreciation in year 2, and under these facts the year 2 depreciation allocation would have to be made to B.[12]

2. Alternate Economic Effect Rules

The difficulty with the regular economic effect rules is that partners are required to have an unlimited deficit restoration obligation. Especially for investors, that may not be wise. For example, assume the partners form a limited partnership and that all partners have unlimited deficit restoration obligations. An employee of the partnership, while conducting partnership business, runs over and kills a neurosurgeon with 8 handicapped children. A large malpractice liability, in excess of insurance limits, results. The general partner is the only one liable under partnership law, and he contributes sufficient funds to the partnership to enable it to pay the liability. The payment results in a large tax loss to the partnership which is primarily allocated to the limited partners. The allocation causes the limited partners to have substantial negative capital accounts. Should they have to restore those deficit capital accounts, they would in effect be paying the malpractice liability, something that likely was not contemplated when they entered into the partnership agreement. The bottomless risk that an unlimited deficit obligation poses causes most advisors to recommend that their investor-clients not agree to such a provision.

The Regulations, recognizing this business reality, contain an alternative in Treas. Reg. § 1.704-1(b)(2)(ii)(d). Under this alternative, an allocation must meet the first two economic effect tests (keep capital accounts according to the rules and upon liquidation, pay to a partner any positive balance in his capital

[12] *See* Treas. Reg. § 1.704-1(b)(3)(iii).

account). The next requirement is that the allocation not cause the partner to have a deficit capital account balance or increase an already existing deficit capital account balance. As we discussed above, if a partner has a negative capital account balance, economically he has taken more out of the partnership than he has put into it, hence the requirement under the regular rules that he restore any deficit on liquidation of his interest. If the partner is not going to have a deficit restoration obligation, then it makes sense that a current allocation not be allowed to cause him to have a deficit capital account. Indeed, at one time that was almost all there was to the rule. The difficulty with keeping the rule that simple is that a capital account can become negative for reasons other than allocations. The partnership could, for example, make a distribution to a partner that would cause a deficit capital account balance. While the IRS can force a partnership to change the way it makes allocations, it cannot control to whom a partnership makes distributions.

The IRS needed a mechanism for eliminating the deficit capital account of a partner who has no obligation to restore it. That mechanism was to require the partnership to allocate income to the partner to offset any such deficit. Further, distributions are not the only events that the IRS cannot control that can cause a capital account to become negative. Certain provisions of Subchapter K can require allocations to a partner that might create a deficit capital account, so the IRS needed to account for these as well. Finally, it is obviously preferable to avoid the deficit capital account to begin with. To this end, the partnership is required to reduce the capital account for certain reasonably expected future events before determining whether or not the proposed allocation will create a deficit capital account. These adjustments are only for purposes of testing whether a current allocation will cause a partner to have a negative capital account. Once this testing has been done, the adjustments for future events are backed out of the capital accounts. They are not permanent adjustments to the capital account. For example, assume a partnership wants to allocate $8,000 of depreciation to a partner who does not have a deficit restoration obligation and falls within the alternate rules. The partner has a $15,000 balance in his capital account. Further assume that under the rules the partnership must reduce his capital account for testing purposes for a $10,000 distribution expected to be made in a future year. That would temporarily give the partner a $5,000 balance in his capital account, meaning that only $5,000 of the $8,000 of depreciation could be allocated to him. After that determination, the $10,000 reduction for the future distribution is removed from the capital account, restoring it to $15,000, and then it is reduced for the $5,000 of depreciation that may be allocated to the partner.

The regulatory rule allowing allocations where a partner does not have an unlimited deficit restoration obligation:

(1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied (i.e., keep capital accounts in accordance with the rules and liquidate in accordance with capital account balances), and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(3) The partnership agreement contains a "qualified income offset," such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for—

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of 1.751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made.[13]

A partnership agreement contains a "qualified income offset" "if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible."[14]

Thus, in the example discussed above, assuming there are no "reasonably expected" future events, if A has no deficit restoration obligation, the allocations to her will still be effective as long as they do not cause her to have a negative capital account.[15]

As the Regulations indicate, sometimes partners have limited deficit restoration obligations. They will agree to restore a deficit in their capital account up to a certain amount, but not beyond that. In this circumstance, the partnership will need to comply with the qualified income offset rules, and allocations can be made to a partner that create a negative capital account up to the fixed amount that partner is obligated to restore. Thus, if a partner has a $10,000 deficit restoration obligation, he could be given allocations that caused him to have up to a $10,000 negative capital account as long as the partnership otherwise complies with the qualified income offset rules.

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[13] Treas. Reg. § 1.704-1(b)(2)(ii)(d). I.R.C. §§ 704(e)(2) and 706(d) are discussed below at §§ 5.08 and 5.09, respectively. I.R.C. § 751(b) (the Code section which the relevant Regulation addresses) is discussed in Chapter 7.

[14] Treas. Reg. § 1.704-1(b)(2)(ii)(d).

[15] The allocation could also not increase a negative capital account she already had for some reason.

3. Economic Effect Equivalence

The Regulations contain an "economic effect equivalence test." Allocations made to a partner that do not otherwise have economic effect under the rules discussed above can nevertheless be deemed to have economic effect under this test. The economic effect equivalence test is met provided that a liquidation of the partnership at the end of the year would produce the same economic results to the partners as would occur if the formal economic effect test were met, regardless of the economic performance of the partnership.[16] For example, assume A and B contribute $ 75,000 and $ 25,000, respectively, to the AB partnership. Assume further that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75 percent to G and 25 percent to H. G and H are ultimately liable (under a state law right of contribution) for 75 percent and 25 percent, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of the economic effect rules discussed above, the allocations have economic effect under the economic effect equivalence test.[17]

C. Substantiality

1. General Rules

For all of their complexity, the economic effect rules are not enough to get the job done. They are, in effect, mechanical rules, and rules can be inappropriately manipulated. Accordingly, the Regulations provide that not only must the allocation have economic effect, that economic effect must be substantial. Initially the Regulations provide, quite unhelpfully, that the economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners independent of tax consequences.[18] The Regulations then go on to provide that an allocation is *not* substantial if:

(1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and

(2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement.

Or, as one of the authors tells his students, the allocation is not substantial if on a present value, after tax basis, someone is better off and no one is worse off than would be the case if no allocation had been made. Under these circumstances, it means that the allocation had a tax effect, but no economic

[16] Treas. Reg. § 1.704-1(b)(2)(ii)(i).

[17] This example is based on Treas. Reg. § 1.704-1(b)(5), Example 4(ii).

[18] Treas. Reg. § 1.704-1(b)(2)(iii)(a).

effect (on a present value basis). For there to be an economic effect, if someone is better off, some else has to be worse off.

For example, assume taxpayers A and B are equal partners in the AB partnership. A expects to be in the 50% tax bracket over the next several years.[19] B, on the other hand, expects to be in the 15% tax bracket. Over the next several years the partnership expects to earn approximately equal amounts of tax-exempt interest and taxable dividends. A and B agree that 80% of the tax-exempt income will be allocated to A and the balance of the tax-exempt income and all of the taxable dividends will be allocated to B. The partners can make this allocation without violating any of the economic effect rules. But according to the Regulations, the economic effect of the allocation will not be substantial, because on a present value, after tax basis, A's position is enhanced (compared to the situation she would be in if she had received half of each type of income) and B's position is not diminished (indeed his position is also enhanced).

Assume the partnership has $10,000 of tax-exempt income and $10,000 of taxable dividends. Under the allocation agreement, $8,000 of tax-exempt income is allocated to A. She owes no tax and so will net $8,000. The other $2,000 of tax-exempt income plus all of the taxable dividends are allocated to B. He will owe a tax of $1,500 on the taxable dividends, and so will net $10,500 ($12,000 − $1,500). Recall that you always have to contrast a given allocation with the alternative, that is, if the allocation were not present. Knowing that alternative is not always easy, but here it would be each partner receiving 50% of each type of income. If A received $5,000 of tax-exempt income and $5,000 of taxable dividends, his tax on the latter would be $2,500, for a net return of $7,500. So A's position is improved with the allocation. If B received $5,000 of tax-exempt income and $5,000 of taxable dividends, he would owe a tax on the dividends of $750, netting him $9,250. Thus, B's position is also enhanced. Since both partners improved their economic position as a result of the allocation, it means that all that was allocated were tax attributes, not economic attributes, and the economic effect of the allocation therefore cannot be substantial.[20]

2. Shifting and Transitory Allocations

The Regulations provide some additional fine-tuning to the substantiality rules for what the Regulations call "shifting" and "transitory" allocations. Generally, shifting allocations occur within a single tax year, and transitory allocations occur over a period of up to five years. In either case, the economic effect of an allocation will not be substantial if there is a strong likelihood that the capital accounts of the partners would be about the same as they would have been had the allocation not been made and the allocation results in a net reduction of the partners' tax liability.

[19] This example is based on Treas. Reg. § 1.704-1(b)(5), Example 5, which uses this now fictitious 50% tax bracket. Even today it is possible for a taxpayer to approach this tax bracket if state and Federal income tax are combined and the taxpayer lives in a state with high income taxes.

[20] Some have criticized the regulatory example because A could have independently made the investments in tax-exempt securities and paid no tax, so why not allow it in a partnership?

Beginning with shifting allocations, assume our AB partnership now owns I.R.C. § 1231 property and capital assets and it expects to sell each type of property in the current tax year and incur a $50,000 I.R.C. § 1231 loss and a $50,000 capital loss. The partnership agreement complies with the economic effect rules. Partner A has ordinary income of $300,000 and no I.R.C. § 1231 gains. She can therefore fully use the I.R.C. § 1231 loss, but make only limited use of the capital loss.[21] Partner B has $200,000 of ordinary income and $100,000 of I.R.C § 1231 gains, meaning that he can fully use either type of loss and receive the same tax benefit. The partnership amends the partnership agreement and provides that for the current tax year only, all I.R.C. § 1231 losses will be allocated to A and all capital losses will be allocated to B. While the allocation will have economic effect, the economic effect will not be substantial because there is a strong likelihood that A and B will have the same capital account balances if the allocation were not contained in the partnership agreement (still a $50,000 loss each, consisting of equal parts of each type of loss), and the total taxes of A and B are reduced as a result of the allocation (A's taxes go down, B's taxes are unaffected).[22]

Transitory allocations operate in essentially the same way as shifting allocations, except they occur over a period of years. Under the Regulations, if there is a strong likelihood that (1) an "original allocation" and a later "offsetting allocation" will leave the capital accounts approximately where they would have been had the allocations not occurred and (2) the tax liability of the partners will be reduced as a result of the allocations, than the economic effect of the allocations will not be substantial. The Regulations provide that if the offset happens and taxes are reduced, it will be presumed that there was a strong likelihood that this would happen unless the taxpayers can present facts and circumstances demonstrating otherwise. However, if there is a strong likelihood that the offsetting allocation will not be made "in large part" within five years of the original allocation, then the economic effect of the allocation will be substantial.[23]

For example, assume that our AB partnership has predictable, approximately equal amounts of income each year and A has an expiring net operating loss. To allow A to take greater advantage of the net operating loss, the partnership allocates all of its income in year 1 to A. It allocates all of its income in year 2 to B. Thereafter, it returns to allocating income equally between the partners. The partnership agreement complies with the economic effect rules. The economic effect of the allocation is insubstantial because there is a strong likelihood of the offset occurring and the partners' tax liability is less

[21] Under I.R.C. § 1231, if a taxpayer has losses in excess of gains from the sale of I.R.C. § 1231 property, the losses and gains are generally treated as ordinary losses. If I.R.C. § 1231 gains exceed I.R.C. § 1231 losses, the gains and losses are generally treated as long-term capital gains and losses. Under I.R.C. § 1211(b), capital losses are fully deductible from capital gains. Individuals may only deduct $3,000 of capital losses in excess of capital gains from ordinary income.

[22] This example is based on Treas. Reg. § 1.704-1(b)(5), Example 6.

[23] Treas. Reg. § 1.704-1(b)(2)(iii)(c).

than it would have been without the allocation (the allocation lowers A's taxes and, except for time value of money considerations, is neutral as to B). Note that if the offset would occur more than five years after the original allocation (not that B would ever agree to that), the allocation would be allowed.[24]

3. Depreciation/Recapture Gain Chargebacks

It is quite common for partnership agreements to contain provisions that provide that gain on the sale of an asset equal to the prior depreciation deductions taken shall be allocated to the partners in the same manner as the depreciation itself was allocated. Such a provision is sometimes called a "gain chargeback." You might ask whether there is a transitory allocation issue, assuming the gain is recognized within five years of the depreciation deduction. The answer is no. There cannot be a strong likelihood of the offset occurring, since the Regulations assume, as we discussed early in this Chapter, that a property has a fair market value equal to its book basis.[25] Any gain is, given the presumption, a "surprise."

Gain chargebacks generally do not pose a problem in the case of depreciable real estate subject to straight-line depreciation as the character of the gain does not change even if it is attributable to the fact that depreciation deductions reduced the basis of the property.[26] There can be a substantiality issue when the gain is from the sale of equipment or other depreciable personal property. Generally, under I.R.C. § 1245, gain equal to the depreciation deductions taken is "recaptured" as ordinary income. Any gain beyond that amount typically falls within I.R.C. § 1231. The economic effect of the allocation of recapture income cannot be substantial as all that is being allocated is a tax attribute. In other words, whether you allocate $100 of I.R.C. § 1245 gain or $100 of I.R.C. § 1231 gain, the capital account goes up by the same amount. Thus, the only difference in the allocations is the tax effect, and as we have learned, an allocation of a tax attribute fails the substantiality test. Nonetheless, the Regulations permit allocations of depreciation recapture. Specifically, the Regulations provide that a partner's share of recapture gain is the lesser of:

— the partner's share of total gain from the disposition of the property, or

— the partner's share of depreciation with respect to the property.[27]

Thus, generally, the Regulations allocate depreciation recapture to the partners who were allocated the associated depreciation deductions. Assume partnership AB purchases equipment for $10,000 and takes $6,000 of depreciation

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[24] This example is based on Treas. Reg. § 1.704-1(b)(f), Example 8(ii).

[25] Treas. Reg. § 1.704-1(b)(2)(iii)(c).

[26] Straight-line depreciation is typically the only type of depreciation allowed. I.R.C. § 168(b)(3). Even if there is character difference, there may be a capital gain tax rate differences on the gain from depreciated real property. *See* I.R.C. § 1(h)(6); *see also* I.R.C. § 1250; Treas. Reg. § 1.1250-1(f).

[27] Treas. Reg. § 1.1245-1(e)(2)(i). Special rules apply to depreciation recapture attributable to property contributed by a partner.

deductions. The depreciation deductions reduce the equipment's basis to $4,000.[28] All the depreciation deductions are properly allocated to A. Then the partnership sells the equipment for $7,000. On the sale, the partnership has $3,000 of gain, all of which would constitute I.R.C. § 1245 recapture. The partnership agreement contains a depreciation chargeback provision allocating gain equal to depreciation to the partners who were allocated the depreciation. The gain recognized by the partnership is less than the total depreciation taken. Under the partnership agreement, A is thus allocated all of the gain. This allocation is allowed by the Regulation discussed above. In this case, A's share of the gain is the "lesser figure," and all the gain allocated to A is recapture income. Now assume the partnership sold the equipment for $13,000. Under the partnership agreement, the first $6,000 of gain is allocated to A, and the remaining $3,000 of gain is allocated equally to A and B. The total gain allocated to A from the sale is thus $7,500. In this case, the lesser figure is the depreciation allocated to A or $6,000, and that amount is recapture income. The balance of the $1,500 of gain allocated to A (and B) falls within I.R.C. § 1231.

4. Tax Credits

Allocations of tax credits and tax credit recapture are not reflected by adjustments to the partners' capital accounts. Therefore, their allocation cannot have economic effect. As we have discussed above, and will discuss below, if an allocation does not comply with the substantial economic effect safe harbor, it must be allocated in accordance with the "partners' interests in the partnership." The Regulations provide that if an allocation of a tax credit also gives rise to a valid allocation of partnership loss or deduction, then the credit may be allocated in the same proportion as the partners' respective shares of the loss or deduction.[29]

5. "q" Adjustments

For reasons too complex to address here, it is possible that the allocation system discussed above will not get the taxpayers to the "right" place, even if they try to comply with it. Treas. Reg. § 1.704-1(b)(2)(iv)(q) provides that if guidance is lacking on how to properly maintain capital accounts, capital accounts should be made in a manner that (1) maintains equality between the aggregate governing capital accounts of the partnership and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (2) is consistent with the underlying economic arrangement of the partners, and (3) is based, wherever practicable, on Federal tax accounting principles. These adjustments are sometimes called "q" adjustments.

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[28] I.R.C. § 1016.

[29] Treas. Reg. § 1.704-1(b)(4)(ii). This rule would not apply to the "investment tax credit" were it still part of the Code, which (with the exception of the rehabilitation tax credit) it is not.

§ 5.04 PARTNER'S INTEREST IN THE PARTNERSHIP

As we discussed above, the substantial economic effect rules constitute a safe harbor. Allocations that comply with those rules will be allowed. If a partnership agreement does not meet the substantial economic effect safe harbor, any allocations must be made in accordance with the partners' "interest in the partnership." While the Regulations contain very extensive provisions on the substantial economic effect rules, they contain very little discussion of how a partnership should determine its partners' interests in the partnership. The Regulations provide a nonexclusive list of factors that should be considered:

1. The partners' relative contributions to the partnership.
2. The interests of the partners in economic profits and losses (if different than in taxable income or loss).
3. The interests of the partners in cash flow and other non-liquidating distributions.
4. The rights of the partners to distributions of capital upon liquidation.

It is happening with increasing frequency that practitioners will consciously avoid the substantial economic effect rules and instead develop an allocation system they believe is consistent with the partners' interests in the partnership. One of this text's authors helped organize a billion-dollar partnership between two major corporations. Each corporation held a 50% interest in the partnership. The partners wanted to be certain they would each receive their 50% share of the assets when the partnership was liquidated. Since all income, losses, and distributions were to be allocated on a 50/50 basis, there was no need to worry about the substantial economic effect rules. The partnership agreement contained no tax or capital account provisions and simply provided that contributions and distributions (and percentage interests) were 50/50. In the words of the co-author: "[There was] no tax gobbledygook to explain to the business people."[30]

[30] *See* Treas. Reg. § 1.704-1(b)(5), Ex. 5. Hedge funds organized as partnerships also often do not comply with the substantial economic effect rules. In many ways, however, the intent of hedge funds is consistent with the substantial economic effect rules. The hedge fund agreements provide that taxable income is to be allocated to the partners who are likely to get the economic benefit of the income. But it is not uncommon for the hedge funds to ignore the substantial economic effect rules because of potential distortions that those rules could create in the economic sharing arrangement to which the partners have agreed. Instead, the hedge funds create an economic capital account (a "trading account"). This trading account reflects the sharing arrangement of the parties and often includes unrecognized gains and losses. Income and losses are allocated in proportion to a partner's trading account. It is also common in commercial partnerships that are intended to survive for an extended period of time to not liquidate according to capital accounts, because of the broad uncertainties as to how capital accounts are maintained. Practitioners sometimes disagree on what the capital account rules require. Allocations in more complex deals that are based on a partner's interest in the partnership generally take a tiered approach with income allocations following rights to cash flow. Loss allocations are in inverse order to the income allocations and then zero out contributed capital.

§ 5.05 BOOK-TAX DISPARITIES—I.R.C. § 704(c) ALLOCATIONS

A. Introduction

Under I.R.C. § 721, no gain or loss is recognized when a partner contributes property to the partnership. The partnership takes a carryover basis in the property under I.R.C. § 723 and the contributing partner takes a substituted basis in the property under I.R.C. § 722. Yet when the partners put their deal together, the primary focus is on the economics, not the tax basis. What is of primary importance is the fair market values of contributed property. This disjuncture between tax basis and economic value gave rise to a host of complex rules.

Example 1

A contributes Land #1 to the AB partnership in which A and B have equal interests. The land has a tax basis of $ 7,000 and a fair market value of $10,000. The partnership takes a tax basis in the property of $7,000, A's tax basis in her partnership interest is increased by that amount, and no gain or loss typically is recognized to A or the partnership under I.R.C. § 721(a). Note that there is $3,000 of tax gain inherent in the property. If the partnership now sells the property for $10,000, to whom should that gain be taxed? The gain arose on A's "watch," so it would make sense for the gain to be taxed to A and indeed, I.R.C. § 704(c) so provides. But for I.R.C. § 704(c), on the sale of the property, half of the tax gain would be taxed to B instead of A. Permitting that violates assignment of income principles, though it should be noted that the shift need not be permanent.

Assume B contributed $10,000 to the partnership and thus has a $10,000 basis in his partnership interest. If $1,500 of the tax gain is taxed to B, B's tax basis increases to $11,500. If the fair market value of B's interest does not change, upon the sale or liquidation of B's interest, B would recognize a $1,500 tax loss offsetting the prior gain. But there could be a significant time lag between the gain and the loss, and there could be a character difference as well. If the land was a lot sold by the partnership in the ordinary course of its trade or business, the gain would be ordinary income whereas B's loss would be a capital loss. I.R.C. § 704(c) also avoids these distortions.

In the absence of I.R.C. § 704(c), could the partnership have made a special allocation of the tax gain in A's land to B under § 704(b)? The answer is no. Recall that the land would be recorded on the books of the partnership at its fair market value of $10,000 (i.e. it has a book value of $10,000). If it were sold for $10,000, there would have been no book gain or loss to allocate, and I.R.C. § 704(b) only applies to *book* gains and losses, not to tax gains and losses. Tax gains and losses do not affect the capital accounts and therefore their allocation cannot have substantial economic effect. How is the tax gain handled? I.R.C. § 704(c)(1)(A) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property and its fair market value at the time of contribution. In the fact pattern we have been discussing, that means that $3,000 of the gain is taxed to A.

What if the property were sold for $12,000? The tax gain would be $12,000 - $7,000 = $5,000. The book gain would be $12,000 - $10,000 = $2,000. The $2,000 of book gain would be allocated equally to A and B or $1,000 each. Under I.R.C. § 704(c), the tax gain would be allocated $3,000 + $1,000 = $4,000 to A and $1,000 to B. Note that in this example, the tax gain equal to the book gain ($1,000 per partner) is allocated in the same manner as the book gain, and the tax gain in excess of the book gain ($3,000) is allocated to the contributing partner. That makes sense. Generally, a partner should receive tax gain equal to his share of book gain. If tax gain exceeds the book gain, it means that the property had gain inherent in it on contribution to the partnership. That gain (here the $3,000) should be taxed to the contributing partner, and I.R.C. § 704(c) provides that it is.

Under the Regulations, I.R.C. § 704(c) property is contributed property that at the time of contribution has a book value that differs from its tax basis.[31] Note that if partners have contributed such property to the partnership, the partnership will have to keep two sets of books. One set will contain the book values of the partnership properties and the other will contain the tax values. The book items will be allocated based on the I.R.C. § 704(b) Regulations, commonly according to the substantial economic effect rules. These allocations generally reflect the economic sharing agreement of the parties. The tax items, when they differ form the book items, are allocated under the I.R.C. § 704(c) Regulations and generally must be determined so as to take account of the variation between the adjusted tax basis and the fair market value of the contributed property.[32] Thus, in Example 1 in which the property was sold for $12,000, the tax and book accounts would be:

	A		B	
	Tax	Book	Tax	Book
Formation	$7,000	$10,000	$10,000	$10,000
Gain	$4,000	$1,000	$1,000	$1,000
Balance	$11,000	$11,000	$11,000	$11,000

As we will see, I.R.C. § 704(c) and its Regulations are very complex, but this is the foundation. Be sure you understand it before proceeding further.[33] Note that after the sale, the book and tax accounts are equal. An objective of I.R.C. § 704(c) is to eliminate the disparities between the book and tax accounts. As we shall see, however, it is not always possible to do so.

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[31] Treas. Reg. § 1.704-3(a)(3)(i).

[32] Treas. Reg. § 1.704-1(b)(1)(vi).

[33] Treas. Reg. § 1.704-3(e) provides that a partnership can opt out of I.R.C. § 704(c) if there is only a "small disparity" between the book value of the property contributed by a partner in a single tax year and its tax basis. A small disparity exists if the book value of all properties contributed by one partner during the partnership's tax year does not differ from its tax basis by more than 15% and the total gross disparity does not exceed $20,000.

B. I.R.C. § 704(c) Methods of Allocation

1. The Traditional Method

The traditional method used to be the only method of allocation allowed by the Regulations. It can lead to distortions. When other methods were added that can remove the distortions, the original approach was given the moniker "traditional method." Example 1 used a simple form of the traditional method. The tax gain or loss inherent in contributed property is allocated to the contributing partner. Any tax gain or loss in excess of that amount is allocated in the same manner as the partnership allocates the book gain or loss on the property.

The difficulty with the traditional method is that under some circumstances it cannot eliminate the disparity between the tax and book accounts.

Example 2

Assume the same facts as in Example 1 except that the land A contributed declines in value and is sold for $8,000. The partnership experiences a $2,000 economic loss, the amount by which the land dropped in value. But because the tax basis of the property is $7,000, there is actually a tax gain of $1,000. Ideally, A should be given a $3,000 tax gain, and the partnership then given a $2,000 tax loss. That would be fair. A realized, but under I.R.C. § 721 did not recognize, $3,000 of gain when she contributed the land to the partnership. The partnership in fact suffered an economic loss of $2,000, and ideally it should be given a tax loss to match its economic loss. A would then have a net tax gain of $2,000 ($3,000 gain - $1,000 loss) and B would have a $1,000 tax loss. But under what has become known as the ceiling rule, if the traditional method is used, these tax gains and losses cannot be created. No partner can be allocated a tax gain or loss other than that which actually incurred. The partnership's tax basis in the land is $7,000. If it sells it for $8,000, it incurs a $1,000 tax gain. That is its "ceiling." It cannot create a greater tax gain or create any tax losses.[34] Accordingly, the tax and book accounts would be:

	A		B	
	Tax	Book	Tax	Book
Formation	$7,000	$10,000	$10,000	$10,000
Gain	$1,000	($1,000)	0	($1,000)
Balance	$8,000	$9,000	$10,000	$9,000

The tax and book accounts are now out of balance, and while the partnership operates, there is no way to bring them into balance under the traditional method. Only upon liquidation could the distortions be cured. If, after the sale of the land, the partnership distributed its $18,000 to the partners, each partner would be given the balance in the capital account, or $9,000. For tax purposes, A would recognize $1,000 of gain ($9,000 -$8,000) and B would recognize $1,000 of loss ($9,000 - $10,000). The distortions between the tax and book accounts would be eliminated. As we discussed above, however, the character of

[34] *See* Treas. Reg. § 1.704-3(b)(1).

the gain and loss recognized on liquidation could be different than that associated with the land and the liquidation may occur many years after the disposition of the land. Finally, if a partner dies before liquidation, his heirs take a fair market value basis as of the date of death under I.R.C. § 1014, eliminating any tax gain or loss inherent in the partnership interest that existed before then. Thus, in the example above, if B dies before the partnership is liquidated, the one thing he can take with him is his unrecognized tax loss.

The distortions caused by the ceiling rule caused the IRS to promulgate Regulations providing two optional alternatives. We discuss those next.

2. Traditional Method with Curative Allocations

Under this method, a partnership may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for *tax* purposes. Recall that the objective is to bring the tax accounts in line with the book accounts, so it would only be appropriate to adjust the tax items. The curative allocation must be of an actually existing tax item incurred by the partnership (it can't make it up), cannot exceed the amount necessary to correct the distortion caused by the ceiling rule, and must generally be of the same character as the tax item limited by the ceiling rule.[35]

Example 3

Assume that in Example 2 the partnership invested the $10,000 B contributed in another parcel of land (Land #2) that it subsequently sold for a book and tax gain of $4,000. Assume both parcels are capital assets to the partnership with holding periods of over one year and thus the character of the gain or loss on each is the same. The book gain would have to be allocated equally, but under the curative allocation method the tax gain could be allocated $3,000 to A and $1,000 to B. By being given less tax gain, B in effect receives a tax loss equal to his book loss on Land #1 and A is placed in the same position as if she had recognized her entire initial gain ($3,000) and then received a $1,000 tax loss equal to her book loss on Land #1. After the smoke clears, the book and tax accounts would be equal:

	A		B	
	Tax	Book	Tax	Book
Formation	$7,000	$10,000	$10,000	$10,000
Sale Land #1	$1,000	($1,000)		($1,000)
Sale Land #2	$3,000	$2,000	$1,000	$2,000
Balance	$11,000	$11,000	$11,000	$11,000

[35] *See* Treas. Reg. § 1.704-3(c). If depreciation deductions have been limited by the ceiling rule, the general limitation on character does not apply to income from the disposition of contributed property subject to the ceiling rule. For example, if allocations of depreciation deductions to a noncontributing partner have been limited by the ceiling rule, a curative allocation to the contributing partner of gain from the sale of that property can be considered reasonable. *See* Treas. Reg. § 1.704-3(c)(3)(iii)(B).

A partnership may make a curative allocation in one tax year to offset the effect of the ceiling rule for a prior tax year if the allocations are made over a "reasonable" period of time, and provided for in the partnership agreement for the year of the contribution.[36] The traditional method with curative allocations tends to be used less often than the traditional method or the remedial method (discussed next). The reason for this is that the curative method is neither as taxpayer-friendly to the contributor as the traditional method nor as likely to remedy book-tax disparities as the remedial method.[37]

3. Remedial Method

The problem with the traditional method with curative allocations is that the partnership may not actually incur tax items that can properly offset other tax items limited by the ceiling rule. The Regulations respond by giving the partnership the option of using the remedial method. This method permits the partnership to create the offsetting tax item out of whole cloth. Again, the book accounts are unaffected. It is only tax items that can be adjusted.

Under the remedial method, the partnership first determines the partners' share of book items under I.R.C. § 704(b). The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method. If the ceiling rule causes the tax item to differ from the book items, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.[38] The remedial allocations have the same tax attributes as the tax item limited by the ceiling rule. Thus, if the ceiling rule limited item is an item of long-term capital loss from the sale of a capital asset that was contributed to the partnership, the offset will be long-term capital gain.[39]

Example 4

The facts are the same as in Example 2 and Land #1 is a long-term capital asset to the partnership. The book accounts are unaffected. For tax purposes, the partnership would create $1,000 of long-term capital loss that it would allocate to B and would create $1,000 of offsetting long-term capital gain that it would allocate to A. This gives B a tax loss equal to his book loss. It places A in the same position as if she had recognized her entire initial gain ($3,000) and then received a $1,000 tax loss equal to her book loss. The tax and book

[36] Treas. Reg. § 1.704-3(c)(ii). The Regulations suggest that a property's economic life is a reasonable period.

[37] *See* ARTHUR WILLIS, JOHN PENNELL & PHILIP POSTLEWAITE, PARTNERSHIP TAXATION ¶ 10.08[3][b] (6th ed.) ("PARTNERSHIP TAXATION").

[38] Treas. Reg. § 1.704-3(d)(1).

[39] *See* Treas. Reg. § 1.704-3(d)(3).

accounts thus would be:

	A		B	
	Tax	Book	Tax	Book
Formation	$7,000	$10,000	$10,000	$10,000
Sale Lane #1	$1,000	($1,000)		($1,000)
Remedial	$1,000		($1,000)	
Balance	$9,000	$9,000	$9,000	$9,000

4. Depreciation

The manner in which depreciation, amortization, and depletion is allocated amongst the partners is also governed by I.R.C. § 704(c)(1)(A). We will focus on depreciation deductions. Recall that the purpose of I.R.C. § 704(c)(1)(A) is to eliminate the disparities between book and tax accounts. Generally, a non-contributing partner should receive tax depreciation equal to that partner's share of book depreciation with the balance of the depreciation being allocated to the contributing partner. The rules are designed to help achieve that objective. This is most easily understood by way of an example.

Example 5(a)

In our ubiquitous AB partnership, in which A and B are equal partners, assume A contributes depreciable equipment with a tax basis of $6,000 and a book value of $10,000 and B contributes $10,000 cash. The equipment is depreciated using the straight-line method at the rate of 10% per year. Tax depreciation is $600 per year, and book depreciation is $1,000 per year. The book depreciation is allocated equally between the partners, or $500 each. The tax depreciation is allocated $500 to B. The balance of $100 is allocated to A.[40] The approach is logical. In a sense, B gave A $10,000 of "credit" for the equipment she contributed and should therefore receive, if possible, his full share of the tax depreciation based on that amount, that is tax depreciation equal to his share of book depreciation. This approach will also have the effect of eliminating the disparities between the tax and book accounts over time:

	A		B	
	Tax	Book	Tax	Book
Formation	$6,000	$10,000	$10,000	$10,000
Depreciation Years 1–10	$1,000	($5,000)	($5,000)	($5,000)
Balance	$5,000	$5,000	$5,000	$5,000

Now assume the property is sold at the end of year two for $9,000. Its tax basis at that time would be $4,800 ($6,000 - $1,200 depreciation) and its

[40] This example is based on Treas. Reg. § 1.704-3(b), Example 1.

book basis would be $8,000 ($10,000 -$2,000 depreciation). There would be tax gain of $4,200 ($9,000 - $4,800) and $1,000 of book gain ($9,000 - $8,000). How are the tax and book gain allocated? Book gain is allocated equally to the partners, or $500 each. Tax gain equal to book gain is allocated in the same manner as book gain, or $500 per partner. Tax gain in excess of book gain of $3,200 ($4,200 − $1,000) is entirely allocated to A, the contributing partner. Note that if the partnership sold the property immediately after it was acquired, the gain that would have been allocated to A is $4,000. After two years, the gain allocated to A is $800 less than that. Why did it go down? Because the tax and book accounts were "caught up" by two years of "preferential" allocations of the tax depreciation to B. Each year B received $400 more depreciation than A, or $800 over two years, hence there is less gain to be allocated to A under I.R.C. § 704(c)(1)(A).

Example 5(b)

The facts are the same as in Example 5(a), except the property that A contributes has a basis of $4,000. The tax depreciation is now $400 per year. The book depreciation remains $1,000 per year. The book depreciation is again allocated equally to the two partners, or $500 each. In this case, there is not sufficient tax depreciation to give B tax depreciation equal to his book depreciation. The ceiling rule has once again reared its ugly head. If the traditional method is being used, all of the tax depreciation is allocated to B, and a disparity will exist on the books of the partnership:

	A		B	
	Tax	Book	Tax	Book
Formation	$4,000	$10,000	$10,000	$10,000
Depreciation Years 1–10		($5,000)	($4,000)	($5,000)
Balance	$4,000	$5,000	$6,000	$5,000

If the partnership uses the remedial method, it can cure the disparity (though the cure can sometimes be complex).[41] If the partnership uses the traditional method with curative allocations, it can also cure the disparity as long as it incurs another tax item that can be used as an offset.[42]

5. Other Considerations

The Regulations permit the partnership to select different methods for different properties.[43] The partnership may use any "reasonable" method, and a method is not necessarily unreasonable merely because another method will result in a higher tax liability. Indeed, the Regulations provide that a method other than one of the three listed above may be used, though only those three

[41] *See* Treas. Reg. § 1.704-3(d), Ex. 1. If the remedial method is used, book depreciation may need to be computed using different periods for different portions of the book basis. *See* Treas. Reg. § 1.704-3(d)(2).

[42] *See* Treas. Reg. § 1.704-3(c), Ex. 1.

[43] Treas. Reg. § 1.704-3(a)(2).

are described in the Regulations.[44] A method that would violate the anti-abuse rules (*see* Chapter 13) would, of course, not be considered to be reasonable, even if it is one of the three specified methods.

Which method the partnership and its partners will prefer will depend on a number of considerations, including the administrative burden of complying with the latter two methods. An important consideration will be the relative tax brackets of the partners. If they are all in approximately the same tax bracket, they generally will prefer a method that will give a tax consequence that is the same as the economic consequence. When choosing between the traditional method with curative allocations and the remedial method, an important consideration will be whether the partners can live with the "phantom income" that often results from the remedial method. In the traditional method with curative allocations, there is an actual taxable transaction that is being used to eliminate the disparities, which can often mean cash is being generated that can be used to pay any additional taxes. That cash might not be generated in the remedial method as no taxable transaction need take place.

If the partners are in different tax brackets, the analysis may change again. In Example 2, if A is in a high tax bracket and B is in a low tax bracket, and the partners are cooperative, they may prefer the traditional method which gives A less total taxable gain.

Recall that, as we discussed in Chapter 2, I.R.C. § 724 can also apply. I.R.C. § 724 provides that any gain or loss recognized by a partnership on the disposition of contributed unrealized receivables, or contributed inventory items during the first five years the partnership holds them, is treated as ordinary income or loss.

C. New I.R.C. § 704(c)(1)(C)

As we discussed above, losses inherent in contributed property are generally allocated to the contributing partner. Before the passage of the American Jobs Creation Act of 2004, however, it was possible for others to benefit from those losses. For example, a transferee of the contributing partner generally steps into the shoes of that partner for I.R.C. § 704(c) purposes and thus previously could have been allocated any remaining I.R.C. § 704(c) losses. (*See* Chapter 6.) The losses could have been allocated to other partners in the case of a liquidation of the entire partnership, if the contributed property was distributed to another partner, or in the case of a liquidation of the interest of the contributing partner if the partnership continued to hold the contributed property. (*See* Chapter 7.) To address these issues Congress enacted I.R.C. § 704(c)(1)(C) in 2004. It provides that if contributed property has a built-in loss, that built-in loss is taken into account only in determining the amount of items allocated to the contributing partner. In determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership is treated as being equal to its fair market value on contribution.

44 Treas. Reg. § 1.704-3(a)(1).

§ 5.06 REVERSE I.R.C. § 704(c) ALLOCATIONS

An issue similar to the one that exists for contributed property arises if a partner enters a partnership after it has been in business for a while. The partnership may have assets that for book purposes are appreciated or depreciated. That appreciation and depreciation occurred before the new partner entered the partnership and logically should be allocated to the preexisting partners. That is indeed one option. The partnership could amend the partnership agreement to provide that the preexisting gains and losses will be allocated to the preexisting partners. Another option made available by the Regulations is to do what is called a "revaluation," often also called a "reverse I.R.C. § 704(c) allocation."[45] The book values of the assets and the partners' capital accounts are restated to fair market value as of the date the new partner enters the partnership. If that is done, depreciation, gain, and loss on the partnership property for book purposes will be different before and after the revaluation. That difference must be allocated following I.R.C. § 704(c) principles. For this purpose, it is as if a new partnership were formed, with the preexisting partners contributing the assets of the partnership and the new partner making his contribution, with I.R.C. § 704(c) then applied to get the gains, losses, depreciation, etc. to the right parties.

It is perhaps easiest to understand revaluations by way of an example. Assume that A and B again form the equal AB partnership.[46] A and B each contribute $10,000 and thus each have an initial capital account of $10,000. The $20,000 is invested in publicly traded securities. The securities appreciate in value to $50,000. At that time C makes a $25,000 contribution and becomes an equal one-third partner with A and B. The securities further appreciate to $59,000, and the partnership then sells them. Assume (not very realistically) that the partnership has no other activity and no other expenditures or income. The question is how to deal with the $39,000 of gain on the securities. $30,000 of that gain arose before C entered the partnership and properly belongs to A and B. The other $9,000 of gain occurred while C was a partner and belongs to all three partners. Since the $39,000 constitutes both book and tax gain, under I.R.C. § 704(b) the first $30,000 could be allocated equally to A and B and the remaining $9,000 could be allocated equally to A, B, and C.

Alternatively, upon C's entry into the partnership, the partnership could do a reverse I.R.C. § 704(c) allocation and restate the capital accounts and book values of partnership property at fair market value. If that is done, A and B will each have a $25,000 capital account and the securities would have a book value and book basis of $50,000, while continuing to have a tax basis of $20,000. When the securities appreciate to $59,000 and are then sold, there will be $9,000 of book gain and $39,000 of tax gain. The book gain is allocated equally to the three partners. Under the Regulations, the tax gain must be allocated in accordance with I.R.C. § 704(c) principles. That is done by allocating tax gain equal to book gain ($9,000) equally to A, B, and C. The balance of the tax gain ($30,000) is allocated equally to A and B. Conceptually, it is as

[45] Treas. Reg. §§ 1.704-1(b)(2)(iv)(f), 1.704-1(b)(4)(i).

[46] This example is based on Treas. Reg. § 1.704-1(b)(5), Example 14.

if the parties formed a partnership with A and B contributing securities with a tax basis of $20,000 and a fair market value of $50,000 and C contributing $25,000, the securities appreciating to $59,000, and then being sold.

Any of the I.R.C. § 704(c) allocation methods may be used in reverse I.R.C. § 704(c) allocations. To make matters more complex, the method used for a reverse I.R.C. § 704(c) allocation with regard to a particular property need not be the same as the method used for that property for "regular" I.R.C. § 704(c) allocation purposes.[47]

Revaluations are optional[48] and are allowed only under certain circumstances. The adjustments must be based on the fair market value of partnership property on the date of the adjustment and be principally made for a non-tax business purpose:

- — in connection with the contribution of money or property in exchange for a new or increased partnership interest;
- — in connection with the distribution of money or property in liquidation of part or all of a partnership interest;
- — in connection with the issuance of a partnership interest in exchange for services performed by someone acting in a partner capacity or in anticipation of becoming a partner; or
- — under generally accepted industry accounting practices, provided substantially all of the partnership's property, excluding money, consists of securities readily tradeable on an established securities market.[49]

Note that the partnership's tax bases in its assets and the partners' tax bases in their partnership interests are unaffected by a revaluation.

When would a partnership prefer a revaluation over an I.R.C. § 704(b) allocation? Revaluations are common in hedge and other investment funds holding marketable securities where partners may have the right to buy in and be bought out at some version of book value and there is a fair amount of partner turnover. By doing revaluation, the book values are kept current for these purposes. It has been noted that applying I.R.C. § 704(c) to revaluations results "in massive complexity for the sake of theoretical purity."[50]

What if in the example the partnership did none of the above? What if it did not do a revaluation and simply allocated the $39,000 of gain equally between the three partners. While there is technically nothing to stop this, the question arises as to why the partnership and the partners would agree to this (assuming they are properly informed, not always a given). Keep in mind that if A and B shift book gain to C, they lose the concomitant capital account increase, meaning less will be distributed to them on liquidation. Therefore, not only book and tax gain are being shifted to C, but economic value as well. Why would A and B

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[47] *See* PARTNERSHIP TAXATION at ¶ 10.08[3].

[48] Though the Proposed Regulations for noncompensatory options require revaluations in some circumstances. *See* Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(s)(1).

[49] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(f).

[50] PARTNERSHIP TAXATION at ¶ 10.08[3].

do this? Well, it might be disguised compensation to C or it might be a gift to C and the IRS could restructure it in line with its true status.[51]

§ 5.07 ALLOCATIONS OF NONRECOURSE DEDUCTIONS

A. Introduction

A good grasp of how nonrecourse liabilities are allocated among the partners is necessary for an understanding of this area. Review Chapter 3, which discusses the allocation of nonrecourse liabilities, if necessary.

It is common for partnerships, particularly partnerships involved in the real estate industry, to use nonrecourse financing. The use of nonrecourse financing involves more than just tax planning. Avoiding personal liability is preferable for obvious reasons. Lenders would, of course, prefer recourse lending, but often make nonrecourse loans to stay competitive in the lending market. As you learned in Chapter 3, a partner's share of partnership nonrecourse liabilities increases his basis in the partnership interest. Subject to the at-risk rules of I.R.C. § 465 and the passive loss rules of I.R.C. § 469, a partner may deduct his share of partnership losses to the extent of his basis in the partnership interest.[52]

The use of nonrecourse financing, however, does pose a dilemma for partnership allocations. Recall that the cornerstone of the substantial economic effect rules is that allocations have a genuine economic effect on the partners. This poses a problem for deductions generated by nonrecourse debt ("nonrecourse deductions,"[53] a term we will define more precisely below), such as depreciation deductions for the part of a property's basis attributable to nonrecourse debt. The partners only have an economic risk to the extent of any cash or property invested. To the extent that basis and associated deductions are generated by nonrecourse debt, in truth only the lender is at risk. If the venture fails, the partners can walk away without any personal obligation on the debt. If the deductions generated by the nonrecourse deductions cause the partners to have negative capital accounts, a deficit restoration obligation may not be very meaningful. If all of the partners have negative capital accounts, which commonly eventually occurs when nonrecourse debt is used, there will be no one to enforce deficit restoration obligations.[54] Consequently, if property is purchased with nonrecourse debt, only allocations of deductions attributable to the equity invested by the partners can have economic effect.[55]

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[51] *See* Treas. Reg. §§ 1.704-1(b)(5), Ex. 14(iv), 1.704-1(b)(1)(iv).

[52] I.R.C. § 704(d) (provides that losses in excess of basis may be carried forward indefinitely).

[53] Treas. Reg. § 1.704-2(b)(1).

[54] Unless the lender could make a claim under a third party beneficiary theory. Giving the lender such a claim would be something of a stretch, since the parties normally intend no personal obligation on the part of the partners, and enforcing a deficit restoration obligation would create that obligation.

[55] If recourse debt was also used, deductions attributable to the recourse debt can also have economic effect.

Allocations of nonrecourse deductions (deemed to occur after the equity has been fully "used up" by depreciation and other deductions that reduce basis) cannot have economic effect.

Example 1

Assume in our AB partnership that A and B invest no funds in the partnership and the partnership borrows $200,000 on a nonrecourse basis and uses the proceeds to buy an apartment building for $200,000. No principal payments on the debt are due for 5 years. Capital accounts are not increased for a partner's share of loan proceeds, so the partners' beginning capital accounts are zero. If the property drops in value to $150,000, the partners could simply default on the loan and would not be obligated to make any payment to the lender. The lender bears the risk of loss on the decline in value of the property. Now assume that the AB partnership takes $20,000 in depreciation deductions on the property. If we assume that the partnership breaks even except for depreciation deductions, A and B will have negative capital accounts of $10,000 each and the partnership's basis in the property will be reduced to $180,000. In the unlikely event that A and B have deficit restoration obligations, it would not be meaningful as there would be no one to enforce it. Thus, neither A nor B have borne the economic burden of the allocation, and thus the allocations to them cannot have economic effect.

Since the allocation of nonrecourse deductions cannot have economic effect, the general rule of the Regulations is that they must be allocated in accordance with the partners' "interests in the partnership."[56] As we now know, that standard is quite vague. The use of nonrecourse debt is fairly common and there are legitimate nontax reasons for its use. It was thus incumbent on the IRS to come up with a more definite approach that would permit partners to allocate nonrecourse deductions, and indeed the Regulations provide a safe harbor. The cornerstone of the safe harbor is the fact that where there are nonrecourse deductions there is also "minimum gain." The Supreme Court held in *Tufts v. Commissioner*[57] that if a taxpayer sells or disposes of property encumbered by nonrecourse debt, the amount realized includes the amount of that debt. Thus, at a minimum, the taxpayer must recognize gain to the extent that the encumbering nonrecourse debt exceeds the taxpayer's tax basis in the property. Indeed, on any taxable disposition of property subject to nonrecourse debt, this excess is the "minimum gain" that a taxpayer will have to recognize. While A and B may not be required to restore the deficits in their capital accounts, we may still be able to bring their capital accounts back to at least zero. This is done by allocating minimum gain to each partner in an amount at least sufficient to bring the capital account to zero. In Example 1, if the AB partnership defaults on the loan after the first year, the partnership and its two partners will have $20,000 of gain on the foreclosure ($200,000 debt minus $180,000 basis). Allocating that gain equally to A and B will bring their capital accounts back to zero. Thus, if allocations of nonrecourse deductions are made and the basis of the property is reduced below the amount of the debt, we can commonly be assured that at some point there will be compensating

[56] Treas. Reg. § 1.704-1(b)(3).

[57] 461 U.S. 300 (1983).

minimum gain. Generally, the Regulations allow allocations of nonrecourse deductions to a partner as long as an equal amount of minimum gain is allocated to that partner (this minimum gain is unrecognized but inherent in the property).[58] Further, partners may generally have negative capital accounts, even if they do not have deficit restoration obligations, to the extent of their shares of minimum gain. There can be a genuine economic impact to this minimum gain. If the only gain that is recognized is the amount of the minimum gain, no cash will be going to the taxpayer and he will have to reach into his pocket to pay the taxes on the minimum gain (income without cash is sometimes called "phantom income").

B. The Regulatory Safe Harbor

As we discussed above, since the allocation of deductions attributable to nonrecourse debt cannot have economic effect, the Regulations provide that they must be allocated in accordance with the partners' interests in the partnership.[59] The Regulations provide a complex safe harbor which contain a number of specialized terms. "Partnership minimum gain" is determined by computing for each partnership nonrecourse liability any *book* gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than the full satisfaction of the liability, in other words, the amount by which the nonrecourse liabilities exceed the property's book basis.[60] If A contributes property with a tax basis of $10,000, a fair market value of $20,000 and subject to a nonrecourse debt of $20,000, initially there would be no minimum gain as the nonrecourse debt does not exceed the $20,000 book value of the property. Indeed, it should be borne in mind that book value rules here. When we, for example, discuss depreciation in this context, book depreciation is meant. Of course, if property is acquired with cash, there will be no book/tax disparities (barring a revaluation).[61] I.R.C. § 704(c) governs book/tax disparities.

The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during that year.[62] In Example 1, if the property was subject to $20,000 of depreciation deductions in the first year and there were no other expenses with regard to the property, the property's book basis would have been reduced by $20,000, meaning that the increase in partnership minimum gain would also be $20,000. It went from zero to $20,000. Note that the partnership can have nonrecourse debt without generating nonrecourse

[58] Technically, the Regulations provide that if the allocation of nonrecourse deductions is in accordance with the regulatory rules, it will also be in accordance with the partner's interest in the partnership. Treas. Reg. § 1.704-2(b)(1).

[59] Treas. Reg. § 1.704-2(b)(1).

[60] Treas. Reg. § 1.704-2(d)(1), (3).

[61] Revaluations, however, generally cannot reduce minimum gain. *See* Treas. Reg. § 1.704-2(d)(4)(ii).

[62] Treas. Reg. § 1.704-2(c)(1). This is reduced by any distributions of nonrecourse liabilities that are allocable to an increase in minimum gain, a subject we will discuss below. Increases in partnership minimum gain resulting from conversions, refinancing, and other changes to the debt instrument do not generate nonrecourse deductions.

deductions. Until there is minimum gain, any deductions are considered to come from the equity in the property. Nonrecourse deductions are created when the partnership generates minimum gain. Nonrecourse deductions and minimum gain are two sides of one coin. Nonrecourse deductions consist first of depreciation deductions with respect to property that is subject to nonrecourse debt and then, generally, pro rata portions of the partnership's other deductions and I.R.C. § 705(a)(2)(B) expenditures.[63]

The formal regulatory rules that have to be met in order for an allocations of nonrecourse deductions to be allowed under the safe harbor are:[64]

1. The partnership must comply with the economic effect test discussed above. Recall that part 3 of that test either requires a partner to have an unlimited deficit restoration obligation or meet the qualified income offset rules. Also, recall that under the qualified income offset rules a partner may have a deficit capital account to the extent of any "limited" deficit restoration obligation. Partnerships using nonrecourse debt commonly do not have deficit restoration obligations. Previously, the qualified income offset rules and the nonrecourse deduction rules were in mortal conflict. The nonrecourse deduction rules allow for deficit capital accounts notwithstanding the lack of a deficit restoration obligation, but the qualified income offset rules did not permit a deficit capital account absent such an obligation. The regulatory error was corrected, and the qualified income offset rules now provide that partners may have negative capital accounts to the extent of their shares of minimum gain. A partner's share of minimum gain is considered to be a "limited" deficit restoration obligation for purposes of the qualified income offset rules.[65]

2. Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, the partnership agreement provides for allocations of nonrecourse deductions in a manner that is "reasonably consistent" with allocations of some other significant partnership item attributable to the property securing the nonrecourse liabilities that have substantial economic effect. (For example, assume depreciation deductions are exactly equal to the nonrecourse deductions. Allocation of any other deductions generally would fall within the substantial economic effect rules.) In an example in the Regulations, allocations that have substantial economic effect are allocated initially 90% to the limited partner and 10% to the general partner until the items of income equal the items of loss, then shift to 50% − 50%. The nonrecourse deductions may be allocated anywhere from 50% − 50% to 90% − 10%, but may not be allocated 99% − 1%.[66] Of course, if nonrecourse deductions are allocated in the exact same manner as all other deductions (in this case starting at 90% − 10% and shifting with the other items to 50%-50%), they are as "reasonably consistent" as is possible.

[63] Treas. Reg. § 1.704-2(j)(1).

[64] Treas. Reg. § 1.704-2(e).

[65] Treas. Reg. § 1.704-2(g)(1).

[66] Treas. Reg. § 1.704-2(m), Ex. 1(ii).

3. The partnership has a "minimum gain chargeback" provision, discussed below.

4. The partnership otherwise complies with the regulatory rules for allocations.

Eventually, minimum gain inherent in partnership property will be reduced. The partnership might sell the underlying property (meaning the associated minimum gain drops to zero) or it might pay down some or all of the nonrecourse debt. Of course, the key item that has been driving this whole allocation system is that there will be minimum gain available to offset the nonrecourse deductions. What does the partnership do when the minimum gain goes down? The Regulations provide that at that time there is a minimum gain chargeback, meaning that the partners must be allocated items of income and gain equal to their shares of the net decrease in minimum gain.[67] Of course, if the partnership sells the underlying property (or has it taken in foreclosure), finding the gain will not be a problem. The gain from the sale or foreclosure will be available for this purpose. Indeed, the Regulations provide that any minimum gain chargeback must consist first of gains recognized from the disposition of partnership property subject to partnership nonrecourse liabilities. But if there is no such disposition gain because, for example, the reduction in minimum gain resulted from paying down the debt, then the partnership must allocate a pro rata portion of the partnership's other items of income and gain to the partners to offset the drop in minimum gain. If insufficient income and gain is available in the year in which the drop in minimum gain occurs, the allocations continue in future years until the full offset has been made. This minimum gain chargeback allocation is made before any other I.R.C. § 704 allocations.[68]

What is a partner's share of partnership minimum gain? Generally, it is the sum of the nonrecourse deductions allocated to the partner, net of prior minimum gain chargebacks.[69]

Example 2[70]

A and B form the AB limited partnership. Neither partner makes a capital contribution. Under the partnership agreement, the partners do not have a deficit restoration obligation, but the agreement contains a qualified income offset provision and otherwise complies with the substantial economic effect rules as well as the rules for allocating nonrecourse deductions. As a consequence, the partnership agreement meets the first test for allocating nonrecourse deductions. All losses are allocated 90% to A and 10% to B. All income is allocated first to restore previous losses and thereafter 50% to A and 50% to B. The partnership borrows $200,000 on a nonrecourse basis from a commercial lender and purchases an apartment building. Interest only is due on the note for the first five years. For its first three years, the partnership breaks even on its operations except for depreciation. Depreciation is $10,000 per year, so the partnership operates at a

[67] Treas. Reg. § 1.704-2(f)(1).

[68] Treas. Reg. § 1.704-2(j).

[69] Treas. Reg. § 1.704-2(g)(1).

[70] This example is based on Treas. Reg. § 1.704-2(f)(7), Example 1.

loss of $10,000 for each of its first three years. The basis of the apartment building is reduced by $10,000 per year under I.R.C. § 1016.

After three years, the partnership's basis in the building is reduced to $170,000. The debt remains at $200,000. Thus, there is $30,000 of minimum gain inherent in the property. Nonrecourse deductions exist to the extent of the increase in minimum gain, or $30,000 over the three years. The nonrecourse deductions must be allocated in a manner that is reasonably consistent with the allocations of items that have substantial economic effect. Note that the partnership is incurring other expenses, for example interest on the debt. The interest expense does not contribute to the nonrecourse deductions as they come first out of cost recovery deductions attributable to the property securing the debt, and the nonrecourse deductions exactly equal to the depreciation deductions. Thus, the allocation of all other items of income and expense fall within the regular allocation rules. The allocation of the nonrecourse deductions must be reasonably consistent with these other allocations. Here they are exactly the same as everything is allocated the same way, thus the second part of the nonrecourse allocation rules is met.

After three years, A and B's capital accounts are as follows:

A	B
($27,000)	($3,000)

You might ask whether the partners can have negative capital accounts given that they do not have deficit restoration obligations. The answer here is yes. A partner is considered to have a deficit restoration obligation to the extent of that partner's share of minimum gain. Recall that under the qualified income offset rules a partner may have a negative capital account to the extent of any limited deficit restoration obligation as long as the partnership otherwise complies with the qualified income offset rules, as is the case here. The partners' shares of minimum gain are the same as the nonrecourse allocations made to them, that is, $27,000 for A and $3,000 for B. A partner's share of minimum gain is considered to be a limited deficit restoration obligation.

At the beginning of year four, the partnership sells the apartment building for $300,000. The total gain of the partnership on the sale is $300,000 - $170,000 = $130,000. Minimum gain drops to zero as the partnership no longer holds the property. Under the minimum gain chargeback rules, gain must be allocated to the partners in the same manner as nonrecourse deductions are allocated to the partners. Here there is gain available from the sale to do this, so the first $30,000 of gain from the sale is allocated $27,000 to A and $3,000 to B. Note this will eliminate the deficit capital accounts of each partner, a primary goal of the system. The one thing the IRS would not want to happen is for someone to be able to walk away from a negative capital account. Even if the partner has an unlimited deficit restoration obligation, as mentioned above, it may not be meaningful in this context as there is no one to enforce it. The minimum gain chargeback solves the problem by requiring an income allocation that offsets the negative capital account.

Continuing with Example 2, under the partnership agreement, income is first allocated in the same manner as losses were allocated. This occurred

when we allocated the first $30,000 of gain to A and B as discussed. Under the partnership agreement, the balance of the $100,000 of gain is allocated equally between the partners. Thus the partners' capital accounts are as follows:

	A	B
Years 1–3	($27.000)	($3,000)
Min. Gain Chargeback	$27,000	$3,000
Other Gain	$50,000	$50,000
Balance	$50,000	$50,000

If the partnership were to now liquidate, it would be required to distribute $50,000 to each partner.[71]

If there is a reduction in partnership minimum gain that does not result from the sale of the underlying asset, as mentioned above, other items of income and gain must be allocated pro rata to the partners. In a limited partnership where the limited partners do not have a deficit restoration obligation, there could well be an adverse tax consequence. Likely, the limited partners will be allocated income sufficient to offset the minimum gain reduction, without perhaps receiving any cash with which to pay the tax on that income with other income and expenses going to the general partner, who in this context commonly would have an unlimited deficit restoration obligation. An LLC might be a better option in this regard than a limited partnership. As none of the members would typically have deficit restoration obligations, there could be no basis for prefering one partner to another.

C. Subsequent Nonrecourse Borrowing

Of course, a partnership might take out a nonrecourse loan other than for the purchase of a property. If the venture goes well and the property goes up in value, the partnership might choose to borrow additional funds on a nonrecourse basis. If the funds are invested in the property, creating additional basis, the rules we discussed above would govern the tax consequences. But what if the funds create additional minimum gain but are invested in an unrelated project or distributed to the partners? The Regulations provide the additional guidance that is needed in this regard.

Recall that nonrecourse deductions generally equal the net increase in partnership minimum gain. The amount of partnership minimum gain is computed by taking all partnership nonrecourse debt into account, including debt

[71] We kept this problem simple for pedagogical purposes, but when nonrecourse debt is used, the way the flip happens must be fine-tuned. In our Example 2, a distortion could have resulted if the flip occurred before the sale and minimum gain chargeback. The minimum gain chargeback would have had to flow mostly to A as he received most of the nonrecourse deductions, which would have been inconsistent with the overall economic structure had the flip already taken place. Generally, nonrecourse deductions should only be able to be offset by the minimum gain chargeback and should be "pulled out" of the general flip arrangement. *See* PARTNERSHIP TAXATION at ¶ 10.05[7][d].

arising from additional borrowings.[72] A partner's share of that minimum gain is based not only on the nonrecourse deductions allocated to that partner, but also on distributions of proceeds of nonrecourse debt made to that partner.[73] Distributions would, of course, reduce a partner's capital account, potentially causing or increasing a deficit capital account. But since a partner's share of partnership minimum gain is increased for proceeds of nonrecourse debt distributed to that partner, that is normally not a problem. Recall that a partner's share of minimum gain is considered to be a deficit restoration obligation.[74] The partnership may use any reasonable method to determine whether the source of a distribution is, in fact, nonrecourse borrowing.[75]

§ 5.08 FAMILY MEMBERS AS PARTNERS

A. Introduction

As you know from your basic tax course, under the assignment of income doctrine (it really should be called the nonassignment of income doctrine), one person generally may not gift income to another. Instead, is it possible, for example, for a parent to give a partnership interest to a child and for the partnership to then allocate income attributable to the interest to the child? Under a substance over form argument you might think the answer is no, but often it is in fact yes. Congress preempted much of the area with I.R.C. § 704(e), though case law that predates the statute remains relevant in many cases.

B. Pre-I.R.C. § 704(e) Case Law

Prior to the enactment of I.R.C. § 704(e), cases addressed whether a donee of a partnership interest should be respected as a bona fide partner. In *Commissioner v. Tower*,[76] the Supreme Court concluded that the parties must have bona fide intent to create a partnership. If a party provided either "original capital" or "vital services" to the partnership, that would be indicative of an intent to become a member of the partnership. The Tax Court then held that in order for a partner to be respected as such, she *must* contribute either original capital or vital services.[77] The Supreme Court responded that no, that is not what it said, neither original capital nor vital services are *required*. The fact that participants are family members is not fatal, though

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[72] Treas. Reg. § 1.704-2(d)(1).

[73] Treas. Reg. § 1.704-2(g)(1). To avoid double counting, nonrecourse deductions equal the increase in partnership minimum gain reduced by the amount of nonrecourse debt proceeds that are distributed to the partners. Treas. Reg. § 1.704-2(c).

[74] Treas. Reg. § 1.704-2(g)(1).

[75] See Treas. Reg. §§ 1.704-2(h)(2), 1.704-2(h)(4), and 1.704-2(m), Ex. (1)(vi), for rules that apply if the distribution in a given year is less than the minimum gain increase caused by the nonrecourse borrowing and how that interplays with nonrecourse deductions in this regard.

[76] 327 U.S. 280 (1946).

[77] *Culbertson v. Commissioner*, 1947 T.C.M. (P-H) ¶ 47,168, *rev'd*, 168 F.2d 979 (5th Cir. 1948), *rev'd*, 337 U.S. 733 (1949); *see also Monroe v. Commissioner*, 7 T.C. 278 (1946).

it may justify further inquiry.[78] The real question is "whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[79]

C. I.R.C. § 704(e)

Congress ultimately stepped in and enacted I.R.C. § 704(e). It provides that a person shall be recognized as a partner if she owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.[80] Accordingly, I.R.C. § 704(e) trumps the assignment of income doctrine. Income may be allocated to a donee partner in a partnership in which capital is a material income-producing factor even if the partner contributed nothing to the partnership.

When is capital a material income-producing factor? While this can sometimes be difficult to ascertain, usually it is not, and generally means what you would expect. For example, a partnership that derives its income mainly from an apartment building will meet the test. A partnership that derives its income from the performance of services (e.g. a partnership of accountants or lawyers) will not. Note that when capital is not a material income-producing factor, I.R.C. § 704(e) does not apply, and we must rely on the *Tower/Culbertson* line of cases in determining whether a person's partnership status is to be respected.

There are other ways to game the system. One would be to underpay the donor partner for services she renders to the partnership. In response, I.R.C. § 704(e)(2) requires that the partnership pay the donor partner reasonable compensation for her services. It also effectively requires that the rate of return on the donee's capital not exceed the rate of return on the donor's capital.

I.R.C. § 704(e)(1) and (2) can apply even if one family member acquires the partnership interest from another family member by purchase. I.R.C. § 704(e)(3) provides that under these circumstances the transferred partnership interest shall be considered to be gifted from the seller, "and the fair market value of the purchased interest shall be considered to be the donated capital." Thus, the assignment of income principles can potentially even apply to the purchase by one family member of another family member's partnership interest, unless capital is an income producing factor. While I.R.C. § 704(e)(3) seems to provide an irrebuttable rule, the Regulations in fact provide exceptions.[81]

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[78] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[79] *Id.* at 742.

[80] I.R.C. § 704(e)(1).

[81] *See* Treas. Reg. § 1.704-1(e)(4)(ii).

§ 5.09 CHANGES IN PARTNERSHIP INTERESTS DURING THE TAX YEAR

The interest that a partner has in the partnership is not locked in stone. A partner's percentage interest in the partnership can vary during a tax year if part of his or another partner's interest is sold or redeemed, if he or another partner contributes new capital to the partnership, or if new partners enter the partnership. The starting point is I.R.C. § 706(c)(2). It provides that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether it be by sale, death, or liquidation.[82] If, on the other hand, a partner disposes of part, but not all, of his interest in the partnership, whether by sale, entry of a new partner, redemption, gift, or otherwise, the partnership tax year does not close.

I.R.C. § 706(d)(1) provides that if a partner's interest changes during the tax year, each partner's distributive share of partnership income or loss is determined by taking into account the partners' varying interests in the partnership during the year. Of course, as you now know, I.R.C. § 704(b) permits the partnership to make allocations other than based on strict partnership ownership percentages. But what I.R.C. § 706(d) does not permit, and in this regard it trumps I.R.C. § 704(b), is for the partnership to make a retroactive allocation to a partner of deductions and losses that the partnership incurred prior to that person becoming a partner.[83]

The partnership has two options for allocating partnership items when the partners' interests change during the year: It can do an "interim closing of the books" or it can prorate the partnership items to the partners based on their varying interests in the partnership during the year.[84] For example, assume in the equal AB partnership, B sells half of his interest (one-quarter interest in the partnership) to C on October 1, so that after that date A has a one-half interest, and B and C each have a one-quarter interest.[85] If the interim closing of the books method is used, the partnership would calculate what its income and expenses were for the first three-quarters of the year and allocate half of those amounts each to A and B. It would make the same calculation for the final quarter and allocate one-half to A and one-quarter each to B and C.

Closing the books in this fashion and determining exactly what was incurred when can be challenging. Accordingly, the partnership has the option of allocating items to the partners on a pro rata basis.[86] The pro rata method is based on the period of time a partner held a particular percentage interest in the partnership, without regard to when a partnership item was actually incurred. Continuing with the above example, under the pro rata method,

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[82] I.R.C. § 706(c)(2)(A).

[83] *See* Staff of the Joint Committee on Taxation, *General Explanation of Tax Reform Act of 1976*, 94th Cong., 2d Sess. 91-94 (1976).

[84] *See* Treas. Reg. § 1.706-1(c)(2)(ii).

[85] *See* PARTNERSHIP TAXATION at ¶ 9.06[7]. This assumes the partnership is on a calendar year, as would typically be the case.

[86] Treas. Reg. § 1.706-1(c)(2)(ii).

A would be allocated half of all partnership items for the year. B would be allocated 1/2 × 9/12[87] of partnership items with respect to the portion of the year he was a one-half partner and 1/4 × 3/12 of partnership items with respect to the portion of the year he was a one-quarter partner. Finally, C would be allocated 1/4 × 3/12 of partnership items with respect to the portion of the year he was a partner.

Cash method partnerships could take advantage of the rules as discussed to this point. Assume in the above example that when C became a partner, the partnership is cash basis and has a $60,000 expense that it has incurred, but not paid. Under the pro rata method, C's share of that loss would be 1/4 × 3/12 × $60,000, or $7,500. If, however, the cash-method partnership used the interim closing of the books method, then paid the expense after C became a partner, C would be entitled to a full one-quarter share or $15,000, double what the result would be if the pro rata method were used.[88]

I.R.C. § 706(d)(2)(a) for the most part has stopped this ploy. Cash-method partnerships must now allocate listed "cash basis items" to the time during the taxable year to which these items are attributable, regardless of whether or not the partnership uses the interim closing of the books method or the pro rata method. The listed items are treated, therefore, as if the partnership were on the accrual method of accounting. The allocable cash basis items are interest, taxes, payments for services or for the use of property, and any other item specified in the Regulations (though to date the Regulations have not specified any). Thus, in the above example, if the $60,000 loss were for services and was attributable to a time before C became a partner, C could be allocated none of it. It would have to be allocated entirely to A and B. If, on the other hand, the $60,000 loss was not an allocable cash basis item (a judgment against the partnership, for example), it should still be possible to close the books and allocate an extra portion to C.

§ 5.10 READING, QUESTIONS AND PROBLEMS

A. I.R.C. § 704(b)

Reading

CODE:

I.R.C. § 704(b)

TREASURY REGULATIONS:

Treas. Reg. §§ 1.704-1(b)(1)(i), (iii), (iv), 1(b)(2)(i)-(iii), (iv)(a)-(e), (h), (n), (p), (q), 1(b)(3), 1(b)(5), examples 1, 2, 3, 4, 5, 6, 7, 8, 15(i), 1.1245-1(e)

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[87] That is, 9 months divided by 12 months.

[88] The partnership successfully used this technique in *Richardson v. Commissioner*, 76 T.C. 512 (1981), *aff'd on other issues*, 693 F.2d 1189 (5th Cir. 1982).

RULINGS:

Rev. Rul. 97-38, 1997-2 C.B. 69

Rev. Rul. 99-2, 1999-2 C.B. 506

Rev. Rul. 2004-43, 2004-1 C.B. 842

Questions and Problems

1. A and B form a partnership on January 1 of year 1. Each makes a cash contribution to the partnership of $80,000. The partnership purchases depreciable equipment for $160,000. The partnership agreement provides that all income and loss are allocated equally, except that all depreciation deductions are allocated to A. Assume (Code provisions to the contrary notwithstanding) that the equipment generates depreciation deductions of $40,000 per year and that in all years the partnership breaks even except for depreciation deductions, and so incurs a loss each year of $40,000.

a. Generally describe what provisions the partnership agreement will have to contain in order for the allocations to A to be respected.

b. Assuming the partnership agreement contains all such provisions, compute capital accounts for A and B on formation and at the end of the first 3 years of partnership operations.

c. How would you answers to "a" and "b" change if A does not have a deficit restoration obligation?

d. Assume the same facts as in "c" except that in year 2 it is reasonably expected that in year 3 the partnership's equipment will appreciate in value by $20,000, and the partnership will borrow $20,000 against the equipment and distribute $10,000 to each partner in year 3. How will your answer change? Would it make a difference if A had a *limited* deficit restoration obligation of $20,000?

e. Assume in "b" of the problem that the equipment is sold on January 1 of year 3 for $180,000. State how the gain should be allocated and compute the partners' capital accounts immediately before the liquidation of the partnership. Does the gain allocation make sense? Do you have any alternative suggestions for how the gain might be allocated?

2. A and B form a partnership to drill for oil and gas. A contributes $10,000 and agrees to devote himself to the activities of the partnership on a full-time basis. B contributes $190,000 and promises to spend all of his time lounging by the pool. The partnership agreement provides that B shall be allocated 95%, and A 5% of partnership taxable income and loss until B has received allocations of taxable income equal to the sum of the prior allocations of taxable losses. Thereafter, A and B will share all taxable income and losses equally. Operating cash flow will be distributed equally between A and B. The partnership agreement provides that capital accounts will be maintained in accordance with the Regulations, and liquidating distributions will be made in accordance with capital account balances. The partnership agreement also gives both A and B an unlimited deficit restoration obligation. Address the tax

consequences. Would your answer change if the partnership's only activity was to make a "triple-net" lease of property to a Fortune 500 corporation?

3. A and B are equal partners in AB partnership. The partnership agreement provides that capital accounts will be maintained in accordance with the Regulations and liquidating distributions will be made in accordance with capital account balances. The partnership agreement also gives both A and B an unlimited deficit restoration obligation. Generally, A and B are in the same marginal tax bracket. All income and losses are allocated equally to A and B. A has a net operating loss from another venture that will expire in the partnership's second tax year. The partnership agreement is amended at the beginning of the second tax year to provide that all of the partnership's net taxable income will be allocated to A for that year. Thereafter, net taxable income is to be allocated to B until B's allocation equals the allocation in the second tax year to A, after which the partnership will revert to 50-50 allocations. Describe the tax consequences.

4. A and B form the AB partnership to operate an international business. They make equal contributions to the partnership. The income of the business, as well as the sources of that income, are uncertain. The partnership agreement provides that capital accounts will be maintained in accordance with the Regulations and liquidating distributions will be made in accordance with capital account balances. The partnership agreement also gives both A and B an unlimited deficit restoration obligation. A is a U.S. citizen and B is full-time resident of Germany, meaning that generally B is only taxable on income that is "U.S. source." The partnership conducts business in the United States and in Germany. The partnership agreement provides that B will be allocated all of the income, gain, loss, and deduction derived in Germany, and A is allocated the remaining income, gain, loss, and deduction. Describe the tax consequences. How would your answer change if the partnership agreement provided that all income, gain, loss and deduction will be shared equally, but that B will be allocated all income, gain, loss, and deduction derived from his country in computing his equal share?

B. I.R.C. § 704(c)

Reading

CODE:

I.R.C. §§ 704(a), (c)(1)(A), (3), 724

TREASURY REGULATIONS:

Treas. Reg. §§ 1.704-3(a)(1)-(5), (10), (b), (c), (d), (e)(1), 1.704-1(b)(1)(vi), 1(b)(2)(iv)(d)(1),(3), 1.7041(b)(2)(iv)(f), 1.704-1(b)(4)(i), 1(b)(5), examples 14(i)-(iv)

Questions and Problems

5. A and B form the equal AB partnership. A contributes cash of $20,000. B contributes land with a basis of $9,000 and a fair market value of $20,000. The land is a capital asset to B and has been held for over one year. Describe the

tax consequences under each of the three I.R.C. § 704(c) allocation methods if the partnership sells the land for either $21,000 or $19,000, assuming the partnership has adequate other income and deductions, if necessary.

6. A and B form the equal AB partnership on January 1 of year 1. A contributes depreciable equipment with a tax basis of $6,000 and a fair market value of $20,000. B contributes cash of $20,000. Assume A's equipment is depreciated at the rate of 20% per year for book and tax purposes. Further assume that A's property generates $2,000 of net operating income each year. Calculate A and B's capital accounts for the first year of operations using the traditional method and the traditional method with curative allocations.

7. A and B form the equal AB partnership on January 1 of year 1. A contributes equipment with a tax basis of $8,000 and a fair market value of $20,000. The equipment has been on a 10-year recovery period and has four years remaining. (Were the equipment newly acquired at the time of the contribution to the partnership, the recovery period would again be 10 years.) B contributes $20,000 which the partnership uses to buy land. The partnership's income equals expenses except for depreciation deductions. Assuming the partnership uses the remedial allocation method, describe how depreciation deductions will be allocated to A and B from the equipment. Ignore any applicable first year depreciation conventions. *See* Treas. Reg. § 1.704-3(d)(7), Ex. 1.

C. Nonrecourse Deductions

Reading

TREASURY REGULATIONS:

Treas. Reg. §§ 1.704-2(b), (c), (d), (e), (f)(1)-(3), (6), (7), Example 1, (g), (h), (i), (j), (m), Examples 1(i)-(iv), (vi), (vii), (viii), 3(i)

Questions and Problems

8. A and B form a limited partnership. A is a limited partner and B is the general partner. A contributes $360 and B contributes $40 to the partnership. The partnership agreement contains a minimum gain chargeback provision and complies with the qualified income offset rules of the I.R.C. § 704(b) Regulations. Neither partner has a deficit restoration obligation. The partnership agreement further provides that all losses will be allocated 90% to A and 10% to B and that all income will be allocated in the same manner until income allocations equal previous loss allocations. Thereafter income and losses will be allocated 50% to A and 50% to B. The partnership borrows $1,600 from an unrelated commercial lender on a nonrecourse basis and purchases depreciable real estate on leased land for $2,000. Only interest on the loan is due for the first five years that the debt is outstanding. The partnership breaks even in its first three years of operation except for depreciation deductions of $400 per year,

and thus generates a loss each of its first three years of $400 (the depreciation rules in real life do not permit this rapid of a depreciation rate—we are ignoring the real world to make the problem more manageable; we are also ignoring first-year conventions).

a. Assume that on January 1 of year 4, the partnership sells the property for $2,400. Assume that aside from this sale, the partnership breaks even on operations in year four. For years 1–4, provide the partners' capital accounts and shares of minimum gain.

b. How would your answer change if instead of selling the property on January 1 of year 4, the partnership borrows an additional $500 on a nonrecourse basis, securing it with a second mortgage on the property, and distributes the proceeds equally to A and B. For purposes of this question, assume the partnership breaks even in year 4 except for depreciation deductions.

D. Family Allocations

Reading

CODE:

I.R.C. § 704(e)

TREASURY REGULATIONS:

Treas. Reg. §§ 1.704-1(e)

CASES:

Commissioner v. Tower, 327 U.S. 280 (1946)

Commissioner v. Culbertson, 337 U.S. 733 (1949)

Questions and Problems

9. Mother owns an apartment building that generates significant rental income. She gifts a 50% interest in the apartment building to Daughter, and they form a partnership. Mother manages the building and Daughter provides no services. The partnership agreement provides that each partner has a 50% interest in all items of income and deduction and each partner is entitled to 50% of any cash distributed and 50% of all liquidating distributions. Ignore gift tax considerations.

c. Describe the income tax consequences.

d. How would your answer in "a" change if Mother provides no services but receives 40% of all items of income and deduction, but 50% of any distributions.

E. Changes in Partnership Interests During the Tax Year

Reading

CODE:

I.R.C. § 706(c)(2)(b), (d)

TREASURY REGULATIONS:

Treas. Reg. § 1.706-1(c)(1), (2) (4)

CASE:

Richardson v. Commissioner, 76 T.C. 512 (1981), *aff'd on other issues*, 693 F.2d 1189 (5th Cir. 1982)

Questions and Problems

10. A and B are equal partners in the AB partnership. The partnership is on the calendar year and is in the construction business. As of July 1 of year 1, the partnership has an unpaid $50,000 bill owed to a consulting company. To cover the obligation and put the partnership on sounder financial footing, the partnership agrees to admit C as a partner on July 1 in exchange for a $50,000 contribution. Upon C's admission, A, B, and C each own a 33 1/3% interest in the partnership. Assume the partnership otherwise breaks even for the year and thus has a $50,000 loss for the year. It uses C's contribution to pay the loss generating a current deduction of $50,000. How will the $50,000 deduction be allocated among the partners if the partnership uses the "proration method" or alternatively "the closing of the books method?" Would your answer change if C's funds were used to pay a judgment against the partnership resulting from a car accident?

Chapter 9

BUSINESS COMBINATIONS: PARTNERSHIP MERGERS AND DIVISIONS

§ 9.01 INTRODUCTION

Chapter 9 will focus on the consequences of partnership mergers and divisions under I.R.C. § 708(b) and the regulations thereunder.

§ 9.02 PARTNERSHIP MERGERS

A. General Rules

I.R.C. § 708(b)(2)(A) provides that in the case of a merger or consolidation of two or more partnerships, the resulting partnership is, for purposes of I.R.C. § 708, considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership. Treas. Reg. § 1.708-1(c)(2) provides that if the resulting partnership could otherwise be considered a continuation of more than one of the merging partnerships, the resulting partnership is solely the continuation of the partnership that is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership. Any other merging or consolidating partnerships are considered to be terminated.[1] If the members of none of the merging partnerships own more than a 50 percent interest in the capital and profits of the resulting partnership, all of the merged partnerships are considered terminated, and a new partnership results.[2] The taxable years of the merging partnerships that are considered terminated are closed under I.R.C. § 706(c) ending upon the date of the merger or consolidation.[3]

The resulting partnership's taxable year does not close, and the partnership files a return for the taxable year of the merging or consolidating partnership that it is considered to be continuing.[4] The resulting partnership retains the taxpayer identification number of the partnership that is continuing.[5]

Example 1. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September

[1] Treas. Reg. § 1.708-1(c)(1).

[2] *Id.*

[3] Treas. Reg. § 1.708-1(c)(2).

[4] *Id.*

[5] *Id.*

30, and form partnership ABCD. Partners A, B, C, and D are on a calendar year, and partnership AB and partnership CD also are on a calendar year. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent. Since A and B together own an interest of more than 50 percent in the capital and profits of partnership ABCD, partnership ABCD is considered a continuation of partnership AB and continues to file returns on a calendar year basis. Since C and D own an interest of less than 50 percent in the capital and profits of partnership ABCD, the taxable year of partnership CD closes as of September 30, the date of the merger, and partnership CD is terminated as of that date. Partnership ABCD is required to file a return for the taxable year January 1 to December 31, indicating that, until September 30, it was partnership AB. Partnership CD is required to file a return for its final taxable year, January 1 through September 30.[6]

The determination of which of the partnerships continues for tax purposes is made without regard to which partnership is treated as continuing for state law purposes.

Example 2. (i) Partnership X, in whose capital and profits A owns a 40-percent interest and B owns a 60-percent interest, and partnership Y, in whose capital and profits B owns a 60-percent interest and C owns a 40-percent interest, merge on September 30. The fair market value of the partnership X assets (net of liabilities) is $100X, and the fair market value of the partnership Y assets (net of liabilities) is $200X. The merger is accomplished under state law by partnership Y contributing its assets and liabilities to partnership X in exchange for interests in partnership X, with partnership Y then liquidating, distributing interests in partnership X to B and C.

(ii) B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, because the fair market value of partnership Y's assets (net of liabilities) was greater than that of partnership X's, under Treas. Reg. § 1.708-1(c)(1), partnership X will be considered to terminate in the merger. As a result, even though, for state law purposes, the transaction was undertaken with partnership Y contributing its assets and liabilities to partnership X and distributing interests in partnership X to its partners, pursuant to Treas. Reg. § 1.708-1(c)(3)(i), for Federal income tax purposes, the transaction will be treated as if partnership X contributed its assets to partnership Y in exchange for interests in partnership Y and then liquidated, distributing interests in partnership Y to A and B.[7]

If this example applied only the rule of I.R.C. § 708(b)(2)(A), which provides that the resulting partnership is considered the continuation of any merging

[6] Treas. Reg. § 1.708-1(c)(5), Ex. 1.

[7] Treas. Reg. § 1.708-1(c)(5), Ex. 2.

or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership, the resulting partnership would be viewed as a continuation of both partnerships X and Y, because B, a member of each of X and Y, owns more that 50 percent of the capital and profits of the resulting partnership. However, under the tie-breaker rule, the resulting partnership is treated as a continuation of partnership Y for tax purposes, because partnership Y contributed the greatest portion of the fair market value of the assets of the resulting partnership.[8] The result of applying the tie-breaker rule in this situation is that a different partnership continues for tax purposes than continues for state law purposes.

B. Form of a Merger

Generally, there are two ways in which the form of a partnership merger may be characterized for tax purposes, as the Assets-Over Form or as the Assets-Up Form. In the Assets-Over Form, any merged or consolidated partnership that is treated as terminated is first treated as contributing its assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership.[9] Immediately after the contribution, the terminated partnership is treated as distributing interests in the resulting partnership to its partners in liquidation of the terminating partnership. In the Assets-Up Form, the terminating partnership distributes its assets and liabilities to its partners who then contribute the assets and liabilities to the resulting partnership.[10]

If two or more partnerships merge or consolidate into one partnership under the applicable local jurisdictional law without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not the Assets-Up Form (described below), then the Assets-Over Form is deemed to apply. This means, for example, that a merger of two partnerships under a state law pursuant to which the merger is accomplished merely by filing articles or a certificate of merger is deemed to be undertaken in the Assets-Over Form.

> *Example 3.* The facts are the same as in Example 2, except that partnership X is engaged in a trade or business and has, as one of its assets, goodwill. In addition, the merger is accomplished under state law by having partnership X convey an undivided 40-percent interest in each of its assets to A and an undivided 60-percent interest in each of its assets to B, with A and B then contributing their interests in such assets to partnership Y. Partnership Y also assumes all of the liabilities of partnership X.[11]

In this example, because partnership X followed the Assets-Up Form for state law purposes, the choice of the form of the partnership merger will be

[8] Treas. Reg. § 1.708-1(c)(2).

[9] Treas. Reg. § 1.708-1(c)(3)(i).

[10] Treas. Reg. § 1.708-1(c)(3)(ii).

[11] Treas. Reg. § 1.708-1(c)(5), Ex. 3.

respected so that partnership X will be treated as following the Assets-Up Form for Federal income tax purposes. However, if partnership X had chosen a form other than the Assets-Up Form or Assets-Over Form, the choice of the form would not be respected.

> *Example 4.* Partnership X and partnership Y merge when the partners of partnership X transfer their partnership X interests to partnership Y in exchange for partnership Y interests. Immediately thereafter, partnership X liquidates into partnership Y. The resulting partnership is considered a continuation of partnership Y, and partnership X is considered terminated.[12]

The partnerships in this example attempted to use what is sometimes called an "interests over" form[13]—the partners contribute their partnership interest to the partnership that continues for state law purposes. However, the partnerships are treated as undertaking the Assets-Over Form for tax purposes because the "interests over" form is not one of the permitted forms for partnership mergers under the Regulations. Accordingly, for Federal income tax purposes, partnership X is deemed to contribute its assets and liabilities to partnership Y in exchange for interests in partnership Y. Immediately thereafter, partnership X is deemed to have distributed the interests in partnership Y to its partners in liquidation of their interests in partnership X.

While a partnership merger may be accomplished by using any number of transactional structures, the result is a single transaction that combines two partnerships. In the two alternatives permitted by the Regulations, each partner must participate (or will be deemed to participate) in the partnership merger in the same manner (with the exception of those partners who are subject to the buy-out rule). Therefore, if the partners wish for a partnership merger to be characterized under the Assets-Up Form, the terminated partnership must undertake the steps of the Assets-Up Form for all of its assets when it distributes the assets to its partners. Otherwise, the transaction will be characterized under the Assets-Over Form. However, where more than two partnerships are combined, each combination will be viewed as a separate merger so that the characterization of a merger of one partnership into the resulting partnership under the Assets-Over Form will not prevent a simultaneous merger of another partnership into the same resulting partnership from being characterized under the Assets-Up Form.

Most partnership mergers are characterized under the Assets-Over Form, because of the greater simplicity in undertaking the form. But, sometimes the Assets-Up Form is viewed as advantageous because of the way in which the basis of the property is calculated in a liquidating distribution. As you learned in Chapter 7, I.R.C. § 732(b) requires that the basis of property (other than money) distributed by a partnership in liquidation of the partner's interest will be equal to the partner's basis in the partnership interest reduced by the

[12] Treas. Reg. § 1.708-1(c)(5), Ex. 4.

[13] The "interests over" form is one of the three permitted structures for converting a partnership to a corporation. *See* Rev. Rul. 84-111, 1984-2 C.B. 88; Eric. B. Sloan, et al., *New Prop. Regs. Provide Expanded Guidance on Partnership Mergers and Divisions—Part 1*, 93 J. TAX'N 198 (2000).

amount of any money distributed in the same transaction. This means that if a partner's basis in her partnership interest were greater than her proportionate share of the partnership's bases in its assets, the partner could obtain a step-up in the bases of the assets distributed to her and re-contributed if the partnership merged using an Assets-Up Form.

Consider the ABC partnership which holds three properties of equal value: Whiteacre, Blackacre and Redacre. C's total proportionate share of the inside bases of the three properties is $300, but her basis in her partnership interest is $500. If ABC were to merge with DEF in a transaction in which ABC was the terminated partnership and the Asset-Over Form were used, the bases of the three properties would carry over without change. However, if the Asset-Up Form were used, C's proportionate share of the bases of the three properties would be increased to $500.

If a partnership merger is part of a larger series of transactions, the Regulations give the IRS authority to disregard the form if the substance of the larger series of transactions is inconsistent with following the form.[14]

C. Built-In Gain Resulting from the Merger

If a merger or consolidation is treated as using the Assets-Over Form, the normal rules under I.R.C. § 721, relating to the contribution of assets to a partnership in exchange for a partnership interest, would apply to the deemed contribution by any terminating partnerships. In the Assets-Up Form, I.R.C. § 721 would apply to the contribution by the partners of any assets of the terminating partnership to the continuing partnership. I.R.C. §§ 731 and 736 would similarly apply to the deemed or actual distribution of the partnership interests or assets of the terminating partnership to its partners (depending upon whether the transaction is characterized under the Assets-Over Form or Assets-Up Form).

In general, I.R.C. § 704(c)(1)(B) provides that if any property contributed to a partnership is distributed to a partner, other than the contributing partner, within seven years of the contribution, the contributing partner will recognize gain or loss in an amount equal to the remaining gain allocable to the contributing partner from the built-in gain in the property at the time of contribution. Similarly, I.R.C. § 737 provides that a partner who contributed property with built-in gain and who receives a distribution (other than the property originally contributed) from a partnership within seven years of the contribution may recognize gain on the distribution. However, Treas. Reg. § 1.704-4(c)(4) provides that I.R.C. § 704(c)(1)(B) does not apply to a transfer by a partnership of all of its assets and liabilities to a second partnership in an exchange described in I.R.C. § 721, followed by a distribution of the interest in the transferee partnership in a liquidation of the contributing partnership. Instead, a subsequent distribution of I.R.C. § 704(c) property by the continuing partnership is subject to I.R.C. § 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to

[14] Treas. Reg. § 1.708-1(c)(6)(i).

I.R.C. § 704(c)(1)(B).[15] Similarly, Treas. Reg. § 1.737-2(b)(1) provides that I.R.C. § 737 does not apply under the same conditions as described in Treas. Reg. § 1.704-4(c)(4).

Neither section provides relief from the application of the seven year holding period if the Assets-Up Form is used.

In spite of the apparent exception from the seven year holding period provided in Treas. Reg. § 1.704-4(c)(4) and Treas. Reg. § 1.737-2(b)(1) for the Assets-Over Form, the Treasury took the position in Rev. Rul. 2004-43[16] that both I.R.C. § 704(b) and I.R.C. § 737 would still apply to the built-in gain or loss that existed in the assets of a continuing partnership that were deemed to be contributed by the terminating partnership to the continuing partnership. Under this interpretation, although gain recognition under I.R.C. § 704(b) and I.R.C. § 737 are not triggered by the deemed contribution and distribution resulting from the merger or consolidation, the merger or consolidation itself begins a new seven-year holding during which the built-in gain in existence at the time of the merger or consolidation could be recognized by the partners of a partnership that is treated as terminating in a merger or consolidation.

Rev. Rul. 2004-43 illustrated its conclusions with the following example:

> *Example 5.* On January 1, 2004, A contributed Asset 1, with a basis of \$200x and a fair market value of \$300x to partnership AB in exchange for a 50 percent interest. On the same date, B contributed \$300x of cash to AB in exchange for a 50 percent interest. Also on January 1, 2004, C contributed Asset 2, with a basis of \$100x and a fair market value of \$200x to partnership CD in exchange for a 50 percent interest. D contributed \$200x of cash to CD in exchange for a 50 percent interest.
>
> On January 1, 2006, AB and CD undertake an assets-over partnership merger in which AB is the continuing partnership and CD is the terminating partnership. At the time of the merger, AB's only assets are Asset 1, with a fair market value of \$900x, and \$300x in cash, and CD's only assets are Asset 2, with a fair market value of \$600x and \$200x in cash. After the merger, the partners have capital and profits interests in AB as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent.
>
> On January 1, 2012, which is eight years after the initial contributions and six years after the merger, AB has the same assets that it had immediately after the merger. Each asset has the same value that it had at the time of the merger. On this date, AB distributes Asset 2 to A in liquidation of A's interest in AB.

In this example, on the date of the partnership merger, CD contributes cash and Asset 2 to AB in exchange for an interest in AB. Immediately thereafter, CD distributes, in liquidation, interests in AB to C and D. Under Treas. Reg.

[15] Treas. Reg. § 1.704-4(c)(4).

[16] 2004-1 C.B. 842, revoked by Rev. Rul. 2005-10, 2005-1 C.B. 492. Although Rev. Rul. 2005-10 revoked Rev. Rul. 2004-43, it also stated that the Treasury intends to promulgate regulations implementing the principles of Rev. Rul. 2004-43.

§ 1.704-4(c)(4) and Treas. Reg. § 1.737-2(b)(1), the transaction considered in the example would appear to meet the exception from the application of I.R.C. § 704(c)(1)(B) and I.R.C. § 737. However, Rev. Rul. 2004-43, applies an I.R.C. § 704(c)(1)(B) analysis as if the exceptions in Treas. Reg. § 1.704-4(c)(4) and Treas. Reg. § 1.737-2(b)(1) did not apply.

As Rev. Rul. 2004-43 continues its analysis, Asset 2 has a basis of $100x and a fair market value of $600x upon contribution. Of the $500x of built in gain in Asset 2, $100x is preexisting I.R.C. § 704(c) gain attributable to C's contribution of Asset 2 to CD, and $400x is additional I.R.C. § 704(c) gain created as a result of the merger. Rev. Rul. 2004-43 concludes, applying Treas. Reg. § 1.704-3(a)(7), that as the transferees of CD's partnership interest in AB, C and D each succeed to one-half of CD's $400x of I.R.C. § 704(c) gain in Asset 2 (each $200x). Thus, C's share of I.R.C. § 704(c) gain is $300x, and D's share of I.R.C. § 704(c) gain is $200x.

The distribution of Asset 2 to A occurs more than seven years after the contribution of Asset 2 to CD. Therefore, I.R.C. § 704(c)(1)(B) does not apply to the $100x of pre-existing 704(c) gain attributable to that contribution. However, the distribution of Asset 2 to A occurs within seven years of the contribution of Asset 2 by CD to AB. According to Rev. Rul. 2004-43, the contribution of Asset 2 by CD to AB creates I.R.C. § 704(c) gain of $400x subject to the seven year holding period. As the transferees of CD's partnership interest in AB, C and D each succeed to one-half of the $400x of 704(c) gain created by the merger. Under the analysis of Rev. Rul. 2004-43, I.R.C. § 704(c)(1)(B) applies to that I.R.C. § 704(c) gain because of the distribution of Asset 2 to A within seven years of the merger, causing C and D each to recognize $200x of gain.

It should be particularly noted that in this example, D, who originally contributed only cash, and who received nothing in the distribution from AB, has been required to recognize $200x of gain on the distribution of Asset 2 to A. This gain is solely attributable to the start of another I.R.C. § 704(c)(1)(B) seven year period at the time of the merger of the two partnerships.

It is currently unclear whether and to what extent the approach of Rev. Rul. 2004-43 will be incorporated in final regulations.

D. Buy-Out Rule

The Regulations contain a special buy-out rule that allows a resulting partnership in a merger to fund the purchase of one or more partners' interests in a terminating partnership without triggering the disguised sale rules, which otherwise could cause all of the partners in the terminating partnership to recognize gain or loss as a result of the purchase. Specifically, the Regulations provide that if the merger agreement (or similar document) specifies that the resulting partnership is purchasing the exiting partner's interest in the terminating partnership and also specifies the amount paid for the interest, the transaction will be treated as a sale of the exiting partner's interest to the resulting partnership.[17] The partner who is being bought-out must also consent to the treatment.

[17] Treas. Reg. § 1.708-1(c)(4).

Example 5 in Treas. Reg. § 1.708-1(c)(4) indicates that the partner who is being bought-out is treated as if his interest was purchased immediately prior to the merger. Thus, the resulting partnership, and the partners (determined prior to the merger) of the partnership that is treated as continuing, would succeed to the withdrawing partner's capital account and built in gain.[18] Although not discussed in the Regulations, it follows from treating the buyout as a sale to the resulting partnership occurring immediately prior to the merger that, if exiting partners sell 50 percent or more of the total interest in the terminating partnership's capital and profits as part of a merger, then a partnership termination under I.R.C. § 708(b)(1)(B) will occur immediately before the merger.

§ 9.03 PARTNERSHIP DIVISIONS

A. General Rules

I.R.C. § 708(b)(2)(B) provides that, in the case of a division of a partnership into two or more partnerships, all the resulting partnerships the members of which had an interest of more than 50 percent in the capital and profits of preexisting partnership are considered a continuation of the preexisting partnership. Treas. Reg. § 1.708-1(b)(2)(ii) provides that any other resulting partnership is not considered a continuation of the preexisting partnership but is considered a new partnership. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the preexisting partnership, the preexisting partnership is terminated.[19] If members of a preexisting partnership do not become members of a resulting partnership that is considered a continuation of the preexisting partnership, such members' interests are considered liquidated as of the date of the division.[20]

As with partnership mergers, the divided partnership in a partnership division is treated as transferring all or a portion of its assets and liabilities to one or more resulting partnerships either in the Assets-Over Form or the Assets-Up Form.[21] A "divided partnership," for the purposes of this discussion, means the continuing partnership that is treated as transferring assets and liabilities to the recipient partnership or partnerships.[22] If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the partnership that is a continuation of the prior partnership is the divided partnership. If more than one resulting partnership is a continuation of the prior partnership, the resulting partnership that, in form, transferred the assets and liabilities of the prior partnership will be treated as the divided partnership (if it is also treated as a continuation of the prior partnership). If a preexisting partnership divides and

[18] Treas. Reg. § 1.708(c)(5), Ex. 5(iii).

[19] Treas. Reg. § 1.708-1(d)(1).

[20] *Id.*

[21] Treas. Reg. § 1.708-1(d)(3).

[22] Treas. Reg. § 1.708-1(d)(4)(i).

more than one resulting partnership is a continuing partnership (but the rule in the preceding sentence does not apply), then the continuing resulting partnership with assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.[23]

The divided partnership that is regarded as continuing is required to file a return for the taxable year of the partnership that has been divided.[24] The divided partnership will also retain the employer identification number of the preexisting partnership. All other resulting partnerships that are regarded as continuing and all new partnerships (i.e., resulting partnerships that are not considered continuing) will file separate returns for the taxable year beginning on the day after the date of the division with new employer identification numbers for each partnership.[25]

All resulting partnerships that are continuing partnerships are subject to preexisting elections that were made by the preexisting partnership.[26] However, a post-division election that is made by a resulting partnership will not bind any of the other resulting partnerships.

> *Example 6.* Partnership ABCD owns three parcels of property: property X, with a value of $500; property Y, with a value of $300; and property Z, with a value of $200. A and B each own a 40-percent interest in the capital and profits of partnership ABCD, and C and D each own a 10 percent interest in the capital and profits of partnership ABCD. On November 1, partnership ABCD divides into three partnerships (AB1, AB2, and CD) by contributing property X to a newly formed partnership (AB1) and distributing all interests in such partnership to A and B as equal partners, and by contributing property Z to a newly formed partnership (CD) and distributing all interests in such partnership to C and D as equal partners in exchange for all of their interests in partnership ABCD. While partnership ABCD does not transfer property Y, C and D cease to be partners in the partnership. Accordingly, after the division, the partnership holding property Y is referred to as partnership AB2.[27]

In this example, partnerships AB1 and AB2 are both continuations of partnership ABCD (because A and B own more than 50 percent of the capital and profits of the preexisting partnership), while partnership CD is considered a new partnership formed at the beginning of the day on November 2. For each of the divisions, partnership ABCD will be treated as following the Assets-Over Form, with partnership ABCD contributing property X to partnership AB1 and property Z to partnership CD, and distributing the interests in such partnerships to the designated partners. ABCD will also be treated as contributing property Y to partnership AB2 for tax purposes even though no transfer occurs for state law purposes. Because property X has a greater fair

[23] *Id.*

[24] Treas. Reg. § 1.708-1(d)(2)(i).

[25] *Id.*

[26] Treas. Reg. § 1.708-1(d)(2)(ii).

[27] Treas. Reg. § 1.708-1(d)(5), Ex. 4.

market value than property Y, partnership AB1 will be viewed as the divided partnership.

The Regulations do not define what constitutes a partnership division. However, the Regulations do clarify that to have a division, at least two members of the preexisting partnership must be members of each resulting partnership that exists after the transaction.[28]

B. Form of a Division

In partnership divisions, a preexisting partnership generally transfers certain assets and liabilities to a resulting partnership in exchange for interests in the resulting partnership, and immediately thereafter, the preexisting partnership distributes the resulting partnership interests to partners who are designated to receive interests in the resulting partnership (the "Assets-Over Form").[29] Alternatively, the preexisting partnership may distribute certain assets and liabilities to some or all of its partners who then contribute the assets and liabilities to a resulting partnership in exchange for interests in the resulting partnership (the "Assets-Up Form").[30] As with partnership mergers, the default rule for partnership divisions is the Assets-Over Form, so that if a transaction does not follow the formal steps of the Assets-Up Form, the transaction will be characterized under the Assets-Over Form regardless of whether that form is followed.[31] Also, as with mergers, the Assets-Up Form will be respected for divisions where the assets are conveyed to the partners under the laws of the applicable jurisdiction and then reconveyed to the resulting partnership.[32]

The rules for divisions also parallel the rules for mergers in that a division resulting in a single new partnership cannot be treated both in the Assets-Over Form and the Assets-Up Form. If a partnership attempted to combine the two forms so that the choice of form was not clear, the Assets-Over Form would be applied. However, where a single partnership is divided in a transaction that involves a transfer of assets (either actual or deemed) to multiple partnerships, the transfer to each resulting partnership should be viewed separately. If a partnership division is part of a larger series of transactions, the Regulations give the IRS authority to disregard the form if the substance of the larger series of transactions is inconsistent with following the form.[33]

C. Built-In Gain in Divisions

The preamble to the Regulations under I.R.C. § 708 dealing with partnership divisions indicates that the IRS and Treasury agree that, in general, a partnership division should not create new I.R.C. § 704(c) property or I.R.C.

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[28] Treas. Reg. § 1.708-1(d)(4)(iv).

[29] Treas. Reg. § 1.708-1(d)(i)(A).

[30] Treas. Reg. § 1.708-1(d)(ii)(A).

[31] Treas. Reg. § 1.708-1(d)(3)(i).

[32] Treas. Reg. § 1.708-1(d)(ii)(A).

[33] Treas. Reg. § 1.708-1(d)(6).

§ 737 net precontribution gain.[34] However, the preamble also indicates that the Treasury was not certain that this result is necessarily appropriate where a division is non-pro rata as to the partners, where some property is extracted from or added to the partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division. Although Rev. Rul. 2004-43 dealt with a partnership merger rather than a division, if the analysis of Rev. Rul. 2004-43 is, in fact, included in final regulations, there is a potential that a similar analysis would be applied to divisions as well—resulting in a new seven year holding period being imposed on partnerships created from partnership divisions.

§ 9.04 THE EFFECT ON THE PARTNERS AND THE PARTNERSHIP

Whether a merger or division of a partnership is structured as an Assets-Up Transaction or an Assets-Over Transaction, two steps occur: there is a transfer of property to a partnership and a distribution of property from the partnership to the partners. Although the sequence and nature of the property distributed varies between the two structures, the partners receive their property as a distribution from the partnership and will have their bases determined in the property received under I.R.C. § 732, which generally provides that the bases to the partners in the property received will be the same as the bases were to the partnership immediately before the distribution. If the distribution was made other than in liquidation of the partner's partnership interest, the partner would reduce her basis in the partnership interest by the basis of the property received.[35]

In each case, a contribution is made to a resulting partnership, and the basis of the partnership interest received in exchange for the contribution will generally be determined under I.R.C. § 722, which generally provides that the basis in the partnership interest will equal the basis of the property contributed to the resulting partnership in the transaction. Similarly, the partnership would generally have a basis in the property contributed equal to the basis in the contributed property in the hands of the party that contributed that property.[36] The holding period of the resulting partnerships will include the holding periods of the contributors of the property, assuming no gain is recognized on the transaction.[37]

The result of these rules in the context of a merger is that the partners of the terminating partnerships will generally have bases in their partnership interests in the continuing partnership equal to their bases in their partnership interests in the terminating partnership (assuming no gain is recognized in the transaction).

However, the form, and thus the sequence, of the transaction chosen may create a difference in the bases of the assets held by the resulting partnerships

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[34] T.D. 8925, 66 Fed. Reg. 715 (Jan. 4, 2001).

[35] I.R.C. § 733.

[36] I.R.C. § 723.

[37] I.R.C. § 1223(2); Treas. Reg. § 1.723-1.

when there is a difference between the bases of the assets held by a terminating partnership and the aggregate bases of the partners' partnership interests in the terminating partnership. I.R.C. § 732(b) provides that the basis of property other than money distributed to a partner in liquidation of the partner's interest will be equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction. This means that if partnership ABC merges into partnership DEF using an Assets-Up Form, because the property of ABC is first distributed to partners A, B and C in liquidation of their partnership interests prior to contribution to DEF, DEF will have a basis in the former property of ABC equal to the aggregate bases of A, B and C in their partnership interests (rather than the basis that such property had in the hands of ABC). In contrast, if the Assets-Over Form is used, the continuing partnership has the same basis in the assets as the terminating partnership had in the assets. The same type of difference between inside and outside bases can result in similar differences between the Assets-Over Form and Assets-Up Form in partnership divisions.

§ 9.05 COMPARISON WITH S CORPORATIONS

Except for the issue of continued qualification of S corporation status, the rules for mergers and divisions of S corporations are generally the same as those for C corporations. A detailed discussion of such rules is beyond the scope of this text, but the following discussion summarizes the basic rules.

A. Mergers and Acquisitions

The rules for mergers and acquisitions of corporations are a combination of common law rules, statutory provisions and regulatory provisions. Three major common law doctrines have developed that are reflected in part in the regulations. The continuity of proprietary interest doctrine requires that the target's shareholders retain a continuing proprietary interest in the acquiring corporation.[38] The continuity of business enterprise doctrine requires that the acquiring corporation must either continue the target's historic business or continue to use a significant portion of the target's historic business assets in a business.[39] The business purpose doctrine requires a reorganization to be motivated by a bona fide corporate business purpose apart from tax avoidance.[40]

The most basic type of merger structure is simply a merger or consolidation of two corporations under local law, called an "A reorganization."[41] One of the most important qualification requirements is that the shareholders of the target corporation ("T") maintain continuity of proprietary interest by owning stock in the acquiring corporation ("P"). For advance ruling purposes, the

[38] Rev. Proc. 77-37, 1977-2 CB 568. Current regulations approve transactions in which at least 40 percent of the consideration received by the shareholders of the acquired company to be in stock of the acquiring company (or, where permitted, its parent). Treas. Reg. § 1.368-1(e)(v), Ex. 1.

[39] Treas. Reg. § 1.368-1(d)(2)(i).

[40] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[41] I.R.C. § 368(a)(1)(A).

Service requires that at least 50% of the consideration paid by P to the T shareholders must consist of P stock, which need not be common or voting stock.[42] Redemptions and related party acquisitions of stock occurring after a merger may be considered in applying the continuity of interest test.

Alternatively, a reorganization may be structured as a stock for stock acquisition, called a "B reorganization." A B reorganization is P's acquisition of T's stock *solely* in exchange for P voting stock where P has control (i.e., 80%) of T immediately after the acquisition.[43] No consideration other than stock may be used in a B reorganization.

A third alternative for corporations is a stock for assets acquisition, called a "C reorganization." A C reorganization is P's acquisition of substantially all of T's assets solely in exchange for P voting stock followed by the liquidation of T.[44] In applying the solely for voting stock requirement, P's assumption of T's liabilities is disregarded. Under a boot relaxation rule, P's use of consideration other than voting stock is permitted provided that P acquires at least 80% of the value of all of T's assets solely for voting stock. For purposes of this rule, liabilities assumed by P are treated as cash consideration. Under the case law, if P previously acquired more than 20% of T's stock and then acquires all of T's assets solely in exchange for P voting stock, the asset acquisition may not qualify as a C reorganization.

If a transaction qualifies as a reorganization, the corporate participants to the reorganization and the target shareholders generally do not recognize gain or loss on an exchange of their T stock solely for P stock, or an exchange of T securities solely for P securities.[45]

B. Corporate Divisions

In general, a distribution of appreciated property by a corporations to its shareholders is taxable to the corporation as if it sold the property distributed for cash.[46] Such distributions may also be taxable to the shareholders.[47]

However, if a corporation distributes solely stock or securities of a controlled corporation to shareholders with respect to the distributing corporation's stock or to security holders in exchange for the distributing corporation's stock or securities, the distribution may qualify for special tax-free treatment.[48] Control in this situation means 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes. The distribution must not be a device for distributing the earnings and profits of the distributing corporation. The

[42] The qualified consideration does not include certain types of nonqualified preferred stock. I.R.C. §§ 354(a)(2)(C), 351(g)(2).

[43] I.R.C. § 368(a)(1)(B).

[44] I.R.C. § 368(a)(1)(C).

[45] I.R.C. §§ 354, 361, 1032.

[46] I.R.C. § 311(b).

[47] I.R.C. § 301.

[48] I.R.C. § 355.

distributing corporation and the controlled corporation must each be engaged immediately after the spin-off in the active conduct of a trade or business. All of the stock of the controlled subsidiary must be distributed or, at a minimum, enough of the stock to constitute control. Other additional technical rules may apply.

§ 9.06 READING, QUESTIONS AND PROBLEMS

A. Reading

CODE:

I.R.C. § 708

TREASURY REGULATIONS:

Treas. Reg. § 1.708-1(c), (d)

RULINGS:

Rev. Rul. 2004-43, 2004-1 C.B. 842

B. Questions and Problems

1. Partnership AB, in whose capital and profits A and B each own a 50-percent interest, and partnership CD, in whose capital and profits C and D each own a 50-percent interest, merge on September 30, and form partnership ABCD. Partners A, B, C, and D are on a calendar year, and partnership AB and partnership CD also are on a calendar year. After the merger, the partners have capital and profits interests as follows: A, 30 percent; B, 30 percent; C, 20 percent; and D, 20 percent.

   a. Which partnership is treated as continuing?

   b. How is the other partnership treated?

   c. For what taxable year is the continuing partnership required to file its first return?

   d. For what taxable year is the other partnership required to file its return?

2. A, B, and C are partners in partnership X. D, E, and F are partners in Partnership Y. Partnership X and partnership Y merge, and the resulting partnership is considered a continuation of partnership Y. Partnership X is considered terminated. Under state law, partnerships X and Y undertake the Assets-Over Form to accomplish the partnership merger. C does not want to become a partner in partnership Y, and partnership X does not have the resources to buy C's interest before the merger. C, partnership X, and partnership Y enter into an agreement specifying that partnership Y will purchase C's interest in partnership X for $150 before the merger, and as part of the agreement, C consents to treat the transaction in a manner that is consistent with the agreement. As part of the merger, partnership X receives from partnership Y

$150 that will be distributed to C immediately before the merger, and interests in partnership Y in exchange for partnership X's assets and liabilities.

a. How will C be treated in the transaction?

b. Who inherits C's tax characteristics in regard to the partnership interest?

c. How is the terminating partnership treated in the transaction?

3. A, B, and C are equal partners in partnership ABC. ABC holds no I.R.C. § 704(c) property. D and E are equal partners in partnership DE. B and C want to exchange their interests in ABC for all of the interests in DE. However, rather than exchanging partnership interests, DE merges with ABC by undertaking the Assets-Up Form, with D and E receiving title to the DE assets and then contributing the assets to ABC in exchange for interests in ABC. As part of a prearranged transaction, the assets acquired from DE are contributed to a new partnership, and the interests in the new partnership are distributed to B and C in complete liquidation of their interests in ABC.

How will the transaction be characterized?

4. Partnership ABCD is in the real estate and insurance businesses. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of the partnership. The partnership and the partners report their income on a calendar year. On November 1, they separate the real estate and insurance businesses and form two partnerships. Partnership AB takes over the real estate business, and partnership CD takes over the insurance business.

a. Which partnership is the continuing partnership?

b. For what taxable year does the continuing partnership file its return?

c. For what taxable year will the other partnership file its first return?

5. Partnership ABCD owns properties W, X, Y, and Z, and divides into partnership AB and partnership CD. Partnership AB is considered a continuation of partnership ABCD and partnership CD is considered a new partnership. Partnership ABCD distributes property Y to C and titles property Y in C's name. Partnership ABCD distributes property Z to D and titles property Z in D's name. C and D then contribute properties Y and Z, respectively, to partnership CD in exchange for interests in partnership CD. Properties W and X remain in partnership AB.

What form will this division be treated as using?

6. The facts are the same as in Problem 5, except partnership ABCD distributes property Y to C and titles property Y in C's name. C then contributes property Y to partnership CD. Simultaneously, partnership ABCD contributes property Z to partnership CD in exchange for an interest in partnership CD. Immediately thereafter, partnership ABCD distributes the interest in partnership CD to D in liquidation of D's interest in partnership ABCD.

What form will this division be treated as using?

7. Partnership ABCD owns three parcels of property: property X, with a value of $500; property Y, with a value of $300; and property Z, with a value

of $200. A and B each own a 40-percent interest in the capital and profits of partnership ABCD, and C and D each own a 10 percent interest in the capital and profits of partnership ABCD. On November 1, partnership ABCD divides into three partnerships (AB1, AB2, and CD) by contributing property X to a newly formed partnership (AB1) and distributing all interests in such partnership to A and B as equal partners, and by contributing property Z to a newly formed partnership (CD) and distributing all interests in such partnership to C and D as equal partners in exchange for all of their interests in partnership ABCD. While partnership ABCD does not transfer property Y, C and D cease to be partners in the partnership. Accordingly, after the division, the partnership holding property Y is referred to as partnership AB2.

a. What partnership(s) is/are continuing partnerships?

b. What partnership is the divided partnership?

c. What form will each division be treated as using?

8. Partnership ABCDE owns Blackacre, Whiteacre, and Redacre, and divides into partnership AB, partnership CD, and partnership DE. Partnership ABCDE is considered terminated (and, hence, none of the resulting partnerships are a continuation of the preexisting partnership) because none of the members of the new partnerships (partnership AB, partnership CD, and partnership DE) owned an interest of more than 50 percent in the capital and profits of partnership ABCDE. Partnership ABCDE distributes Blackacre to A and B and titles Blackacre in the names of A and B. A and B then contribute Blackacre to partnership AB in exchange for interests in partnership AB. Partnership ABCDE distributes Whiteacre to C and D and titles Whiteacre in the names of C and D. C and D then contribute Whiteacre to partnership CD in exchange for interests in partnership CD. Partnership ABCDE does not liquidate under state law so that, in form, the assets in new partnership DE are not considered to have been transferred under state law.

What form will each division be treated as using?

CHAPTER SIX

THE ALLOCATION OF NONRECOURSE DEDUCTIONS

■ ■ ■

Background

In the preceding chapter we examined the "substantial economic effect" rules, which require that a partnership allocate its income and deductions for tax purposes to the partners who enjoy the benefit of the income, or bear the economic burden associated with the deduction. However, those rules are of no help in allocating deductions attributable to nonrecourse financing. When partnership property is pledged as security for a nonrecourse loan, it is the lender, not the partnership, who bears the economic risk that the value of the property will not satisfy the loan. Therefore, the allocation of the deductions generated by the property to the partners cannot have substantial economic effect.[1]

Nevertheless, the Code (as interpreted by the Supreme Court) permits the owner of property to take depreciation and other deductions that may be economically borne by a nonrecourse lender (these deductions are referred to in the regulations as "nonrecourse deductions").[2] After completing the substantial economic effect regulations, Treasury turned to drafting rules for allocating these deductions in the partnership setting. The rules appear in § 1.704–2, and are commonly referred to as the "nonrecourse deduction regulations."

To illustrate why the allocation of nonrecourse deductions cannot have substantial economic effect, and the problems faced by Treasury in establishing rules for the allocation of these

[1] See § 1.704–2(b)(1), which states that because they cannot have substantial economic effect, allocations of nonrecourse deductions must be allocated in accordance with the partners' interests in the partnership.

[2] The regulatory definition of the term "nonrecourse deductions" is quite complex, and will be discussed later in this chapter. For present purposes, it is enough to understand that the most common type of nonrecourse deduction is depreciation on property which is acquired or improved with the proceeds of nonrecourse financing.

deductions, consider the following fact pattern based on the Supreme Court decision in *Commissioner v. Tufts*:[3]

> ***Example #1:*** A and B form a general partnership to construct and operate an apartment complex. They agree to allocate all income, deductions, gains and losses 60% to A and 40% to B. AB obtains construction financing of $1,850 from a local bank for the entire project by giving a mortgage secured by the property; the partners invested negligible capital of their own. The building is depreciable at the rate of $100 per year. During the first four years of the partnership's operation, the partnership's rental income precisely offsets its out-of-pocket expenses, resulting in annual losses of $100 (as a result of the depreciation). At the end of Year 4, the partnership's balance sheet looks as follows:

Assets		***Liabilities & Capital***	
	Basis/Book		
Building	1,850	Mortgage	$ 1,850
Less four years depreciation	(400)		
	$1,450	***Capital Accounts***	
			Tax/Book
		A	($240)
		B	(160)
		Total	($400)

Let us first assume that the mortgage is recourse. By examining this balance sheet we can discern three things:

1. First, the AB partnership has lost $400 during its four years of operation, consisting of the decline in value of the building which the depreciation represents. This decline in value is reflected in the book value of the building and in the capital accounts of the partners.

2. Second, this loss has been allocated 60% to A and 40% to B, reducing their capital account balances to ($240) and ($160) respectively.

3. Third, if the partnership were dissolved at this time, a sale of the building at its presumed value of $1,450

[3] 461 U.S. 300 (1983). For a detailed discussion of the *Tufts* case, see Laura E. Cunningham and Noël B. Cunningham, *The Story of Tufts: The 'Logic' of Taxing Nonrecourse Transactions* in BUSINESS TAX STORIES (Foundation Press 2005).

> would leave the partnership shy by $400 of the cash necessary to repay the lender. A and B, as general partners, must make good on the partnership's debts. The negative balances in their respective capital accounts represent the amount that each must contribute to pay the lender.

The bottom line is that the $400 loss described by this balance sheet will be economically borne by A and B, and the § 704(b) regulations mandate that the partnership allocate its depreciation deductions between its partners in proportion to the burden each will bear, i.e., 60% to A and 40% to B. Any other allocation would be disregarded as without substantial economic effect.

If we assume instead that the mortgage is nonrecourse (as it was in *Tufts*) and reexamine the balance sheet, it is clearly misleading. In portraying the partners' capital accounts as negative, it implies that if the partnership dissolves after selling the building for its book value, A and B will contribute the amount of the deficit balances in their capital accounts to satisfy the lender. That is clearly not the case. Since the loan is without recourse, A and B need contribute nothing; neither will suffer any of the burden associated with the decline in the value of the building below the amount of the debt. That entire loss will be borne by the lender, who must discharge the $1,850 liability even though it receives only $1,450 in repayment. In this context, the partnership's capital accounts are meaningless (or at best misleading) in that they do not accurately reflect the partners' economic burdens.

In the last chapter, we learned that the basic underlying principle on which all partnership allocations are based is that tax deductions must be allocated to the person who bears the economic burden associated with those deductions. Here that person is the lender. To be consistent with this principle, shouldn't we allocate the cost recovery deductions to the lender?[4] The answer is unequivocally yes. Nevertheless, ever since the Supreme Court's decision in *Crane v. Commissioner* (which the Court reaffirmed in *Tufts*) it has been the law that when property is purchased with the proceeds of a nonrecourse mortgage, the

[4] Noël B. Cunningham & Deborah Schenk, Taxation Without Realization: A 'Revolutionary' Approach to Ownership, 47 Tax L. Rev. 725 (1992).

purchaser is the sole owner of the property, and the only party entitled to deduct depreciation with respect to it.[5]

Now the problems faced by Treasury in drafting rules to govern the allocation of nonrecourse deductions should be apparent: These deductions must be taken by the partnership as the sole owner of the property, even though none of the partners are economically at risk. In theory, therefore, the partnership might allocate the deductions among the partners in any way they agree. No allocation scheme would be more rational than another, since none would be anchored to the economic burden borne by any partner. The theory, if taken to its limits, would permit the partners to allocate these deductions arbitrarily to whichever partner might gain the greatest tax advantage.[6]

Fortunately, given the reality that no nonrecourse lender will extend credit on an unsecured basis, the analysis and holding of *Tufts* suggests a solution. In *Tufts*, the Supreme Court held that when property subject to a nonrecourse mortgage is disposed of in a taxable transaction, the full amount of the liability must be included in the amount realized, regardless of the value of the property at that time. The Supreme Court reasoned that since a nonrecourse mortgage was treated as "true debt" when it was incurred (generating full basis credit in the acquired property, even though the proceeds are tax-free), the mortgage must be treated as true debt when it is discharged. Hence, even though the debtor is not legally obligated to satisfy any shortfall between the amount of the loan and the value of the security, consistency requires us to treat it as if it received consideration for the property sufficient to pay the debt in full. Failing to do so would permit the debtor to receive the funds tax-free when the loan is taken out, yet never pay tax on those funds when the loan is discharged. The result of *Tufts* is that when property is transferred subject to a nonrecourse liability which exceeds the property's basis, the debtor will be forced to include in income an amount equal to the difference. This inclusion offsets the nonrecourse deductions previously allowed to the debtor, i.e., those for which the lender ultimately bore the economic burden.

To illustrate, on the facts of ***Example #1***, this means that by looking at the balance sheet at the end of Year 4, we can see that

[5] *Crane v. Commissioner*, 331 U.S. 1 (1947); *Commissioner v. Tufts*, 461 U.S. 300 (1983), see especially fn. 5.

[6] Indeed, this is precisely the position that was taken by the proposed regulations.

if the partnership disposed of the property subject to the mortgage in a taxable transaction, including transferring it to the lender, the partnership would have to include the full amount of the mortgage, $1,850, in its amount realized. Subtracting its basis of $1,450 would yield a gain of $400. Because of *Tufts*, we know that no matter what the value of the underlying property, the partnership would have a gain of at least $400 (if you will, a "minimum gain"), the difference between the principal amount of the mortgage and the partnership's adjusted basis. This "minimum gain" is at the heart of the regulations governing allocations of nonrecourse deductions. As we shall see, the regulations permit partnerships to allocate nonrecourse deductions in virtually any way the partners agree, so long as the minimum gain is allocated in the same fashion.

In drafting the regulations dealing with nonrecourse deductions, Treasury's task was not to revisit the question of who should be entitled to these deductions, the owner/partnership or the lender. Rather, its task was to determine how much flexibility partnerships should be given in allocating these deductions among their partners. The regulations take a very liberal and flexible approach to the allocation of nonrecourse deductions, but are quite strict with respect to how the resulting *Tufts* gain must be allocated. They were drafted in tandem with the regulations that allocate nonrecourse debt for basis purposes,[7] and together combine to permit the allocation of nonrecourse deductions with few constraints and ensure that the partners have sufficient basis to make use of those deductions.[8]

Regulations

Introduction

Like the SEE regulations, the nonrecourse deduction regulations adopt a safe harbor approach. If the partnership agreement complies with all of the requirements of the safe harbor, then the allocations of nonrecourse deductions will be respected, i.e., they are deemed to be in accordance with the partners' interests in the partnership.[9] If the partnership does not comply with the requirements of the safe harbor, then the Service

[7] § 1.752–3. These rules are discussed in *Chapter Eight*.

[8] The partners themselves may be subject to further limitations. See e.g., §§ 465 and 469.

[9] § 1.704–2(b).

has the authority to reallocate the deductions under the facts and circumstances rules of § 1.704–1(b)(3). Because the PIP analysis focuses on the economics of the partners' deal, and nonrecourse deductions are actually borne economically by the lender, it is not at all clear how the rules should apply in this context.[10]

The safe harbor is found in § 1.704–2(e), and its requirements are as follows:

1. The partnership agreement must satisfy either the basic or the alternate test for economic effect;[11]

2. Nonrecourse deductions must be allocated by the partnership agreement in a manner that is "reasonably consistent" with allocations of some other "significant" partnership item attributable to the property securing the debt;[12]

3. The partnership agreement must contain a "minimum gain chargeback" provision;[13] and

4. All other material allocations and capital account adjustments must be respected under § 1.704–1(b).[14]

In general, the safe harbor requirements are relatively straightforward. You should already be familiar with requirements (1) and (4) and have a general understanding of (2). The third requirement, requiring the partnership agreement to contain a minimum gain chargeback provision, is really the heart of the regulations. In the simplest case, this provision simply requires those partners who received allocations of nonrecourse deductions to report an offsetting amount of gain when the partnership disposes of the property. However, it is not possible to fully understand how the minimum gain chargeback works without examining several new terms used in the regulations. As we examine these terms, we will revisit ***Example #1.***

[10] Prior to 2009, the regulations created a presumption that that nonrecourse deductions should be shared equally by the partners, on a per capita basis. In 2009, the regulations were amended and this presumption was eliminated.

[11] § 1.704–2(e)(1). The nonrecourse debt safe harbor is actually a safe harbor within a safe harbor: if the partnership chooses not to comply with the safe harbor for SEE under § 1.704–1, then the nonrecourse debt safe harbor is unavailable to it.

[12] § 1.704–2(e)(2).

[13] § 1.704–2(e)(3), and 1.704–2(f).

[14] § 1.704–2(e)(4). This requirement seems somewhat redundant given the first requirement.

Definitions

"Partnership Minimum Gain" (PMG).[15] PMG can be thought of as (and we will sometimes refer to it as) *"Tufts gain,"* i.e., the minimum amount of gain that the partnership would realize were it to make a taxable disposition of property secured by nonrecourse financing. At any given time, that gain is the excess of the amount of the loan over the property's basis (except where book value differs from basis).[16] As you will recall, when the partnership in ***Example #1*** disposed of the property, the partnership had a gain of $400, the amount by which the principal amount of the mortgage ($1,850) exceeded the partnership's basis ($1,450), even though the value of the property had fallen below the amount of the mortgage.

Measurement of PMG is important to the regulatory scheme governing nonrecourse deductions for two primary reasons. First, the regulations measure the amount of nonrecourse deductions for a given year *indirectly* by reference to the increase in PMG during the year. Second, a decrease in a partner's share of PMG may trigger a minimum gain chargeback.

Because PMG at any given time is the spread between the loan and the property's basis, there are two principal events that will cause it to increase: (1) cost recovery deductions and (2) secondary financing. Cost recovery deductions will increase the amount of PMG if they reduce the partnership's adjusted basis in the secured property faster than the principal of the nonrecourse liability is repaid. To illustrate, in ***Example #1*** the partnership's original basis in the apartment complex was $1,850, an amount exactly equal to the principal of the mortgage. At that time, there was no PMG. During Year 1, the partnership took $100 of depreciation, reducing its basis to $1,750. Since the partnership did not repay any portion of the principal of the mortgage, $100 of PMG was created during Year 1, or phrased somewhat differently,

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[15] § 1.704–2(d).

[16] Although PMG is normally equal to the difference between the amount of the nonrecourse liability and the basis of the property securing it, when the property's book value differs from its basis, either because it was contributed to the partnership at a value different from its basis, or because it was revalued and "booked up or down" to reflect changes in its value, the regulations use book value, rather than basis, in measuring PMG. This is because, under the principles of § 704(c) (discussed in *Chapter Seven*), any inherent gain (including *Tufts* gain) that exists at the time appreciated property is contributed to the partnership must be allocated to the contributing partner, and any inherent gain (including PMG) that exists at the time of a revaluation must be allocated to the partners whose book capital accounts were adjusted to reflect the change in book value.

there was an increase in PMG of $100. If the partnership had repaid $40 of principal during Year 1, then the increase in PMG would have been only $60.

PMG may also increase if a partnership borrows funds without incurring personal liability, using its property as security for the loan. To illustrate, suppose a partnership that holds unencumbered land with a value of $500 and a basis of $200 borrows $350 without recourse, using the land as security. Prior to the borrowing, the partnership has no PMG; after the borrowing, since the principal amount of the nonrecourse liability exceeds the partnership's basis by $150, it has $150 of PMG, an increase of $150. If the proceeds of such a borrowing are distributed to the partners, then to the extent that the borrowing caused an increase in PMG (here $150), we will refer to it as a **"nonrecourse distribution."**[17]

An increase in PMG for a particular year generally will equal the sum of the nonrecourse distributions and nonrecourse deductions for that year. The total amount of partnership minimum gain at any time represents the total of deductions taken by the partnership and distributions made by the partnership for which the lender has borne the burden. Although the tax law permits the partnership to take these deductions, and permits these distributions, it requires that, upon disposition of the underlying property, the partnership recognize an offsetting minimum gain.

"Nonrecourse Deductions" (NRDs).[18] Nonrecourse deductions are those deductions attributable to nonrecourse financing and represent amounts for which no partner bears the economic burden. NRDs are measured annually and are equal to the "net increase in the partnership's minimum gain" during the taxable year, less any nonrecourse distributions made during the year. In ***Example #1***, for example, since there was an annual increase in PMG of $100 and no nonrecourse distributions, the partnership had NRDs of $100 each year.

Normally, NRDs are comprised of the cost recovery deductions taken on the encumbered property. This is sensible because the most common source of an increase in PMG is cost recovery. For a number of reasons, however, the cost recovery deductions of the partnership may be less than the increase in

[17] §§ 1.704–2(c) & 1.704–2(h).

[18] § 1.704–2(c).

PMG.[19] Therefore, the regulations create the following ordering rule to determine which of the partnership's deductions are characterized as nonrecourse:

1. First, depreciation or cost recovery deductions with respect to the encumbered property, and

2. then, if necessary, a pro rata portion of the partnership's other expenses (including deductible items and non-deductible § 705(a)(2)(B) expenses) for the year, and

3. finally, if there are insufficient deductions for the year, the excess nonrecourse deductions are carried over to the following year.[20]

As a practical matter, in the absence of secondary borrowing, there will always be sufficient cost recovery deductions, because those deductions will have been responsible for the increase in partnership minimum gain. Therefore, the NRDs in ***Example #1*** are exclusively cost recovery deductions.

"Partner's Share of Partnership Minimum Gain."[21] The ultimate objective of the regulations is to ensure that each partner will eventually report an amount of income or gain equal to her share of nonrecourse deductions and distributions. Treasury did not want one partner to be allocated all of the NRDs and another all of the *Tufts* gain. For this reason, the regulations require partnerships to keep track of each partner's share of PMG. Thus, each year's increase in PMG is allocated among the partners in accordance with the amount of NRDs allocated to each and the amount of nonrecourse distributions made to each. If there has been a net decrease in PMG during the year, it too will be allocated among the partners and may trigger the minimum gain chargeback provision. Thus, at any given point in time each partner's share of the total PMG of the partnership will be equal to the excess of:

(1) the sum of the NRDs allocated to her and nonrecourse distributions she has received, OVER

(2) that partner's share of net decreases in PMG.

[19] For example, the increase in PMG may be attributable to secondary financing which is not distributed, but used to pay partnership expenses.

[20] §§ 1.704–2(j)(1)(ii) & (iii).

[21] § 1.704–2(g)(1).

In effect, these shares represent the amount by which each partner has benefitted from nonrecourse financing, through deductions or distributions, without incurring risk. On the facts of ***Example #1***, A's share of PMG is $240, and B's share is $160.

"Minimum Gain Chargeback Provision."[22] Although the rules with respect to the allocation of nonrecourse deductions are quite liberal, they are quite strict in how the resulting *Tufts* gain is allocated. The underlying principle is that the partner who enjoyed the benefit of a nonrecourse deduction (or distribution) should be required to report a corresponding share of the partnership's minimum gain. This principle is implemented by the minimum gain chargeback provision, which generally requires that if there is a "net decrease in PMG" for a taxable year, each partner must be allocated an amount of income or gain equal to her share of the decrease.

Although there are many possible causes for a decrease in PMG, the most common cause is the disposition of the encumbered property. For example, in ***Example #1***, at the beginning of the year in which the partnership disposed of the property, the partnership had $400 in minimum gain; after the disposition, its minimum gain is reduced to zero, resulting in a net decrease of $400. Under the minimum gain chargeback provision, the partnership would be required to allocate the $400 gain from the disposition of this property in an amount equal to each partner's share of the decrease in PMG. As a technical matter, a partner's share of a net decrease in PMG equals the amount of the decrease times each partner's share of the total PMG. On the facts of ***Example #1***, this means that the partnership would be required to allocate $240 ($400 times 60%) of this gain to A and $160 ($400 times 40%) of it to B.

Although the disposition of the underlying property is the most common cause of a decrease in partnership minimum gain, there are several other possible causes, four of which Treasury found to be inappropriate to trigger the minimum gain chargeback provision. In each of these cases, Treasury concluded that it was not necessary to trigger the gain chargeback to protect the basic principle that each partner must report her share of PMG. These four exceptions are:

[22] § 1.704–2(f).

1. *Conversions and refinancing.*[23] A decrease in PMG can result simply from the conversion of a nonrecourse obligation into one on which one or more of the partners are personally liable. As to those partners who become personally liable there is no reason to trigger the minimum gain chargeback since these partners are now actually bearing the economic burden associated with the deductions they have already taken. The minimum gain chargeback, however, applies with full force to any partner who does not incur personal liability.

2. *Contributions of capital.*[24] A decrease in PMG may result from a partner's contribution of capital that is used either to repay the principal of a nonrecourse liability or to make a capital improvement to the encumbered property. The repayment reduces the liability, and the improvement increases basis, either of which will reduce the spread between basis and the amount of the liability. In either case, since the decrease is caused by an actual investment in the property, it is inappropriate to trigger the gain chargeback.

3. *Revaluations.*[25] Although a decrease in PMG can result from the revaluation of a partnership's assets, the minimum gain chargeback provision will not apply. The reason for this exception, as we shall see in the next chapter, is that a revaluation has the effect of converting each partner's share of PMG into "§ 704(c)-type gain" for which the partners remain personally responsible.[26]

4. *Waiver.*[27] Finally, Treasury recognized that under certain other circumstances the minimum gain chargeback could distort the economic arrangement among the partners. In such a case, the partnership may request a waiver of the provision.

[23] § 1.704–2(f)(2).

[24] § 1.704–2(f)(3).

[25] § 1.704–2(d)(4).

[26] § 1.704–3(a)(6).

[27] § 1.704–2(f)(4). For an example of when a distortion may be created, see § 1.704–2(f)(7) Ex. 1.

Illustrations

The following examples illustrate these rules.

Example #2: On January 1, 2016, G and L formed a limited partnership to acquire and operate a rental apartment building. L, the limited partner, contributed $135 and G, the general partner, contributed $15. The partnership obtained a nonrecourse loan from an unrelated financial institution for $850 and purchased a building for $1,000 on leased land. The loan is secured by the building. The loan requires interest to be paid currently, but does not require any principal payments for 25 years. The building is depreciable over 10 years at the rate of $100 per year.

The partnership agreement satisfies the first two requirements of the basic test for economic effect (i.e., the capital account and liquidation requirements). L has no obligation to make up any deficit in her capital account. The partnership agreement, however, does have a QIO provision. It also has a "minimum gain chargeback" provision as described in § 1.704–2(f). The partners agree that nonrecourse deductions will be shared equally. Finally, the agreement provides that all items of income, deduction and loss, *other than nonrecourse deductions*, will be allocated 90% to L and 10% to G until the first time that income and gain exceed losses taken in prior years. Thereafter, all items of income, gain, and loss will be allocated equally between the partners.

For the taxable years 2016–2018, the partnership has $70 of gross rental income and $70 of out of pocket expenses ($60 in interest and $10 in operating expenses). As a result of the depreciation deduction on the building, the partnership has an annual net tax loss of $100 each year. During this period, the partnership makes no distributions.

The partnership's initial balance sheet is as follows:

Assets		***Liabilities & Capital***	
	Basis/Book		
Building	$1,000	Mortgage	$850
		Capital Accounts	
			Tax/Book
		G	$15
		L	135
			$150

Example #2 raises several different issues that we will explore.

Issue #1: How much flexibility does the partnership have in allocating the nonrecourse deductions that the partnership expects to have?

The partnership is permitted to allocate these deductions in any way it wishes *as long as* the allocation is "reasonably consistent" with the allocation of another significant item relating to the property that has SEE. At the outset, all significant items other than nonrecourse deductions are to be allocated 90/10. Assuming there is a reasonable likelihood that income and gain will eventually exceed prior losses and deductions, these items will eventually be allocated 50/50. Therefore, according to the regulations, the allocation of NRDs would be respected if the sharing ratio is anywhere within the range of 90/10 to 50/50.[28] A sharing ratio outside this range may be attacked by the Service.[29] In this example, we shall assume that the partnership allocates all nonrecourse deductions equally. This will allow us to distinguish the partnership's nonrecourse deductions from its other deductions.

Issue #2: What are G's and L's initial bases in the partnership?

Their initial bases depend on how they share the nonrecourse debt. On these facts, it is probable that the partners will share the

[28] See § 1.704–2(m) Ex. 1(ii).

[29] § 1.704–2(m) Ex. 1(iii)(on similar facts held that a sharing ratio of 99/1 was not reasonably consistent).

debt equally, or $425 each.[30] On this assumption, G's initial outside basis is $440 and L's is $560.

Issue #3: How should the partnership allocate the $100 loss for 2016 between G and L? Phrased somewhat differently, are there any NRDs in 2016?

At the end of 2016, the book value of the building still exceeds the principal amount of the mortgage; therefore, this partnership has neither minimum gain nor any NRDs. According to the agreement, the $100 loss is to be allocated $10 to G and $90 to L. For reasons discussed in the preceding chapter, this allocation has SEE and will be respected.[31] On January 1, 2017, the partnership's balance sheet would look as follows:

Assets		***Liabilities & Capital***	
	Basis/Book		
Building	$900	Mortgage	$850
		Capital Accounts	
			Tax/Book
		G	$ 5
		L	45
			$50

Issue #4: How should the partnership allocate the $100 loss for 2017? Are there any NRDs in 2017?

At the end of 2017, the adjusted basis of the building is now $800 while the balance of the mortgage remains at $850; therefore, $50 of PMG has been created—a net increase of $50. Since there are no distributions, $50 of the depreciation deduction is characterized as a NRD and is allocated equally between the partners, $25 each. In addition, the partnership has a $50 loss (calculated without taking into account the NRDs), that is allocated $5 to G and $45 to L; this allocation has SEE. The adjustments to the partners' capital accounts for 2017 are as follows:

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[30] See § 1.752–3 for the rules allocating nonrecourse debt. These rules are discussed in Chapter Eight.

[31] As you will recall, this is because the alternate test for economic effect is satisfied and the allocation is not transitory because of the value equals basis rule.

	Capital Accounts	
	G	*L*
Balance (as of 1/17)	$5	$45
NR Deduction	(25)	(25)
Loss (w/o NRDs)	(5)	(45)
	($25)	($25)

Issue #5: What are G's and L's shares of the $50 partnership minimum gain?

Since G and L each received $25 of the NRD, each has a $25 share of the PMG.

Issue #6: Normally, a QIO is triggered whenever a deficit in a partner's capital account is created in excess of the amount that a partner is obligated to restore. At the end of 2017, L's balance in her capital account is ($25). Since she does not have a deficit make-up obligation, is the partnership's QIO provision triggered?

No. Essentially, each partner's share of PMG is treated as a limited deficit make-up obligation.[32] This is a sensible rule for two reasons: First, in the absence of such a rule, few limited partners would be able to benefit from an allocation of NRDs: the allocation would trigger the QIO, which would offset the benefit. Second, in a very real way, the integrity of the alternate test is not threatened by this rule, because the minimum gain chargeback provision ensures that a partner who is allocated NRDs is obligated to eventually include a similar amount in income, thereby restoring the deficit in her capital account.

Issue #7: How should the partnership allocate the $100 loss for 2018?

At the beginning of 2018, there was $50 of PMG. During 2018, the partnership's basis in the building is reduced to $700 while the balance of the mortgage remains $850. As a result, at the end of 2018, there is $150 of PMG, a net increase of $100. Therefore, the entire $100 depreciation deduction is a NRD which is allocated equally between the partners in accordance with the partnership agreement, i.e., $50 each. This increases each partner's share of PMG to $75, and reduces the balance in her capital account to ($75). The partnership's balance sheet on January 1, 2019 would look as follows:

[32] § 1.704–2(g)(1). See also § 1.704–1(b)(2)(ii)(d).

Assets		***Liabilities & Capital***	
	Basis/Book		
Building	$700	Mortgage	$850
		Capital Accounts	
			Tax/Book
		G	$ 75
		L	(75)
			($150)

> ***Example #3:*** Assume the same facts as in ***Example #2.*** In addition, assume the following ALTERNATIVE events occur during 2019. Ignore any possible depreciation deduction for 2019.
>
> ***Alternative #1:*** On January 1, 2019, the partnership transfers the building to the lender in complete satisfaction of its obligation under the mortgage.

Under *Tufts*, the partnership realizes a gain of $150 on the disposition of this building. As a result of the disposition, the partnership has a net decrease in PMG of $150 for the year.[33] This decrease in PMG triggers the minimum gain chargeback provision, which requires the partnership to allocate to each partner her share of that decrease. On these facts, the partnership MUST allocate $75 to L and $75 to G, even though they generally share gains 90/10. The minimum gain chargeback provision, in other words, establishes an overriding layer of profit sharing.

> ***Alternative #2:*** On January 1, 2019 the partnership sells the building for $100 cash, the buyer taking the building subject to the $850 mortgage.

On the sale of the building, the partnership has $250 of gain. As in ***Alternative #1***, the disposition of the building results in a net decrease in PMG of $150. This triggers the minimum gain chargeback provision, and, for the same reasons as in ***Alternative #1***, $150 of this gain must be allocated equally between G and L in accordance with their share of the decrease in PMG. The $100 balance represents real partnership profit, not just a restoration of the lender's notional earlier losses. According to the agreement, this profit is allocated $10 to G and $90 to L, restoring to each partner a portion of her initial capital

[33] Since there is no longer a nonrecourse liability, there can't be any PMG.

contribution. This allocation will have substantial economic effect.

Alternative #3: On January 1, 2019, G personally guarantees the mortgage.

As a result of the guarantee, the mortgage changes its character from a partnership nonrecourse liability to a partner nonrecourse debt.[34] Essentially, a partner nonrecourse debt is one that is nonrecourse with respect to the partnership, but is recourse with respect to one or more of the partners. Here, G has undertaken the entire economic burden represented by the difference between the value of the building and the face amount of the debt. As in each of the other alternatives, the guarantee results in a net decrease in PMG of $150. Nevertheless, the regulations recognize that this would be an inappropriate time to trigger the minimum gain charge back with respect to G, since G now is personally liable on the obligation.[35] This is not true for L. At the beginning of 2019, the balance in her capital account was a negative $75, even though she had no deficit restoration obligation. This $75 represents NRDs allocated to L but whose economic burden was being borne by the lender. Now that G has undertaken that burden, it is not appropriate for L to have a negative balance for amounts for which G is responsible. Therefore, the minimum gain charge-back provision applies to her. Note, however, that there is no gain to "charge-back." In this situation, the regulations require a pro rata portion of the partnership's other items of gain and income for that year be allocated to L.[36]

Conclusion

From the foregoing discussion it should be clear that the safe harbor created by the regulations gives partnerships enormous flexibility in allocating nonrecourse deductions among their partners. If a partnership does not come within the safe harbor, its nonrecourse deductions will be allocated in accordance with

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[34] § 1.704–2(b)(4). Partner nonrecourse debt is debt that is technically nonrecourse under § 1.1001–2, but for which one or more partners (or related parties) are personally liable. Under § 1.704–2(i), the deductions and distributions attributable to partner nonrecourse liabilities must be allocated among those partners who are liable under rules parallel to those for nonrecourse liabilities.

[35] § 1.704–2(f)(3).

[36] § 1.704–2(f)(6). See also § 1.704–2(j)(2)(i) and (iii). Cf. § 1.704–1(b)(2)(iv) (the rules relating to qualified income offsets).

the partners' interests in the partnership under § 1.704–1(b)(3). Because the burden represented by these deductions is being borne by the lender, and not the partnership, there is no certainty as to exactly how these deductions would be allocated.[37] Since this type of uncertainty makes many investors uneasy, for many years most limited partnerships opted for the safe harbor. As we mentioned at the end of *Chapter Five*, many partnerships are now using targeted allocations, allocations that may or may not have substantial economic effect under § 1.704–1(b)(2). If they do not, then the safe harbor under § 1.704–2(e) is not available. Even if that is the case, it is our understanding that many practitioners believe that their allocation of nonrecourse deductions will be respected *as long as* they are allocated in the same way as other partnership items. As we shall see in *Chapter Eight*, the rules governing the sharing of nonrecourse liabilities are designed to work in tandem with these allocation rules to ensure that the partner who is allocated nonrecourse deductions will in most cases have sufficient basis to benefit from these deductions.

[37] This was especially true when the regulations created a presumption that all partnership interests were equal.

CHAPTER SEVEN

CONTRIBUTIONS OF PROPERTY: SECTION 704(c) AND SECTION 704(c) PRINCIPLES

■ ■ ■

Introduction

The last two chapters have shown that partnerships are given significant flexibility in allocating items of income or loss, so long as the allocation has substantial economic effect, or is determined to be in accord with the partners' interests in the partnership. Underlying these rules is the mandate that, however a partnership allocates its book items, it must allocate its corresponding tax items in the same manner. In other words, "tax must follow book."

The "tax follows book" principle generally works well when a partnership purchases an asset and reflects it on the books at cost for both tax and book purposes. In that case, the partnership's gain, loss, or depreciation with respect to that asset will be the same for book and tax purposes, so that the partnership can comply with the tax follows book mandate.[1]

Nevertheless, as we discussed in *Chapter Four*, there are certain events that predictably create a disparity between a partnership's book and tax accounts. Two events that have this effect are (i) the contribution to a partnership of property with a fair market value that exceeds its basis, i.e., property with a "built-in gain,"[2] and (ii) the revaluation of a partnership's assets

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[1] This assumes that the partnership elects to follow the capital accounting rules prescribed in § 1.704–1(b)(2)(iv) which are discussed in *Chapter Four*.

[2] As discussed later in the chapter, § 704(c)(1)(C) mandates that built in losses be allocated to the contributor, and treats the noncontributor as having a fair market value basis in the property. As interpreted in recently issued proposed regulations, this requires the partnership will take a basis in the property equal to its fair market value, so there will be no tax/book disparity. The general rules discussed here continue to apply to revaluations that result in a built-loss, § 704(c)(1)(C) only applies to contributions.

as permitted by § 1.704–1(b)(2)(iv)(f).[3] In each situation, the tax/book disparity is created because at the time of contribution or revaluation, the property will be reflected on the partnership's books at its fair market value even though no gain or loss is recognized for tax purposes. In effect, the gain or loss inherent in the property is recognized for book purposes but not for tax purposes. As a result, when the partnership makes a taxable disposition of the property there will be tax gain (or loss) for which there is no corresponding book gain (or loss). In the case of depreciable property, the partnership's book depreciation will not match its tax depreciation. For this reason, with respect to the disparity, tax *cannot* follow book, and it is impossible for the tax allocations to have substantial economic effect. The allocation of these tax items is governed by the special rules (and principles) of § 704(c) and the regulations thereunder.[4]

Section 704(c) imposes two mandates with respect to contributed property:

- Section 704(c)(1)(A) requires that "income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution."
- Section 704(c)(1)(C) requires that "if any property so contributed has a built-in loss—such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner . . . "[5]

Thus, if appreciated or depreciated property is contributed to a partnership, the built-in gain or loss (when recognized by the

[3] Because the book/tax disparity resulting from revaluing partnership assets is so much like that caused by the contribution of § 704(c) property, allocations with respect to revalued assets are referred to as "reverse § 704(c) allocations."

[4] Section 1.704–1(b)(2)(iv)(f)(4) requires that allocations of tax items with respect to revalued property must be governed by § 704(c) principles. The § 704(c) regulations explicitly describe allocations with respect to revalued property as "reverse § 704(c) allocations," and make clear that the principles of those regulations are applicable to those allocations. Thus, when a partnership revalues its assets as permitted by the capital accounting rules, § 704(c) principles require that the built-in gain or loss be allocated to the partners to whom the gain or loss was allocated for book purposes at the time of the revaluation.

[5] It also requires that for purposes of the non-contributors, the partnership's basis should equal fair market value. That rule is illustrated below.

partnership) must be taken into account for tax purposes by the contributing partner, i.e., the partner to whom the gain or loss was allocated for book purposes at the time of contribution. This requirement is consistent not only with assignment of income principles, but also, in a very fundamental way, with the "tax follows book" principle that underlies § 704(b). Because the capital accounting rules require that contributed property be reflected on the books of the partnership at its fair market value,[6] all built-in gain or loss is essentially recognized for book purposes by the contributing partner. By requiring that the partnership allocate the corresponding tax gain or loss to the contributing partner, § 704(c) can be thought of as requiring tax to follow book, albeit on a deferred basis, i.e., when the tax gain or loss is recognized by the partnership.

While the principles of § 704(c) appear relatively straightforward, their implementation can be quite complex. In this chapter we examine how the regulations implement these principles, first in the context of contributions of property, then in the context of revaluations.

Contributions of Property

Section 704(c) requires that tax items with respect to contributed property must be shared so as to take into account the built-in gain or loss at the time of contribution. The statute defers to the Secretary for guidance on how this should be accomplished. The regulations state that the partnership may use a "reasonable method that is consistent with the purpose of section 704(c),"[7] and go on to identify three methods that Treasury generally will find reasonable: the "traditional method,"[8] the "traditional method with curative allocations,"[9] and the "remedial allocation method."[10] We will first examine each of these as they apply to nondepreciable property, and then will tackle the more complex rules applicable to depreciable property.[11]

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[6] § 1.704–1(b)(2)(iv)(b). When a partnership revalues its assets, it "books up" the assets on its balance sheet to fair market value, and must allocate that book gain or loss among the partners' capital accounts in the same manner as if it had been sold for fair market value. § 1.704–1(b)(2)(iv)(f)(2).

[7] § 1.704–3(a)(1).

[8] § 1.704–3(b).

[9] § 1.704–3(c).

[10] § 1.704–3(d).

[11] As discussed below, under § 704(c)(1)(C) these methods do not apply to property contributed with a built-in losses, but will apply to revalued property with a

Nondepreciable Property

To illustrate the various ways to account for built-in gain and loss inherent in nondepreciable property, we will consider several variations of the following fact pattern:

> ***Example #1:*** A and B form an equal partnership to which A contributes land with a basis of $60 and a fair market value of $100, and B contributes $100 cash. The land is a capital asset in both A's and the partnership's hands.

The partnership capital accounting rules of § 1.704–1(b)(2)(iv) require the partnership to account for this transaction for *book* purposes by giving A credit in her capital account for the land's full fair market value, and the land will be reflected on the asset side of the partnership's balance sheet at that value.[12] As a result, a disparity exists between the partnership's tax and book accounts, i.e., the land has a tax basis of $60 but a book value of $100. As we learned in *Chapter Four*, to reflect these disparities, and to assist in tracing them to the partner to whom they are attributable, we create "tax capital" accounts for the partners, which essentially reflect each partner's share of the partnership's inside basis, net of liabilities.[13] Thus, at formation, the partnership's balance sheet is as follows:

Assets		
	Basis	*Book*
Cash	$100	$100
Land	60	100
	$160	$200

Liabilities & Capital		
Capital Accounts		
	Tax	*Book*
A	$ 60	$100
B	100	100
	$160	$200

It is apparent from the balance sheet that if the partnership were to sell the land for $100, it would realize a tax gain of $40,

built-in loss. For that reason, all references to built-in losses are limited to revaluations, not contributions.

[12] § 1.704–1(b)(2)(iv)(d). Although partnerships are not required to follow the capital accounting rules of § 1.704–1(b)(2)(iv) unless they wish to rely upon the safe harbor for substantial economic effect under § 1.704–1(b)(2)(ii), the regulations governing contributed property under § 704(c) require that partnerships which do not do so must use book capital accounts "based upon the same principles." § 1.704–3(a)(3).

[13] These concepts were introduced in *Chapter Four*.

but no book gain. A's book capital account reflects that she received the benefit of that book gain at the time she contributed the property. Thus, if any of the $40 tax gain were reported by B, the result would be to tax B on gain that was credited to A for book purposes.

Traditional Method

Under the "traditional method,"[14] the noncontributing partner is taxed only on gains or losses that accrue after formation of the partnership, and the contributor is responsible for the built-in gain or loss. Another way to view it is that the goal is to treat the noncontributory as though she purchased her proportional interest in the property. As a result, where the contributed property is nondepreciable, only tax gains (or losses) corresponding to book gains (or losses) will be allocated to the noncontributor. Thus, in ***Example #1***, if the partnership were to sell the property for $100, there would be no book gain, but there would be $40 of tax gain. Because B sustained no book gain, no tax gain would be allocated to her. A, on the other hand, has a $40 disparity in her tax and book capital accounts. This reflects that $40 of book gain was credited to her when she contributed the property, but that was not matched by a tax gain. Therefore all of the corresponding $40 tax gain will be allocated to her, fulfilling the basic mandate that tax must follow book, even though the tax allocation followed the book allocation on a delayed basis. As a methodology to follow in analyzing this type of transaction, we suggest:

1. First calculate book gains or losses and tax gains or losses;

2. Next allocate the book gain or loss in accordance with the partnership agreement;

3 Allocate tax items to the noncontributor(s) to match their book gains or losses, if possible;

4. Allocate the balance of the tax items to the contributor.

[14] § 1.704-3(b).

To illustrate further, consider the following variation:

> ***Variation #1:*** Assume the land in ***Example #1*** increases in value and AB sells it for $120. As a result of the sale, AB has a book gain of $20 and a tax gain of $60.

Under their agreement, A and B share the book gain equally, $10 apiece. Under the traditional method the tax gain is allocated as follows: B, the noncontributing partner, is allocated an amount of tax gain equal to her book gain of $10, and A is allocated the balance, $50. By allocating the tax gain first to the noncontributing partner to match her book gain, the traditional method maintains the equality between B's book and tax capital accounts, which is another way of saying that her tax allocations match the economic agreement of the partners. Once this is accomplished, the remaining tax gain is necessarily allocable to the contributing partner, A. Note that, in this variation, this allocation has the effect of eliminating entirely the book/tax disparity on the partnership's books.

The regulations impose one important limitation on the principle prohibiting shifts of built-in gain: the so-called "ceiling rule."[15] Traditionally, the ceiling rule has imposed a limit upon the amount of any tax item that a partnership may allocate among its partners: that limit is the amount of tax gain, income, loss, or deduction that the partnership, as an entity, actually recognizes for the year. In operation, the ceiling rule can cause serious distortions, by shifting a portion of a built-in gain to the noncontributing partners. This is illustrated by ***Variation #2.*** Prior to 2004, the ceiling rule also could operate to shift built-in losses to noncontributing partners. However, § 704(c)(1)(C), enacted in 2004, explicitly states that a built-in loss can *only* be taken into account by the contributing partner. This provision would appear to override the regulatory ceiling rule with respect to built-in losses.[16] Treasury issued proposed regulations under § 704(c)(1(C) in 2014, and they are discussed in ***Variation #3.***

> ***Variation #2:*** Assume the facts of ***Example #1***, but that instead the land goes down in value and AB sells it for $70. As a result of this sale, although AB has a book loss of $30, it has a tax gain of $10.

[15] § 1.704-3(b)(1).

[16] Section 704(c)(1)(C) also has the effect of preventing a purchaser of a partnership interest from being able to benefit from a built-in loss in property contributed by the seller. This is discussed in *Chapter Ten*.

For book purposes, A and B suffer a loss of $15 each; however, the partnership has no tax loss to match B's book loss. The ceiling rule prevents us from allocating any loss to him, and we have created a tax/book disparity in B's accounts. What to do with the tax gain? If we allocate any of the gain to B, we will only increase the amount of the tax/book disparity. We must allocate the entire tax gain of $10 to A, but this amount is not sufficient to eliminate A's book/tax disparity. Immediately after the sale, AB's balance sheet appears as follows:

Assets		
	Basis	Book
Cash	$170	$170

Liabilities & Capital		
Capital Accounts		
	Tax	Book
A	$ 70	$ 85
B	100	85
	$170	$170

Notice that, although the disparity between tax and book has been eliminated on the asset side of the balance sheet, a new one has been created between B's tax and book accounts. This is because B has recognized a real economic loss that has been taken into account for book purposes but not for tax purposes: her $15 economic loss has not been matched by a tax loss. A, on the other hand, who enjoyed a book gain of $40 at the time she contributed the property (and was given a book capital credit of $100) and sustained an offsetting loss of $15 when the property was sold, (for a net gain of $25), has only reported $10 of tax gain, effectively (albeit temporarily) shifting $15 of that gain to B (via the deferred loss deduction). Even though it violates the basic purpose of § 704(c), to preventing shifting of gains and losses, this result is compelled by the ceiling rule, and these effects will presumably be offset one day, when the partnership liquidates or when A and/or B sell their partnership interests.[17] In the meantime, however, B's unrecognized loss and A's unrecognized gain will be locked in.

[17] If the partnership were immediately to liquidate, distributing cash of $85 to each partner, A would recognize a gain of $15 under § 731(a)(1) and B would recognize a $15 loss under § 731(a)(2). Similarly, if either were to sell his or her partnership interest, recognition of the deferred gain or loss under § 741 would result.

Contribution of Built-in Loss Property

Prior to 2004, the ceiling rule could result in shifting losses among partners. Consider the following:

> ***Variation #3:*** Assume the same facts of ***Example #1*** except that A's basis in the land on the date of contribution is $140 and that the partnership sells the land for $120. Prior to the enactment of § 704(c)(1)(C), after formation the partnership's balance sheet would have been as follows:

Assets

	Basis	Book
Cash	$100	$100
Land	140	100
	$240	$200

Liabilities & Capital

Capital Accounts

	Tax	Book
A	$140	$100
B	100	100
	$240	$200

Prior to 2004 this built-in loss would have been treated the same as a built-gain, i.e., under the traditional method, the loss would have been subject to the ceiling rule. Under that rule, when the partnership sells the land for $120, it would have had a book gain of $20 and a tax loss of $20. Under their agreement, A and B share the book gain equally, or $10 each. Under the traditional method, the ceiling rule would have applied and B would not have been taxed on her share of the gain (because the partnership had no gain), and A would have been allocated the entire $20 loss. In effect, this would have resulted in a shift of $10 of A's loss to B. Section 704(c)(1)(C) now prohibits this result and establishes two additional rules for determining tax allocations when property with a built-in losses is contributed to a partnership, one for the contributing partner and one for the noncontributing partners. These are:

> 1. Contributing partner: If a partner contributes property to a partnership with a built-in loss (as A did), then the partnership must allocate any tax item related to that loss to the contributor,[18] and

[18] § 704(c)(1)(C)(i).

2. Non-contributing partner: To determine the amount of any item with respect to built-in loss property that is to be allocated to a noncontributing partner (such as B), the partnership shall be treated as having an initial tax basis in the property equal to its fair market value on the date of contribution.[19]

The general idea behind § 704(c)(1)(C) is clear: Built-in losses are no longer subject to the ceiling rule and cannot be shifted to other partners. Between the time that the statute was enacted in 2004 and proposed regulations were issued in 2014, it was not exactly clear how this was going to be accomplished. In a prior edition of this book we posited a solution that would essentially apply the remedial allocation method (discussed below) to built-in loss property. In the 2014 proposed regulations, Treasury took a different, admittedly clever approach,[20] which reaches the same result as the method we suggested.

The regulations refer to built-in loss property that is contributed to a partnership as "section 704(c)(1)(C) property"[21] and the partnership has a total basis in it equal to that of the contributor under § 723. However, the partnership must divide the total basis in the property into two amounts: one equal to the property's fair market value, the second equal to the excess of basis over fair market value (that's the built-in loss). The partnership uses the fair market value portion as its "common inside basis" (our term), eliminating the tax/book disparity from the asset side of the partnership's balance sheet. As a corollary, for purposes of determining the balance in the contributor's tax capital account she is also treated as contributing property with a basis equal to fair market value.[22] Therefore, there is no disparity between the balances in the contributor's capital accounts. The second portion of the partnership's basis, the built-in loss portion, which the regulations call the "section 704(c)(1)(C) basis adjustment," is dealt with separately, as described below.

Applying these rules to ***Variation #3***, the partnership's initial balance sheet (and the partners' outside bases) is as follows:

[19] § 704(c)(1)(C)(ii).

[20] Prop. Reg. § 1.704–3(f).

[21] Prop. Reg. § 1.704–3(f)(2)(i).

[22] Note that the formula that outside basis equals tax capital plus share of liabilities will no longer hold true in this case. This is not the only situation in which this occurs, we will see another in *Chapter Ten*.

	Assets		*Liabilities & Capital*
	Basis	*Book*	
Cash	$100	$100	
Land	100	100	
	$200	$200	

Capital Accounts

	Tax	*Book*
A	$100	$100
B	100	100
	$200	$200

Outside Bases

A	$140
B	100
	$240

A's outside basis is $140, determined under the normal rules of § 722. This includes the entire basis in the land, while the balance sheet reflects only the common inside basis of $100. The remaining $40 is not reflected. This is the second portion of the basis we described above, the "section 704(c)(1)(C) basis adjustment." It is part of the partnership's basis, but it can be utilized *solely* with respect the contributing partner.[23] It must be accounted for separately; it is not part of the common inside basis. The contributor will account for this adjustment in a variety of ways. If the property is depreciable, the contributor would be entitled to additional depreciation each year, and in that way the built-in loss is allocated to the contributor over time.[24] If § 704(c)(1)(C) property is sold, like the land in our variation, the built-in loss is taken into account in a two-step process: (1) the partnership determines its book and tax gain or loss on the sale using its common inside basis, and allocates that gain or loss among all of its partners, and (2) the contributing partner reduces her share of that gain or loss by the § 704(c)(1)(C) basis adjustment. Applying this process to ***Variation #3***, when the partnership sells the land for $120, it will have a book and tax gain of $20, $10 of which it will allocated to A and B. B will report her $10 share of the tax gain.

[23] Prop. Reg. § 1.704–3(f)(2)(iii). This adjustment is modelled after the special basis adjustments that are often created when a partnership interest is sold. These latter adjustments are discussed in depth in *Chapter Ten*.

[24] § 1.704–3(f)(3)(ii)(D).

At the end of the day, however, A has a tax loss of $30, determined as follows:

$10	A's allocable share of the $20 gain
(40)	A's § 704(c)(1)(C) adjustment
($30)	A's net loss on the sale

Under § 705, this loss of $30 reduces A's outside basis from its starting point of $140 to $110. After the sale, the partnership's balance sheet (and outside bases) would be as follows:

	Assets		*Liabilities & Capital*		
	Basis	Book			
Cash	$220	$220			
			Capital Accounts		
				Tax	Book
			A	$110	$110
			B	110	110
				$220	$220

Outside Bases	
A	$110
B	110
	$220

The partnership has successfully allocated the entire built-in loss to A, thereby satisfying the general rule of the statute.

In sum, it is no longer possible to shift built-in losses on *contributed property* via the ceiling rule.[25] No one other than the contributor is entitled to benefit from them. On the other hand, built-in gains remain subject to the ceiling rule, which results shifts in built-in gains among partners. As mentioned above, this can cause in serious distortions.

Traditional Method with Curative Allocations[26]

Recognizing the problems caused by the ceiling rule, the regulations permit partnerships to use the "traditional method with curative allocations".[27] Partnerships using this method may elect to make reasonable "curative allocations" to eliminate ceiling rule distortions. A "curative allocation" is an allocation of an item for tax purposes that differs from the allocation of the

[25] Remember § 704(c)(1)(C) does not apply to revaluations.

[26] § 1.704–3(c).

[27] § 1.704–3(c)(1).

corresponding book item. The allocation is meant to "cure" the disparities caused by the ceiling rule and is available only if the ceiling rule creates an initial book/tax disparity. Curative allocations must be reasonable in amount and of the same type as the item that was subject to the ceiling rule.[28] Absent an appropriate item to allocate, a curative allocation cannot be made. To illustrate this method, consider the following:

Variation #4: Assume the facts of ***Example #1***. Further assume that AB invested the $100 cash in stock that appreciates in value to $150 and that the land declines in value to $70. AB sells the land for $70 (recognizing a $30 book loss and a $10 tax gain) and sells the stock for $150 (recognizing a $50 gain for both book and tax purposes). After these sales, in the absence of curative allocations, the capital accounts of A and B would be as follows:

	A		*B*	
	Tax	*Book*	*Tax*	*Book*
Initial Balance	$60	$100	$100	$100
Land Sale	10	(15)	–	(15)
Stock Sale	25	25	25	25
	$95	$110	$125	$110

Once again, the ceiling rule has created a disparity between book and tax capital of $15 for both partners. Realization of gain on the stock, however, presents an opportunity to eliminate the disparity by reallocating gain on the stock for *tax* purposes, $40 to A and $10 to B. The regulations permit this, so long as the reallocated amount does not exceed the amount of ceiling limited item for the taxable year, and is of the same type or character as that item. Since the amount of the curative allocation is precisely the amount of the distortion, and since both the land and the stock are capital assets, the curative allocation of gain on the stock can be expected to have the same effect as loss limited by the ceiling rule. The allocation, therefore, would be reasonable and would result in the following adjustments to the partners' capital accounts:

[28] § 1.704–3(c)(3). In the case of depreciable property, the period of time over which the curative allocations are made must also be reasonable.

	A		*B*	
	Tax	Book	Tax	Book
Initial Balance	$ 60	$100	$100	$100
Land Sale	10	(15)	–	(15)
Stock Sale[29]	40	25	10	25
	$110	$110	$110	$110

Again note that curative allocations have no impact on the ***book*** allocation. Instead they vary only the ***tax*** allocation to cancel out the ceiling rule problem, and in doing so they violate the principal that "tax must follow book." That is acceptable here because it resolves the distortion caused by the ceiling rule.

Remedial Allocation Method[30]

The third method blessed by the regulations is the "remedial allocation method," which provides an alternative method of curing ceiling rule distortions. In essence, the remedial allocation method permits partners to ignore the ceiling rule: tax allocations will always be available to match book allocations to the noncontributors because the partnership is permitted to "create" them. Remedial allocations are fictitious, or notional, offsetting tax allocations; their only role is to precisely eliminate any disparities between book and tax accounts created by the ceiling rule. These allocations are offsetting, and their amount always exactly equals the amount necessary to eliminate the tax/book disparity. They must be the same character as that of the item limited by the ceiling rule. Because they are notional and offsetting, they do not have any effect on the partnership's taxable income or adjusted bases.[31] Remedial allocations are treated as actual tax items by the partners, however, and therefore may affect both their tax liability and their outside bases.[32] As we shall see below in the context of depreciable property, the remedial allocation method treats the contribution of property to a partnership in some ways as if it were a sale, with the gain on

[29] Note that curative allocations violate what was thought to be an "inviolate principle:" tax allocations must follow book. As we will see below, these differ from remedial allocations which are solely offsetting tax allocations.

[30] § 1.704–3(d).

[31] § 1.704–3(d)(4)(i).

[32] § 1.704–3(d)(4)(ii).

that sale recognized by the contributing partner only as necessary to neutralize the application of the ceiling rule.[33]

To illustrate how the remedial allocation method applies to nondepreciable property, reconsider ***Variation #2***, where the land fell in value and the AB partnership sold it for $70, resulting in a $30 book loss and a $10 tax gain. The $30 book loss was allocated equally between A and B, $15 each. Since there was no tax loss, under the traditional method the ceiling rule prevented B from receiving a tax loss to match her book loss. Immediately after the sale the capital accounts were as follows:

	A		*B*	
	Tax	*Book*	*Tax*	*Book*
Initial Balance	$60	$100	$100	$100
Land Sale	10	(15)	–	(15)
	$70	$ 85	$100	$ 85

What the remedial allocation method allows us to do is to create the necessary tax items (not book items) to eliminate the tax/book disparity. B needed a capital loss of $15 to match her book loss, so we create one for her. Because none exists, however, we must offset it with a matching capital gain to A. We have added nothing to the net income of the partnership, but B, as noncontributor, is avoiding the $15 shift of income caused by the ceiling rule. The partners would adjust their capital accounts as follows:

	A		*B*	
	Tax	*Book*	*Tax*	*Book*
Initial Balance	$60	$100	$100	$100
Land Sale	10	(15)	–	(15)
Remedial Allocation	15	0	(15)	0
	$85	$ 85	$ 85	$ 85

A thus reports total gain of $25, B reports a loss of $15, netting out to the partnership entity's gain of $10: just the appropriate result that was prevented by the ceiling rule. Notice that, in contrast with the traditional method with curative allocations, remedial allocations do not depend on the existence of

[33] The remedial allocation method is based upon the so-called "deferred sale method" for accounting for built-in gains and losses which had been periodically considered and rejected by Congress and the Treasury since 1954. For a discussion of the history of the method and an argument that the deferred sale method be made mandatory, see Laura E. Cunningham and Noël B. Cunningham, *Simplifying Subchapter K: The Deferred Sale Method,* 51 SMU L. Rev. 1 (1997).

other items of income or loss. If this partnership had used the traditional method with curative allocations, the lack of other capital gains would have prevented elimination of the disparity created by the ceiling rule.

Depreciable Property—Built-in Gains

When the contributed property is depreciable, allocation of built-in gain is more complex. Unlike the case of nondepreciable property, simply waiting until sale to allocate the gain or loss will not ordinarily accomplish the purpose of taxing the contributing partner on the built-in gain. This is so because, in the normal course, depreciable property does not generate gain on sale if held for its useful life; instead its value is realized by the owner during the property's life in the form of the current income that it generates. In such a case, the only way to ensure that the contributor will be taxed on the built-in gain is to increase her share of current income from the property. This is accomplished under the traditional method by allocating depreciation *away* from the contributing partner: i.e., the noncontributing partner receives tax depreciation up to her share of book depreciation, and only if tax depreciation remains thereafter is it allocated to the contributing partner. The result is to tax the contributing partner on more than her book share of income from the property, thereby resolving the book/tax disparity over the life of the asset. To illustrate:

> ***Example #2:*** C and D form an equal partnership to which C contributes equipment with a basis of $80 and a value of $120 and D contributes $120 cash. The equipment originally had a 10 year recovery period and C elected to use the straight-line method. Although there are only 4 years remaining in its recovery period, if CD had purchased the equipment on the date of formation, it would have had a 10 year recovery period. C and D agree to share all book items equally. Upon formation, CD's balance sheet would be as follows:

Assets		
	Basis	*Book*
Equip't	$ 80	$120
Cash	120	120
	$200	$240

Liabilities & Capital

Capital Accounts		
	Tax	*Book*
C	$ 80	$120
D	120	120
	$200	$240

There is $40 of built-in gain, highlighted by the tax/book disparity in C's capital accounts. Before looking at the various ways to account for this built-in gain, there are two additional rules with which you must be familiar. First, when a partner contributes depreciable property to a partnership, the partnership steps into the shoes of the partner for purposes of cost recovery; the partnership must recover its transferred basis in the property over the remaining recovery period using the same method as the contributor.[34] Second, for book purposes under the capital accounting rules, a partnership must recover the same percentage (proportion) of basis for book purposes as it does for tax purposes.[35] Applying these rules to ***Example #2***:

1) CD must recover its $80 tax basis using the straight-line method over its remaining recovery period of 4 years (i.e., $20/yr.), and therefore,

2) CD *must* also recover its $120 book basis using the straight-line method over the same 4 year period (i.e., $30/yr.).

The Traditional Method

Consistent with the goal of the traditional method to treat noncontributing partners as if each purchased an undivided interest in contributed property for cash, the noncontributors are allocated (if possible) the same amount of cost recovery for tax purposes as they are for book purposes; if the partnership's cost recovery deduction exceeds the noncontributors' share, the partnership will allocate the balance to the contributing partner.

[34] § 168(i)(7).

[35] § 1.704–1(b)(2)(iv)(d), (g)(3).

A methodology similar to that used above for nondepreciable property can be used here:

1. First calculate book depreciation and tax depreciation;

2. Next allocate the book depreciation in accordance with the partnership agreement;

3. Allocate tax depreciation to the noncontributor(s) to match their book depreciation;

4. Allocate the balance of the tax depreciation to the contributor.

On the facts of ***Example #2***, in the first year of the partnership there will be $30 of book depreciation and $20 of tax depreciation. The book depreciation is allocated equally between C and D. The first $15 of tax depreciation is allocated to D, to match her book depreciation, and the balance of $5 is allocated to C. If we assume for the moment that book income is a surrogate for economic income, C is being "overtaxed" by $10 each year, and is effectively reporting the built-in gain over the remaining recovery period of the property. After 4 years, C will have taken into account all $40 of built-in gain and the disparity between book and tax capital will have been entirely eliminated.

If the total partnership tax basis is less than the noncontributors' shares of book basis, a ceiling rule problem will arise. We cannot treat the noncontributor as if she purchased an undivided interest in the property if there is insufficient tax basis to fully cover her share of book basis. In that case, the ceiling rule prevents the traditional method from completely eliminating the contributor's book/tax disparity, and allows some of the built-in gain to be shifted to the noncontributing partner. That is because there will not be sufficient tax depreciation to allocate to the noncontributing partner. To illustrate, consider the following:

> ***Example #3:*** The same as ***Example #2***, except C's adjusted basis in the equipment at the time of contribution is only $40. Thus, CD's initial adjusted basis in the equipment is also $40 and CD is permitted only $10 of annual depreciation for tax purposes. In addition, CD has $20 of ordinary business income every year *before* taking depreciation into account.

Although D's share of the equipment's initial book value is $60, the total tax depreciation available under the ceiling rule is

the $40 tax basis at the time of contribution. Thus, it will be impossible to treat D as though she purchased an undivided one-half interest in the property. Book depreciation remains at $30 per year, but tax depreciation is now only $10 per year. The partners will first allocate the book depreciation. There is insufficient tax depreciation to match D's book allowance, we need $15 but have only $10. So we give D all that we can, which is $10, but no more. As a result, we have created a disparity between D's tax and book capital accounts that will grow at the rate of $5 per year. After the first year, the partners' capital accounts are:

	C		*D*	
	Tax	*Book*	*Tax*	*Book*
Initial Balance	$40	$120	$120	$120
Depreciation		(15)	(10)	(15)
Ordinary Income	10	10	10	10
	$50	$115	$120	$115

The $5 disparity between D's book and tax accounts tells us that we have shifted $5 of C's built-in gain to D. This disparity will grow to $20 after 4 years and thereafter will be locked in until D sells or retires her partnership interest. In effect, the ceiling rule causes D to be overtaxed in the amount of $5 per year for 4 years, thereby taxing D on a portion of C's built-in gain. Resolution of these disparities will be deferred until liquidation of the partnership, or sale by C and D of their partnership interests.

Traditional Method with Curative Allocations

If the partnership in ***Example #3*** elected to use the traditional method with curative allocations, the partnership could eliminate this annual distortion by making curative allocations of its ordinary income. In ***Example #3***, CD has $20 of ordinary income that the partners share equally—$10 each. By allocating $15 of this income for tax (*not* book) purposes to C and $5 to D, the ceiling rule distortion would be "cured." Since this allocation would be reasonable in both amount and type it would be respected. If this were done, the partners' capital accounts would be adjusted as follows:

	C		D	
	Tax	*Book*	*Tax*	*Book*
Initial Balance	$40	$120	$120	$120
Depreciation		(15)	(10)	(15)
Ordinary Income	15	10	5	10
	$55	$115	$115	$115

The purpose of curative allocations is easy to see in the context of depreciable property: under the traditional method, the built-in gain in the property is amortized over the life of the property, as it produces income. When the ceiling rule applies, in the absence of curative allocations, the noncontributor is reporting more than her economic share of the property's income. The curative allocation of additional income to the contributing partner solves this inequity.

Remedial Allocation Method

The remedial allocation method for depreciable property sounds simple enough. The partnership calculates its book and tax depreciation, then uses the traditional method to allocate the related tax items, i.e., it allocates the book depreciation, then matches the noncontributor's book allocation with a tax allocation, and allocates the balance of the tax depreciation to the contributor. If the ceiling rule prevents the noncontributing partner from receiving a tax allocation equal to the corresponding book allocation, the partnership makes offsetting remedial allocations of the appropriate character and amount (ordinary) to both the contributing and noncontributing partners.

It does essentially work that way, except it's not quite so simple. Under the regulations, the partnership must use a "special rule"[36] for calculating its book depreciation. The special rule for determining book depreciation with respect to the property is loosely based on the notion that the contributing partner sold the property on a deferred basis to the partnership on the date of contribution for its fair market value. To the extent of its transferred basis, the partnership steps into the shoes of the contributing partner for both book and tax purposes and will continue to use the contributing partner's cost recovery method. The value of the property in excess of its basis (the "purchased portion") is treated for book purposes as if the partnership had

[36] § 1.704–3(d)(2).

purchased the property for this amount.[37] With respect to this latter amount, the partnership may use any method of cost recovery that is allowed for property of that type.[38]

To illustrate, assume the partnership in ***Example #3*** adopted the remedial allocation method. For book purposes, the partnership would be treated as if it acquired two pieces of equipment, one that was contributed by C with a value and a basis of $40, and one that it purchased with a value of $80.

- With respect to the $40 contributed portion, the partnership would step into C's shoes and would use the straight-line method over the remaining four years of that property's life, resulting in depreciation of $10 per year for both book and tax purposes over those four years.
- With respect to the $80 purchased portion, the partnership may adopt any appropriate method of cost recovery permitted by the Code for property of that type. Ignoring conventions, if CD chooses the straight-line method over 10 years, the purchased portion will provide CD with $8 of book (but not tax) depreciation each year for 10 years.

Therefore, CD's book and tax depreciation will vary depending on the year.

- For the first four years (the property's remaining tax recovery period) the partnership will have book depreciation of $18 per year ($10 from the contributed portion and $8 from the purchased portion) and tax depreciation of $10 per year.
- For the next six years it will have book depreciation of $8 per year, but NO tax depreciation.

CD's initial balance sheet would look as follows:

[37] These rules do not apply to contributed built-in loss property. See § 704(c)(1)(C), discussed below.

[38] The partnership must also use the appropriate first year convention. See § 1.704–3(d)(2) and § 168(d). In our examples in this text we ignore conventions for simplicity's sake.

Assets		
	Basis	Book
Equip't[39]	$ 40	$120
Cash	120	120
	$160	$240

Liabilities & Capital

Capital Accounts		
	Tax	Book
C	$ 40	$120
D	120	120
	$160	$240

For each of the first four years, for book and tax purposes, C and D would each be entitled to one-half of the partnerships $20 of ordinary income. In addition, each would be entitled to one half of the partnership's book depreciation. D would receive $9 in tax depreciation to match his book share, and C would receive the $1 balance. To illustrate:

	C		D	
	Tax	Book	Tax	Book
Net ordinary income	$10	$10	$10	$10
Depreciation	(1)	(9)	(9)	(9)
	$ 9	$ 1	$ 1	$ 1

Note we have not encountered a ceiling rule problem, because we have sufficient tax depreciation to match D's book allocation. These allocations will continue for the next three years, and at the end of the first four years the capital accounts of the partnership would be as follows:

	C		D	
	Tax	Book	Tax	Book
Initial Balance	$ 40	$120	$120	$120
Aggregate Adj. first 4 years	36	4	4	4
	$ 76	$124	$124	$124

Notice that during this period of time, the book/tax disparity in C's capital account has declined from $80 to $48. This is a result of the fact that C has taken only $1 a year in depreciation each year even though for book purposes she was entitled to $9. In effect, C has over-reported her taxable income by $8 for each of four years, thereby taking into account $32 of the $80 built-in gain that was inherent in the property when it was contributed. Also

[39] In fact, CD only acquired one piece of equipment, and that by contribution. The two-item, or bifurcation, model is a fiction created by the remedial allocation regime.

notice that, to this point, the ceiling rule has not caused any tax/book disparity for D (because tax depreciation was sufficient to match D's book depreciation each year) and the partnership has not used any remedial allocations.

The analysis changes in year 5. During years 5 through 10, the partnership continues to have $20 of ordinary income. But the calculation of depreciation is changed because the partnership has entirely recovered the portion of basis inherited from C. Now the book depreciation is only $8 each year, and there is no tax depreciation. The partnership will allocate the book depreciation equally between C and D, but we have no tax depreciation to match it, and the ceiling rule will apply. Nevertheless, the remedial allocation method will permit the partnership to make two offsetting remedial allocations of $4 each year. Each year the partners' capital accounts will have the following adjustments:

	C		*D*	
	Tax	*Book*	*Tax*	*Book*
Ordinary Income	$10	$10	$10	$10
Depreciation	0	(4)	0	(4)
Remedial Allocation	4		(4)	
Annual Net Adjust.	$14	$ 6	$ 6	$ 6

Notice that each year C reports $8 more taxable income than she has for book purposes: she does not receive a tax allocation to match her book allocation of depreciation, and she additionally must report the $4 remedial allocation. This reduces the disparity between her tax and book accounts, so that by the end of year 10 the disparity will have disappeared.

Notice also that the effect of the special rule is to "slow down" D's cost recovery to an amount closer to that she would have had if she had purchased a one-half interest in the property. Her basis in that case would have been $60, and she would have recovered it over 10 years, or $6 per year. Where instead she and C form a partnership, in the absence of the special rule, she would be allowed to recover her $60 share of the book depreciation, and an equivalent amount of tax depreciation, plus remedial allocations, over the property's four year remaining recovery period, or $15 per year. While the regulations tolerate the accelerated recovery period with respect to the portion of the basis contributed to the partnership, as to the "purchased portion" they require that the basis is treated as if purchased.

Depreciable Property—Built-in Losses

Prior to the 2004 enactment of § 704(c)(1)(C), depreciable property with built-in losses contributed to a partnership was subject to the same rules as built-in gain property. Since 2004, however, this transaction has been governed by § 704(c)(1)(C) and a different approach is required. Because the statute prohibits allocation of built-in losses to noncontributors, ceiling rule issues cannot arise. To illustrate, consider the following:

> ***Example #4:*** Recall the basic facts of **Example #2**, in which D contributed cash of $120, and C contributed equipment with a value of $120. In this example assume that C's s basis in the equipment was $160.

Because the contributed equipment has a built-in loss, it is § 704(c)(1)(C) property. Therefore CD would take a common inside basis in the property of $120 and C would be entitled to a § 704(c)(1)(C) basis adjustment of $40. Book and tax depreciation taken on the common inside basis would be the same: the partnership will recover its $120 common inside basis over the equipment's remaining recovery period of four years, $30 per year, which C and D would share equally, $15 each.

In addition, CD would also depreciate C's § 704(c)(1)(C) basis adjustment of $40 over 4 years at a rate of $10 per year. This latter amount would be entirely allocated to C, and while it would not be reflected on the partnership's balance sheet, it would reduce C's outside basis. So at the end of four years, the property will be fully depreciated and C has reported her entire built-in loss.

Choice of Methods

The regulations are extremely flexible. Partnerships are permitted to choose a "reasonable method" for resolving book/tax disparities, and the Treasury has provided three examples of methods which may be reasonable. The choice of allocation method may be made on a property-by-property basis, so that a partnership is not bound to use one method with respect to all contributed or revalued property.[40] This flexibility is tempered, however, by the caveat that "the overall method or combination of methods [must be] reasonable based on the facts and

[40] § 1.704–3(a)(2).

circumstances and consistent with the purpose of section 704(c)."[41]

A partnership's choice of a particular method will depend on a variety of factors, most importantly the tax profiles of the individual partners. Nevertheless, there are certain generalizations that can be made. First, each of the three methods yields precisely the same amount of annual net tax depreciation; they differ only in how that net amount is allocated among the partners.[42] For this reason, if all partners are in the same tax bracket, both the government and the partnership (as a whole) should not care which method is adopted; all methods result in the same aggregate tax savings. Yet because of the differences among the methods, the individual partners may care enormously.

If the partners are in different tax brackets, a partnership will probably choose the method that results in the largest aggregate tax savings for its partners. The most important factor in making this determination is the partners' relative tax brackets. To illustrate, reconsider ***Example #3***. From C's point of view, the most beneficial method is the traditional method because C will never have to include any curative or remedial allocations. From D's point of view, however, the traditional method is the least favorable method, for she will only receive a total of $40 of depreciation rather than $60. Assuming that there are other items of the appropriate type and amount, the most beneficial method for D is the traditional method with curative allocations. Even though the traditional method with curative allocations and the remedial allocation method both provide D

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[41] *Id.*

[42] To demonstrate, compare the annual depreciation to which each partner would have been entitled in ***Example #3*** under each of the three methods:

Method	***Years***				
	1	***2***	***3***	***4***	***5–10***
Traditional					
C	0	0	0	0	0
D	(10)	(10)	(10)	(10)	0
Net	(10)	(10)	(10)	(10)	0
Curative Allocations					
C	+5	+5	+5	+5	0
D	(15)	(15)	(15)	(15)	0
Net	(10)	(10)	(10)	(10)	0
Remedial Allocations					
C	(1)	(1)	(1)	(1)	+24
D	(9)	(9)	(9)	(9)	(24)
Net	(10)	(10)	(10)	(10)	0

with $60 of depreciation, under the former it is spread over 4 years, rather than 10. Everything else being equal, the choice of methods should depend on the relative tax brackets of C and D. If C is in a relatively high bracket as compared with D, the traditional method will generate the most savings; if C is in a relatively low bracket, then the traditional method with curative allocations is best.[43]

Anti-Abuse Rules

Treasury's blessing of the three alternative methods for making § 704(c) allocations is subject to the anti-abuse rule of § 1.704–3(a)(10). That rule states that an allocation method is *not* reasonable if

> "the contribution of property . . . and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability."

The regulations give two examples illustrating the anti-abuse rule. To understand Treasury's concerns, it is important to recognize that, ever since 1981, the Internal Revenue Code has provided very accelerated methods of cost recovery involving recovery periods that are generally much shorter than true economic lives. This was particularly true in the early 1980's when, for example, a taxpayer who purchased an airplane could recover its cost over 5 years even though the plane's economic useful life was in excess of 20 years. These methods of cost recovery have resulted in taxpayers holding valuable property with a low (or no) basis. This situation is central to both of the anti-abuse examples in the regulations.

In both of these examples, an equal partnership is formed with one partner ("P") contributing property with a value of $10,000 and an adjusted basis of $1,000 and the other partner ("O") contributing $10,000 cash. The property has only one year left in its recovery period, but has a substantially longer economic life.

[43] Whichever method is chosen, the partner who bears the additional tax burden will have to be otherwise compensated.

The first example illustrates an unreasonable use of the traditional method.[44] In this example, P is in a high marginal bracket and O is in the zero bracket because of NOLs that are expected to expire unused. P contributes the property to the partnership with a view to shifting some of the built-in gain to O by selling the property in Year 2. Under the traditional method, the partnership takes $10,000 of depreciation for book purposes and $1,000 of depreciation for tax purposes in the first year. This reduces the partnership's basis in the property to zero for both book and tax purposes, eliminating all of the § 704(c) gain. The partners share the book depreciation equally, while O is allocated all of the tax depreciation. In year 2, the partnership sells the property at a $10,000 gain, which is shared equally for both book and tax purposes. If these allocations were respected, the capital accounts would be adjusted as follows:

	P		*O*	
	Tax	*Book*	*Tax*	*Book*
Initial Balance	$1,000	$10,000	$10,000	$10,000
Depreciation	0	(5,000)	(1,000)	(5,000)
Sale	5,000	5,000	5,000	5,000
	$6,000	$10,000	$14,000	$10,000

The interplay of the one-year cost recovery period and the traditional method results in a shift for tax purposes of $4,000 of gain from P to O. The regulations find this to be an unreasonable use of the traditional method because it was used with a view to shifting built-in gain from a taxpayer in a high marginal rate to one with a lower marginal rate.

The second example involves the unreasonable use of the traditional method with curative allocations.[45] The facts of this example are strikingly similar to the first, but there are important differences: P is the zero bracket taxpayer who has NOLs, and O is in a high bracket; the partnership does not intend to sell the property; and the partnership has $8,000 of sales income. Under the traditional method with curative allocations, during its first year of operations, the partnership takes $10,000 of book depreciation which is shared equally, and $1,000 of tax depreciation which is all allocated to O. Due to an insufficient amount of tax depreciation, a curative allocation of sales income is made. For book purposes, each partner receives $4,000 of sales

[44] § 1.704–3(b)(2) Ex. 2.

[45] § 1.704–3(c)(4) Ex. 3.

income, but for tax purposes, all $8,000 is allocated to P. If this were respected, the partners' capital accounts would be adjusted as follows:

	P		*O*	
	Tax	*Book*	*Tax*	*Book*
Initial Balance	$1,000	$10,000	$10,000	$10,000
Depreciation	0	(5,000)	(1,000)	(5,000)
Sale	8,000	4,000	0	4,000
	$9,000	$ 9,000	$ 9,000	$ 9,000

Notice that the curative allocation has eliminated the disparity between tax and book capital. Nevertheless, the regulations find this to be an unreasonable use of the traditional method with curative allocations. The abuse, it appears, is that O, the high bracket taxpayer, is essentially allowed immediately to deduct its entire cost of its share of the equipment ($5,000) at practically no cost to either P or the partnership. The "cost" is simply an acceleration of the built-in gain for which P should ultimately be responsible, but since P currently is in the zero bracket, P will owe no additional tax.

The role that this § 704(c) anti-abuse rule should play is unclear. By its terms, it could potentially apply anytime a ceiling rule shift of income to a lower bracket taxpayer has the effect of reducing the partners' aggregate income tax liability. We believe, however, that a more appropriate reading of the rule would limit it to situations like those in the two examples illustrating the rule, where the noneconomic capital accounting rules have the effect of accelerating a ceiling rule shift of income (as in § 1.704–3(b)(2) Ex. 2), or permitting the noncontributor to expense her investment (as in § 1.704–3(c)(4) Ex. 3).[46]

Revaluations

The second common event that predictably creates a disparity between book value and tax basis is the revaluation of partnership assets in connection with a contribution (or distribution) of money or other property to (or from) a partnership in exchange for an interest in that partnership.[47] When a

[46] For a more complete analysis of the anti-abuse rule, see Laura E. Cunningham, *Use and Abuse of Section 704(c)*, 3 Fla. Tax Rev. 92 (1996).

[47] Section 1.704(b)–1(b)(2)(iv)(f) permits revaluations only under certain circumstances. The reference to an interest in the partnership should be interpreted

revaluation occurs, all of the partnership's existing built-in gains and losses are recognized for book purposes and allocated among the existing partners in accordance with their agreement; the corresponding tax items, however, are not recognized. The resulting book/tax disparity is directly analogous to one created when § 704(c) property is contributed to a partnership, and raises the same issues. Indeed, the parallels are so striking that the regulations refer to allocations with respect to property that has been revalued as "reverse § 704(c) allocations," and require that these allocations be made in accordance with "§ 704(c) principles."[48]

There is one important way, however, that revaluations are treated differently than contributions: § 704(c)(1)(C) only applies to property that has a built-in loss at the time of contribution, it does *not* apply to a built-in loss that is created by a revaluation.[49] In this latter case, the built-in loss will be accounted for using one of the three reasonable methods discussed above. The main significance of this rule is that the ceiling rule might apply to those losses, whereas § 704(c)(1)(C) prohibits it in the context of contributed built-in loss property.

To illustrate how § 704(c) principles are applied in the context of revaluations, consider the following:

Example #4: Several years ago, C and D formed an equal partnership. On January 1 of this year, CD's balance sheet is as follows:

Assets	***Basis/Book***
Cash	$ 50
Equip't	50
Land	100
	$200

Liabilities & Capital

Capital Accounts	***Tax/Book***
C	$100
D	100
	$200

to mean any meaningful change in the profit or loss sharing ratios of the partners in response to a contribution or distribution of money or other property.

[48] § 1.704–3(a)(6)(i).

[49] Prop. Reg. § 1.704–3(f)(2)(i).

On January 1, the equipment has a value of $210 and the land has a value of $140. The equipment originally had a 5-year recovery period and CD elected to use the straight-line method. Two years remain in its recovery period. On this date, E contributes $200 cash and becomes a full one-third partner in all income, gains and losses of the partnership. The partnership elects to book up its assets under § 1.704–1(b)(2)(iv)(f). After the revaluation, the partnership's balance sheet is as follows:

Assets		
	Basis	*Book*
Cash	$250	$250
Equip't	50	210
Land	100	140
	$400	$600

Liabilities & Capital

Capital Accounts		
	Tax	*Book*
C	$100	$200
D	100	200
E	200	200
	$400	$600

As a result of the revaluation, the built-in gains in both the equipment and the land have been recognized by the partnership for book purposes (but not for tax purposes) and allocated equally between C and D. A sale of the properties for their revised book values would result in tax gains, but no corresponding book gains. The only substantive difference between this and a contribution of § 704(c) property to a partnership is that the existing partners, not the contributor, are credited with the unrealized appreciation from the revaluation. Not surprisingly, the regulations require that those partners who shared the book gain be allocated the corresponding tax item "so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) . . . "[50] Thus, just as the revaluation creates the same type of book/tax disparity as a contribution of appreciated property, the principles of § 704(c) must be applied to resolve this "§ 704(c) type" situation.[51]

[50] § 1.704–1(b)(2)(iv)(f)(4).

[51] Another way to think about this revaluation is to recognize that its consequences are economically identical to those that would have resulted if the old partnership had been liquidated, and then a new partnership formed, with E

Applying these principles to ***Example #4***, the partnership must use one of the three allocation methods approved by the regulations to resolve the book/tax disparities with respect to the equipment and the land. As noted above, the partnership does not have to use the same method for both properties. In the three variations below, we make two simplifying assumptions: First, we assume the land is not sold (and therefore the method chosen for the land does not matter); second, we assume that during its first two years of operation the CDE partnership has $30 of net income from operations *before* taking into account depreciation. Consider how the equipment would be treated under each of the methods.

Variation #1: The partnership uses the traditional method.

Under the traditional method, CDE must recover its cost in the equipment for both book and tax purposes over 2 years, the equipment's remaining recovery period. For book purposes, it has $105 of annual book depreciation, which it allocates $35 to each partner. For tax purposes, there is only $25 depreciation. Under the traditional method, E, the new partner, must be allocated tax depreciation equal to her book depreciation, if possible. This is not possible in ***Example #4*** because of the ceiling rule: E's share of book depreciation is $35, but the partnership has only $25 of tax depreciation, all of which is allocated to E. This creates a $10 book/tax disparity in E's capital accounts at the end of the first year:

	C		***D***		***E***	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Initial Balance	$100	$200	$100	$200	$200	$200
Ordinary Income	10	10	10	10	10	10
Cost Recovery[52]	0	(35)	0	(35)	(25)	(35)
	$110	$175	$110	$175	$185	$175

In the second year of operations, the ceiling rule again will limit E's tax depreciation to $25, even though her share of book depreciation is $35. This will increase her book/tax disparity to

contributing cash of $200 and C and D jointly contributing cash and property worth $400 with a basis of $200. If in fact CDE had been created in this manner, § 704(c) would have clearly applied.

[52] The cost recovery allowance is separately stated because its allocation to E under § 704(c) principles in effect amounts to a special allocation. See § 1.702–1(a)(8)(i).

$20, which will be locked in until she disposes of her interest in the partnership.

> ***Variation #2:*** The partnership uses the traditional method with curative allocations.

As in ***Variation #1***, the ceiling rule creates a book/tax disparity of $10 in each of the first two years of CDE's operations. Under the traditional method with curative allocations, CDE may allocate E's share of ordinary income for tax purposes, ***not*** for book purposes, equally between C and D to cure the disparity. This allocation is reasonable in amount and is of the same type as the depreciation that was limited by the ceiling rule. Under this method, the adjustments to the partners' capital accounts for the first two years would be as follows:

	C		*D*		*E*	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Initial Balance	$100	$200	$100	$200	$200	$200
Year 1 Adjustments:						
Ordinary Income	15	10	15	10	0	10
Cost Recovery	0	(35)	0	(35)	(25)	(35)
End of Year 1	$115	$175	$115	$175	$175	$175
Year 2 Adjustments:						
Ordinary Income	15	10	15	10	0	10
Cost Recovery	0	(35)	0	(35)	(25)	(35)
End of Year 2	$130	$150	$130	$150	$150	$150

Notice that this allocation precisely cures the book/tax disparity that otherwise would arise. Also, notice that C and D each has a $20 disparity in her capital account. This reflects the $40 built-in gain still inherent in the land.

> ***Variation #3:*** The partnership uses the remedial allocation method for the equipment.

If the remedial allocation method is used in this context, then the partnership must first compute its book depreciation under the special rule, and then use the traditional method for allocating tax items. If the ceiling rule prevents the new partner from receiving a tax allocation equal to her book allocation, the partnership makes the appropriate offsetting remedial allocations. On these facts, the special rule bifurcates the book

value of the equipment ($210) into two portions. The first portion is equal to the partnership's basis in the equipment (i.e., $50) and must be recovered using the same method of cost recovery the partnership used immediately before the revaluation; therefore, CDE must recover this $50 using straight-line over two years (i.e., $25 per year). The second portion is equal to the excess of the equipment's fair market value over its basis, here $160,[53] and may be recovered using any method that would have been appropriate if the partnership had purchased the equipment for this amount. Ignoring conventions, if the partnership chooses to recover its cost in the "purchased" portion using the straight-line method over five years, the partnership will be entitled to $32 of book depreciation each year for 5 years. Therefore, the partnership will have a book cost recovery deduction with respect to the equipment of $57 per year ($25 + $32) for the first 2 years, and $32 per year for the remaining three years. It will have tax cost recovery of $25 for the first two years, and none thereafter.

Under the traditional method, for the first two years there is sufficient tax depreciation so that the ceiling rule does not come into play. For each of those years, the partnership has $57 of book depreciation, which is divided equally among the partners, and $25 of tax depreciation the first $19 of which is allocated to E, and the balance shared equally by C and D. The adjustments to the partners' capital accounts for depreciation (ignoring other adjustments) would be as follows:

	C		*D*		*E*	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Initial Balance	$100	$200	$100	$200	$200	$200
Depreciation						
Year 1	(3)	(19)	(3)	(19)	(19)	(19)
Year 2	(3)	(19)	(3)	(19)	(19)	(19)
End of Year 2	$ 94	$162	$ 94	$162	$162	$162

For years 3 through 5, however, since CDE is no longer entitled to any tax depreciation, the partnership must make remedial allocations equal to the amount of E's share of depreciation. The adjustments to the partners' capital accounts for depreciation and remedial allocations over the three year period would be as follows:

53 $210 – $50 = $160.

	C		D		E	
	Tax	*Book*	*Tax*	*Book*	*Tax*	*Book*
Balance (1/1/3)	$ 94	$162	$ 94	$162	$162	$162
Depreciation[54]	0	(32)	0	(32)	0	(32)
Remedial all[55]	16		16		(32)	
	$110	$130	$110	$130	$130	$130

The remaining disparity between C's and D's book and tax capital accounts reflects the built-in gain in the land.

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[54] Each partner would be entitled to book depreciation of ⅓ of $32 ($10.67) each year for three years.

[55] E would be entitled to a remedial allocation of ($10.67) each year for three years. This is precisely offset by annual remedial allocations of $5.33 to both C and D.

§ 8.07 Basis Adjustments Related to Distributions

A distribution of some partnership assets to a partner generally does not affect the partnership's basis in its undistributed property.[177] Under I.R.C. Section 754, however, a partnership may elect to adjust the basis of its retained assets after certain distributions. The election applies to all distributions and transfers of partnership interests during the year of the election and subsequent years until it is revoked with the Service's permission.[178] If the election is in effect when a distribution is made, the total adjustment to the basis of partnership property is determined under I.R.C. Section 734(b), and that amount is allocated among partnership assets under the rules of I.R.C. Section 755.

Mandatory Basis Reduction. I.R.C. Section 734(d) makes a basis adjustment mandatory whenever a distribution occurs that creates a *substantial basis reduction* to the basis of partnership assets.[179] A substantial basis reduction is defined as a gross reduction of more than $250,000 that would be made to the common basis of all partnership assets if an I.R.C. Section 754 election were in effect.[180] This new provision is likely to affect cases where a partnership redeems a partner's interest when its assets have declined in value and a basis reduction of more than $250,000 is required. Similarly, under I.R.C. Section 743, a partnership must reduce the basis of its property if a partnership interest is transferred by reason of sale, exchange, or death and the partnership has a *substantial built-in loss* immediately after the transfer.[181]

The Tax Cuts and Jobs Act of 2017 modifies the definition of a substantial built-in loss for transfers of partnership interests occurring after December 31, 2017. Under the new provision, a substantial built-in loss also exists if the transferee partner would be allocated a net loss in excess of $250,000 upon a hypothetical disposition of all partnership assets in a fully taxable transaction for an amount of cash equal to the fair market value of the assets immediately after the partnership interest is transferred.

A *securitization partnership* is exempt from the mandatory downward basis adjustment rule for distributions.[182] A securitization partnership is a partnership whose sole business activity is issuing securities with fixed principal that are primarily serviced by the cash flows of a discrete pool of receivables or other financial assets.

A partnership makes an I.R.C. Section 754 election to eliminate changes in the timing and character of the nondistributee partners' gains and losses caused by a distribution. These changes occur in three situations summarized below.

177. I.R.C. § 734.

178. Treas. Reg. § 1.754-1(a).

179. I.R.C. § 734(d), as amended by the American Jobs Creation Act (AJCA), Pub. L. No. 108-357 (2004). These rules apply to distributions after October 22, 2004.

180. I.R.C. § 734(d)(1).

181. I.R.C. § 734(d)(1).

182. I.R.C. §§ 734(e), 743(f).

Situation (1): When the distributee partner recognizes gain on the distribution.

Under I.R.C. Section 731(a)(1), a partner recognizes gain if he receives a cash distribution that exceeds the basis of his partnership interest. Because the distributee's gain is attributable to appreciation of assets retained by the partnership, the other partners recognize that gain when the partnership sells those assets, and they recognize an offsetting loss when they dispose of their partnership interests. Although the partners' increased gain is offset, the time value and consequences of capital-loss treatment cannot be recovered.

Example: John's interest in the JKL Partnership is liquidated in exchange for a $120,000 cash distribution. Immediately before the distribution, the partnership has the following balance sheet:

Assets	Basis	Value
Cash	$120,000	$120,000
Capital asset	86,000	140,000
Inventory	94,000	100,000
Total Assets	$300,000	$360,000
Partner's Capital		
John	$100,000	$120,000
Karen	100,000	120,000
Larry	100,000	120,000
Total Partners' Capital	$300,000	$360,000

Because the $120,000 cash distribution exceeds the basis of John's partnership interest, he recognizes a $20,000 gain. He reports the entire amount as capital gain, even though $2,000 of the gain is attributable to his share of the appreciation in partnership inventory, and $18,000 is attributable to his share of the appreciation of the capital asset. I.R.C. Section 751(b) does not apply because the inventory is not substantially appreciated.

After the distribution, the partnership's balance sheet appears as follows:

Assets	Basis	Value	Potential Gain
Capital Asset	$86,000	$140,000	$54,000
Inventory	94,000	100,000	6,000
Total Assets	$180,000	$240,000	
Partners' Capital			
Karen	$100,000	$120,000	
Larry	100,000	120,000	
Total Partners' Capital	$200,000	$240,000	

If the partnership sells its remaining assets for value, it recognizes a $54,000 capital gain on the sale of the capital asset and $6,000 of ordinary income on the sale of the inventory. Karen and Larry each report a $27,000 capital gain and $3,000 of ordinary income. Thus, the gain realized by all three partners from partnership property totals $80,000, even though the total appreciation in partnership property is only $60,000. The partnership's balance sheet now appears as follows:

Assets	Basis	Value
Cash	$240,000	$240,000
Partner's Capital		
Karen	$130,000	$120,000
Larry	$130,000	$120,000
Total Partners' Capital	$260,000	$240,000

Upon liquidation of the partnership, Karen and Larry each recognize a $10,000 capital loss. Although the net amount of gain each partner recognizes is $20,000 ($27,000 capital gain + $3,000 ordinary income – $10,000 capital loss), the timing and character of their gain is greatly distorted by the previous cash distribution to John.

An I.R.C. Section 754 election eliminates this distortion. When the property is distributed to John, the partnership increases the basis of its assets by the $20,000 gain John recognizes, and this basis adjustment reduces the amount of gain the partnership recognizes when it sells its assets.

Situation (2): When the distributee partner recognizes a loss on the distribution.

Under I.R.C. Section 731(a)(2), a partner recognizes loss if he receives a liquidating distribution consisting solely of cash, unrealized receivables, and inventory, and the total basis of the distributed property exceeds the basis in his partnership interest. Because the distributee's loss is attributable to depreciation of assets retained by the partnership, the other partners recognize that same loss when the partnership sells those assets, and the partners recognize an offsetting gain when they dispose of their partnership interests.

Situation (3): When the distributee partner takes the distributed property with a basis that differs from the partnership's basis for the asset before the distribution.

This basis difference occurs in the following situations:

(1) In a current distribution, the partner's basis in distributed property cannot exceed the basis in his partnership interest.[183] This limitation decreases the basis of distributed property when the partner's basis in his interest is less than the partnership's basis in the property.

183. I.R.C. § 732(a)(2).

(2) In a liquidating distribution, the partner's total basis in the assets he receives equals the basis in his partnership interest.[184] This rule increases or decreases the basis of distributed property, depending on whether the partner's basis in his interest is more or less than the partnership's basis in the distributed property.

Example: The DEF Partnership distributes land worth $46,000 to Dave in complete liquidation of his partnership interest. Immediately before the distribution, DEF's balance sheet is as follows:

Assets	Basis	Value
Stock	$48,000	$92,000
Land	42,000	46,000
Total Assets	$90,000	$138,000
Partners' Capital		
Dave	$30,000	$46,000
Edward	30,000	46,000
Fran	30,000	46,000
Total Partners' Capital	$90,000	$138,000

Dave's basis in the land is $30,000—the basis in his partnership interest when the liquidating distribution is made. Because the partnership's basis in the land was $42,000, the distribution decreases the basis of the land by $12,000. Dave recognizes a $16,000 gain when he sells the land, and the partnership recognizes a $44,000 gain when it sells the stock. Consequently, the total amount of gain recognized on these sales is $60,000, even though the amount of gain inherent in these assets before the distribution was only $48,000. This discrepancy occurs because $12,000 of the basis for the land was "lost" in the distribution. DEF's balance sheet appears as follows after it distributes the land to Dave and sells the stock:

Assets	Basis	Value
Cash	$92,000	$92,000
Partners' Capital		
Edward	$52,000	$46,000
Fran	$52,000	$46,000
Total Partners' Capital	$104,000	$92,000

184. I.R.C. § 732(b).

Upon liquidation of the partnership, Edward and Fran each recognize a $6,000 capital loss. Although the net amount of gain each partner recognizes is $16,000 ($22,000 capital gain – $6,000 capital loss), the timing is distorted by the previous distribution to Dave.

If DEF has a basis-adjustment election in effect, however, the basis of its undistributed property increases by $12,000 when the land is distributed to Dave. Thus the partnership recognizes $12,000 less gain when it sells the stock.

[A] Computing and Allocating Basis Adjustments under I.R.C. Section 754 Election

The effect of an I.R.C. Section 754 election is that the partnership is treated as an aggregate of individuals who own undivided interests in the partnership's assets. Each partner has a separate basis in his share of each partnership asset that he uses to compute his share of the partnership's gain, loss, depreciation, or depletion. Once made, the election applies to all transfers and distributions, and it cannot be revoked without the Service's permission.[185] If the I.R.C. Section 754 election is in effect when a distribution is made, the bases of the partnership's undistributed properties are adjusted as follows:

(1) The total amount of increase or decrease in the bases of partnership assets that is allowable under I.R.C. Section 734(b) must be determined. The bases of partnership properties

  (a) increase by the amount of gain the distributee partner recognizes under I.R.C. Section 731(a)(1) for a cash distribution that exceeds the basis in his partnership interest;

  (b) decrease by the amount of any loss the distributee partner recognizes under I.R.C. Section 731(a)(2) for a liquidating distribution consisting solely of cash, unrealized receivables, and inventory;

  (c) increase by the amount that the distributee partner's basis in property he receives in a current or liquidating distribution is less than the partnership's basis before the distribution; or

  (d) decrease by the amount that the distributee partner's basis in property he receives in a liquidating distribution is greater than the partnership's basis in the property.

(2) The total basis adjustment determined under I.R.C. Section 734(b) is then allocated among the partnership's assets under the rules of I.R.C. Section 755. The allocation is made as follows:

  (a) All partnership property is divided into two classes:

185. I.R.C. § 732(b).

(i) capital assets and I.R.C. Section 1231 property (i.e., capital gain property), and

(ii) all other property (i.e., ordinary income property).[186] This class includes all unrealized receivables as defined in I.R.C. Section 751(c). For this purpose, any potential gain subject to recapture as ordinary income is considered a separate unrealized receivable.[187] *See* § 8.05, *supra.*

(b) Any increase or decrease arising from gain or loss a distributee partner recognizes under I.R.C. Section 731(a)(1) (gain on cash distribution) or 731(a)(2) (loss on certain liquidating distributions) is fully allocated to the class of partnership capital gain property.[188]

(c) Any increase or decrease arising from a change in the basis of distributed property is allocated to the class of partnership assets that the distributed property belonged to before the distribution.[189] Thus, (i) adjustments attributable to distributions of capital gain property are allocated to the partnership capital-gain assets, and (ii) adjustments attributable to distributions of other kinds of property are allocated to the partnership ordinary-income assets.

(d) The total basis increase or decrease allocated to a class is allocated among the assets in the class as follows:[190]

(i) The total basis increase or decrease allocated to each class of partnership property is allocated among the assets in the class, so that it reduces the difference between the value and basis of each asset. Consequently

- Basis increases are allocated only among assets with values that exceed their bases. The total basis increase is allocated among those assets in proportion to the differences between the value and basis of each asset. The basis of an asset cannot increase above its fair market value.
- Basis decreases are allocated only among assets with values that are less than their bases. The total basis decrease is allocated among those assets in proportion to the differences between the basis and value of each asset. The basis of an asset cannot decrease below zero.

(ii) A basis increase is first allocated to properties with unrealized appreciation in proportion to the amount of the appreciation. Any remaining increase is allocated among the properties within the class in proportion to their fair market values.

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186. I.R.C. § 755(b); Treas. Reg. § 1.755-1(c).
187. Treas. Reg. § 1.755-1(a).
188. Treas. Reg. § 1.755-1(c)(1)(ii).
189. Treas. Reg. § 1.755-1(c)(1)(i).
190. Treas. Reg. § 1.755-1(c)(2). These allocation rules apply to distributions on or after December 15, 1999.

(iii) A basis decrease is first allocated to properties with unrealized depreciation in proportion to the amount of the depreciation.[191] Any remaining decrease is allocated among the properties within the class in proportion to their adjusted bases.

In applying the basis allocation rules to a distribution in liquidation of a partner's interest, a partnership may not decrease the basis of corporate stock of a partner or a related person. The effect of this rule is to deny basis reductions to the stock of a corporate partner.[192] Any basis that would have been allocated to the stock must be allocated to other partnership assets. If a basis decrease exceeds the basis of other partnership assets, the partnership recognizes gain in the amount of the excess.

> **PRACTICE NOTE**
>
> Proposed regulations would provide that in allocating any decrease to the adjusted basis of partnership property, no allocation is made to stock in a corporation or any person related, within the meaning of I.R.C. Sections 267(b) or 707(b)(1), to such corporation, that is a partner in the partnership.[193] This rule broadly interprets I.R.C. Section 755(c) to apply to all persons related under either of these Code sections.

Adjustments to basis of cost recovery property. In computing cost recovery adjustments arising from an adjustment to the basis of partnership property:[194]

(1) If the basis of partnership recovery property increases because of a property distribution, the increased portion of basis is accounted for as newly purchased recovery property placed in service when the distribution occurs. Thus, any applicable recovery period and method may be used for the increased portion of the basis.

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191. The basis of partnership property cannot be reduced below zero. Treas. Reg. § 1.755-1(c)(3).

192. I.R.C. § 755(c), as amended by the American Jobs Creation Act (AJCA), Pub. L. No. 108-357 (2004). These rules apply to distributions after October 22, 2004.

193. 79 FR 3042-01 (Jan 16, 2014); Prop. Treas. Reg. § 1.755-1(e).

194. Treas. Reg. § 1.734-1(e).

(2) If the basis of a partnership recovery property decreases because of a property distribution, the basis decrease is accounted for over the property's remaining recovery period beginning with the period in which the basis is decreased.

[B] Illustrating Basis Adjustments

[1] Distributee Partner Recognizes Gain on Cash Distribution

Example (1): Tony's interest in the RST Partnership is liquidated in exchange for a $90,000 cash distribution. Immediately before the distribution is made, the partnership has an I.R.C. Section 754 election, in effect and its balance sheet is as follows:

Assets	Basis	Value
Cash	$90,000	$90,000
Capital Asset 1	30,000	60,000
Capital Asset 2	25,000	20,000
Capital Asset 3	15,000	30,000
Inventory	65,000	70,000
Total Assets	$225,000	$270,000
Partners' Capital	Basis	Value
Rhea	$75,000	$90,000
Tony	75,000	90,000
Sara	75,000	90,000
Total Partners' Capital	$225,000	$270,000

Because the cash distribution exceeds the basis of Tony's partnership interest, he recognizes a $15,000 capital gain. (I.R.C. Section 751(b) does not apply because the inventory is not substantially appreciated.) The distribution results in a $15,000 basis increase to partnership assets, all of which is allocated to the class of capital assets. The basis increase is first allocated among the appreciated assets in that class properties in proportion to the amount of unrealized appreciation. Capital Asset 1 has $30,000 of unrealized appreciation and Capital Asset 3 has $15,000 of unrealized appreciation. Consequently, the basis of Capital Asset 1 increases by $10,000 [$15,000 × ($30,000 / $45,000)], and the basis of Capital Asset 3 increases by $5,000 [$15,000 × ($15,000 / $45,000)].

The partnership's balance sheet after the basis adjustments appears as follows:

Assets	Basis	Value
Capital Asset 1	40,000	60,000
Capital Asset 2	25,000	20,000
Capital Asset 3	20,000	30,000
Inventory	65,000	70,000
Total Assets	$150,000	$180,000
Partners' Capital		
Rhea	$75,000	$90,000
Sara	75,000	90,000
Total Partners' Capital	$150,000	$180,000

Example (2): Moira's one-fourth interest in the MNOP Partnership is liquidated in exchange for a $110,000 cash distribution. Immediately before the distribution is made, the partnership has an I.R.C. Section 754 election, in effect and its balance sheet is as follows:

Assets	Basis	Value
Cash	$110,000	$110,000
Capital Asset 1	48,000	50,000
Capital Asset 2	24,000	30,000
Inventory	222,000	250,000
Total Assets	$404,000	$440,000
Partners' Capital	Basis	Value
Moira	$101,000	$110,000
Nathan	101,000	110,000
Oliver	101,000	110,000
Penny	101,000	110,000
Total Partners' Capital	$404,000	$440,000

Moira recognizes a $9,000 capital gain, resulting in a $9,000 basis increase to partnership capital assets. (I.R.C. Section 751 does not apply because the inventory is not substantially appreciated.) First, $2,000 of basis increase for unrealized appreciation is allocated to Capital Asset 1 and $6,000 of basis increase is allocated to Capital Asset 2. The remaining $1,000 of basis increase is allocated among all the capital assets in proportion to their fair market values. Thus $625 of basis is allocated to Capital Asset 1 (50,000/80,000 ×

1,000) and $375 is allocated to Capital Asset 2 (30,000/80,000 × 1,000). The partnership's balance sheet now appears as follows:

Assets	Basis	Value
Capital Asset 1	50,625	50,000
Capital Asset 2	30,375	30,000
Inventory	222,000	250,000
Total Assets	$303,000	$330,000
Partners' Capital		
Nathan	101,000	110,000
Oliver	101,000	110,000
Penny	101,000	110,000
Total Partners' Capital	$303,000	$330,000

[2] Distributee Partner Recognizes Loss on Liquidating Distribution

The KLM Partnership distributes $50,000 in cash to Marsha in complete liquidation of her partnership interest. Immediately before the distribution, KLM's balance sheet is as follows:

Assets	Basis	Value
Cash	$50,000	$50,000
Capital Asset 1	70,000	55,000
Capital Asset 2	60,000	45,000
Total Assets	$180,000	$150,000
Partners' Capital		
Ken	$60,000	$50,000
Lewis	60,000	50,000
Marsha	60,000	50,000
Total Partners' Capital	$180,000	$150,000

Because the amount of cash Marsha receives in the liquidating distribution is less than the basis of her partnership interest, she recognizes a $10,000 loss under I.R.C. Section 731(a)(2). If KLM has an I.R.C. Section 754 election in effect, the basis in its class of capital assets decreases by $10,000. Since both Capital Asset 1 and Capital Asset 2 have equal amounts of unrealized depreciation ($15,000), $5,000 of basis decrease is allocated to each asset. After the I.R.C. Section 754 adjustment, the partnership's balance sheet appears as follows:

Assets	Basis	Value
Capital Asset 1	$65,000	$55,000
Capital Asset 2	55,000	45,000
Total Assets	$120,000	$100,000
Partners' Capital		
Ken	$60,000	$50,000
Lewis	60,000	50,000
Total Partners' Capital	$120,000	$100,000

[3] Basis of Distributed Property Changes

Situation (1). The ABC Partnership makes a current distribution of Capital Asset A to Arthur. The partnership has an I.R.C. Section 754 election in effect immediately before the distribution is made, and its balance sheet is as follows:

Assets	Basis	Value
Capital Asset A	$60,000	$60,000
Capital Asset B	10,000	50,000
Inventory Item 1	10,000	30,000
Inventory Item 2	70,000	70,000
Total Assets	$150,000	$210,000
Partners' Capital		
Arthur	$50,000	$70,000
Barry	50,000	70,000
Carol	50,000	70,000
Total Partners' Capital	$150,000	$210,000

Although the partnership's basis for Capital Asset A is $60,000, Arthur's basis for the property is limited to the $50,000 basis of his partnership interest. Because the distributed property is a capital asset, the partnership increases the basis of its undistributed capital assets by the $10,000 in basis "lost" in the distribution.

After the basis adjustment, the balance sheet appears as follows:

Assets	Basis	Value
Capital Asset B	20,000	50,000
Inventory Item 1	10,000	30,000
Inventory Item 2	70,000	70,000
Total Assets	$100,000	$150,000
Partners' Capital		
Arthur	$0	$10,000
Barry	50,000	70,000
Carol	50,000	70,000
Total Partners' Capital	$100,000	$150,000

Situation (2). Assume the same facts as in Situation (1), except that the partnership distributes Inventory Item 2 to Arthur. Although the partnership's basis for the inventory is $70,000, Arthur's basis for the property is limited to the $50,000 basis of his partnership interest. Because the distributed property is not a capital asset, the partnership increases the basis of its undistributed ordinary-income property by the $20,000 in basis "lost" in the distribution. After the adjustment, ABC's balance sheet appears as follows:

Assets	Basis	Value
Capital Asset A	$60,000	$60,000
Capital Asset B	10,000	50,000
Inventory Item 1	30,000	30,000
Total Assets	$100,000	$140,000
Partners' Capital		
Arthur	$0	$0
Barry	50,000	70,000
Carol	50,000	70,000
Total Partners' Capital	$100,000	$140,000

Situation (3). The CDE Partnership distributes Capital Asset A to Charles in complete liquidation of his partnership interest. When the property is distributed, the partnership has an I.R.C. Section 754 election in effect, and its balance sheet is as follows:

Assets	Basis	Value
Capital Asset A	$50,000	$70,000
Capital Asset B	10,000	30,000
Capital Asset C	10,000	6,000
Capital Asset D	10,000	4,000
Inventory	100,000	100,000
Total Assets	$180,000	$210,000
Partners' Capital	Basis	Value
Charles	$60,000	$70,000
Dana	60,000	70,000
Errol	60,000	70,000
Total Partners' Capital	$180,000	$210,000

Although the partnership's basis for Capital Asset A is only $50,000, Charles's basis for the property is $60,000—the basis of his partnership interest at the time he receives the liquidating distribution. Because the distributed property is a capital asset, the partnership decreases the basis of its capital-gain property by the $10,000 of basis Charles "gained" in the distribution. The basis decrease is allocated to the assets with unrealized depreciation—$4,000 to Asset C and $6,000 to Asset D. After the adjustment, ABC's balance sheet appears as follows:

Assets	Basis	Value
Capital Asset B	$10,000	$30,000
Capital Asset C	6,000	6,000
Capital Asset D	4,000	4,000
Inventory	100,000	100,000
Total Assets	$120,000	$140,000
Partners' Capital	Basis	Value
Dana	$60,000	$70,000
Errol	60,000	70,000
Total Partners' Capital	$120,000	$140,000

[4] Elective Adjustment under I.R.C. Section 732(d)

I.R.C. Section 732(d) provides special rules for determining the basis in property distributed to a partner who acquires his partnership interest by sale or exchange or as successor to a deceased partner when the partnership did not have an I.R.C. Section 754 election in effect. A distributee partner may elect under I.R.C. Section 732(d) to determine his basis in property the partnership distributes to him within two years of the date he acquired his interest as if the partnership had an I.R.C.

Section 754 election in effect on the acquisition date. In some situations, a partner may be required to determine his basis in distributed property under the rules of I.R.C. Section 732(d), regardless of when the distribution is made (i.e., the two-year limitation does not apply). For complete discussion of I.R.C. Section 732(d), *see* § 12.08, *infra*.

Example:[195] Toni purchased a one-fourth interest in the PRS Partnership for $17,000 when no election under I.R.C. Section 754 was in effect. On the purchase date, the partnership owned inventory with a basis of $14,000 and a fair market value of $16,000. Thus, $4,000 of the amount Toni paid for her interest was attributable to her share of inventory with a basis to the partnership of $3,500. One year later, Toni retired from the partnership and made an election under I.R.C. Section 732(d) with respect to her liquidating distribution of the following property (which includes her one-fourth share of partnership inventory):[196]

Assets	Basis to PRS	Fair market value
Cash	$1,500	$1,500
Inventory	3,500	4,000
Asset X	2,000	4,000
Asset Y	4,000	5,000
Total Assets	$11,000	$14,500

Toni's basis for the inventory increases by $500 (one-fourth of the $2,000 difference between the $16,000 fair market value of the inventory and its $14,000 basis to the partnership when Toni purchased her interest). This adjustment applies only to Toni's distribution and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. The total basis allocated among the properties Toni received in the liquidating distribution is $15,500 ($17,000 basis for Toni's partnership interest less $1,500 of cash she received). Of this amount, $4,000 of basis is allocated to the inventory ($3,500 common partnership basis plus the $500 basis adjustment). The remaining $11,500 of basis is allocated among the two capital assets as follows:

(1) $5,111 basis to Asset X ($2,000 partnership basis, plus $2,000 of unrealized appreciation, plus $1,111 [$4,000/$9,000 × $2,500]).

(2) $6,389 basis to Asset Y ($4,000 partnership basis of Asset Y plus $1,000 of unrealized appreciation plus $1,389 [$5,000/$9,000 × $2,500]).

195. Treas. Reg. § 1.732-1(d)(1)(vi).

196. The Regulations indicate that it is immaterial whether the inventory Toni received was on hand when she acquired the interest. Treas. Reg. § 1.732-1(d)(1)(vi), *Example*.

[C] Unusable Basis Adjustments Carried Forward

A partnership may be unable to apply all or a part of the basis increase or decrease triggered by a distribution because the partnership owns no property in the class to which the adjustment applies, or because the basis of all the property in that class has been reduced to zero. In these situations, the adjustment is suspended and subsequently applied when the partnership acquires property to which the adjustment can be made.[197]

(1) *Basis adjustment cannot be used currently because the partnership does not retain any property in the class to which the basis adjustment must be allocated.* The unused adjustment is carried forward indefinitely, and it is applied when the partnership subsequently acquires property to which the adjustment can be made.

Example: The MNO Partnership has an I.R.C. Section 754 election in effect when it distributes stock valued at $60,000 to Mary in liquidation of her partnership interest. Before MNO distributes the stock, MNO's balance sheet is as follows:

Assets	Basis	Value
Cash	$30,000	$30,000
Stock	60,000	60,000
Inventory	84,000	90,000
Total Assets	$174,000	$180,000
Partners' Capital	Basis	Value
Mary	$58,000	$60,000
Ned	58,000	60,000
Oliver	58,000	60,000
Total Partners' Capital	$174,000	$180,000

Because this is a liquidating distribution, Mary's basis in the stock equals the $58,000 basis of her partnership interest. I.R.C. Section 751(b) does not apply because the inventory is not substantially appreciated. The distribution decreases the basis of the stock by $2,000, and therefore, MNO may increase the basis of its capital gain property by $2,000. Because the partnership has no remaining capital gain property, the basis adjustment is carried forward. When the partnership acquires capital gain property, the suspended basis adjustment may be applied to increase the basis of that asset.

197. I.R.C. § 755(b); Treas. Reg. § 1.755-1(c)(4).

(2) *Basis adjustment cannot be used currently to the extent that the basis decrease allocated to an asset would result in a basis that is less than zero.*[198]

Example: The CDE Partnership distributes Capital Asset A to Charles in complete liquidation of his partnership interest. When the distribution is made, the partnership has an I.R.C. Section 754 election in effect, and its balance sheet is as follows:

Assets	Basis	Value
Capital Asset A	$50,000	$70,000
Capital Asset B	10,000	5,000
Inventory	135,000	135,000
Total Assets	$195,000	$210,000
Partners' Capital		
Charles	$65,000	$70,000
Dana	65,000	70,000
Errol	65,000	70,000
Total Partners' Capital	$195,000	$210,000

Although the partnership's basis for Capital Asset A is only $50,000, Charles's basis for the property is $65,000 — the basis of his partnership interest at the time he receives the liquidating distribution. Because the distributed property is a capital asset, the $15,000 basis decrease resulting from the distribution is allocated to the class of partnership capital gain property. Because the basis of Capital Asset B cannot be reduced to less than zero, its basis decreases by $10,000. The remaining $5,000 of basis decrease is suspended until the partnership acquires property in the capital asset class to which the basis adjustment can be applied.

[D] Distributions by Tiered Partnerships

Distribution of interest in another partnership. When the property distributed to a partner consists of an interest in another partnership, the last sentence of I.R.C. Section 734(b)(2)(B) provides a special rule: a distributing partnership (parent) with a basis-adjustment election in effect cannot increase the basis of its retained property, unless the partnership whose interest is distributed (subsidiary) also has an election in effect. This rule was enacted to prevent parent-subsidiary partnerships from being used to defer recognition of gain.[199]

198. Treas. Reg. § 1.755-1(a)(1)(iii).

199. H.R. Rep. No. 98-861, 98th Cong., 2d Sess. 21 (1984).

The basis adjustment limitation of I.R.C. Section 734(b)(2)(B) applies only if the subsidiary partnership does not have an I.R.C. Section 754 election in effect when the parent distributes its interest in the subsidiary. If both parent and subsidiary partnerships have elections in effect when the distribution occurs, the parent adjusts the basis of its undistributed property under the general rules of I.R.C. Section 734(b)(1)(B).[200]

Revenue Ruling 92-15[201] indicates that certain distributions will reduce the basis of property held by both parent and subsidiary partnerships if both have I.R.C. Section 754 elections in effect. For example, a liquidating distribution by a parent partnership to a partner having a higher basis in his partnership interest than in the distributed property may trigger decreases in the basis of both parent's and subsidiary's assets.

[E] Basis Adjustment on Distributions Subject to I.R.C. Section 751(b)

A partnership that makes a distribution subject to I.R.C. Section 751(b) must determine the assets to which an I.R.C. Section 754 basis adjustment may apply. A disproportionate distribution of I.R.C. Section 751 property is treated as if:

(1) the distributee partner received a current distribution of his proportionate share of the partnership's I.R.C. Section 751 property and other property; and

(2) the distributee partner exchanged a portion of one class of property for an extra amount of the other class of property that he actually received.

To determine the effect of an I.R.C. Section 754 election on a distribution subject to I.R.C. Section 751(b), the distribution must be divided into two parts:

Part (1) — The property deemed to have been distributed to the partner and transferred back to the partnership in exchange for the property he actually received.

Although no direct authority exists, statutory language indicates that the basis-adjustment rules do not apply to this deemed distribution. I.R.C. Section 734(b) indicates that adjustments are made to reflect:

(1) gain or loss recognized under I.R.C. Section 731(a); and

(2) changes in the basis of distributed property that occur pursuant to I.R.C. Section 732.

200. Rev. Rul. 92-15, 1992-1 C.B. 215, Situation (2).

201. 1992-1 C.B. 215.

Neither I.R.C. Section 731(a) nor I.R.C. Section 732 apply to the extent that a distribution is subject to I.R.C. Section 751(b).[202]

Part (2) — The property actually distributed to the partner that is not subject to the hypothetical sale treatment under I.R.C. Section 751(b).

The basis-adjustment rules of I.R.C. Section 734(b) clearly apply to this part of the distribution. Thus, the partnership increases or decreases the basis of its undistributed assets if the partner recognizes gain or loss on the distribution or if the distribution changes the basis of the property.

[F] Making a Basis-Adjustment Election

A partnership makes a basis-adjustment election by filing a statement, signed by a partner, with its income tax return, filed in a timely manner, for the year the distribution or transfer was made.[203] The election applies to distributions and transfers of partnership interests in that tax year[204] and in all subsequent years, unless it is revoked with the permission of the Service.

Under proposed regulations, a taxpayer making a basis adjustment election under I.R.C. Section 754 must file a statement with its return that: (i) states the name and address of the partnership making the election; and (ii) declares that the partnership elects to apply the provisions of I.R.C. Sections 734(b) and 743(b).[205] The proposed rules would remove the signature requirement under the current basis adjustment regulations. Accordingly, a partnership that files a timely partnership return containing an election statement that would be valid but for the missing signature of a partner, need not to seek an extension of time for making an election. The proposed regulations are effective when finalized, but taxpayers may rely on them for earlier periods.

202. I.R.C. §§731(c), 732(e).
203. Treas. Reg. § 1.754-1(b)(1).
204. Jones v. U.S., 553 F.2d 667 (Ct. Cl. 1977).
205. 82 F.R. 47408-01 (Oct. 10, 2017).

Chapter 2

Tax Classification of Economic Relationships

§ 2.01 Overview of Tax Classification Issues

The tax consequences of a joint economic relationship depend on whether the relationship is classified for tax purposes as a partnership or as some other arrangement, such as a corporation, sole proprietorship, trust, or co-ownership. Ventures classified as partnerships are governed by the complex rules of Subchapter K, while other joint endeavors are taxed under other rules, based on the enterprise's classification. The classification of an economic relationship is determined under federal tax rules and not under state or local law.

The significance of classification is illustrated by assuming that two persons jointly own income-producing property. If the arrangement between the parties is a partnership, the character and timing of each partner's income or loss is determined at the partnership level and the partnership makes most tax elections affecting the property. In contrast, if the two parties hold the property as co-tenants, each party separately determines the time and character of his income, and each party is free to make his own elections for the co-owned property.

This chapter describes the criteria for determining whether a joint economic relationship is a partnership for tax purposes. The discussion focuses on the following areas:

The current classification regulations. Classification regulations that became effective on January 1, 1997, provide rules for determining whether an economic venture is taxable as a partnership or corporation. Certain domestic and foreign entities are automatically classified as corporations. An unincorporated business entity (i.e., an entity that is not a trust), such as a partnership or limited liability company, may choose to be taxed either as a partnership or as a corporation. Special treatment applies to single-member entities. These rules are described in § 2.02, *infra*.

Cases and rulings on whether an entity exists. Under the regulations, the first step in the classification process is to determine if the venture is an "entity" for federal tax purposes. The regulations provide little guidance as to what constitutes an "entity" other than to state that the determination is made under federal tax law rather than state or local law. Presumably, whether an entity exists is decided under

principles similar to those applied in pre-1997 federal tax cases and rulings on whether a joint economic arrangement created a partnership. These rules are described in § 2.03, *infra.*

Publicly traded partnerships. The classification regulations do not apply to entities that are subject to classification under specific provisions of the Internal Revenue Code. Under the publicly traded partnership rules of I.R.C. Section 7704, a partnership is treated as a corporation for tax purposes if its interests are readily tradable on securities markets. A partnership is exempt from this treatment if it derives substantially all of its income from certain qualifying passive investment sources or if it was in existence before the effective date of I.R.C. Section 7704. The rules for determining if a partnership is publicly traded and for determining if it is exempt from corporate taxation are described in § 2.04, *infra.*

The anti-abuse rule. The regulations establish an "anti-abuse" rule designed to prevent taxpayers from using Subchapter K for tax avoidance. If a partnership transaction violates the anti-abuse rule, the Service can:

(1) disregard the existence of the partnership;

(2) treat the taxpayer as a non-partner;

(3) change the method of accounting used by the partnership or a partner;

(4) reallocate partnership income and loss among the partners; or

(5) otherwise adjust the claimed tax treatment.

The anti-abuse rule is described in § 2.05, *infra.*

The election to be excluded from the partnership tax rules of Subchapter K. This election is available to partnerships engaged in investment activities, production, extraction, or use of certain kinds of property and to certain partnerships of securities dealers. This chapter explains the rules applicable to the election, including eligibility for the election, how the election is made, and what effect the election has on Code sections outside of Subchapter K. The election rules are discussed in § 2.06, *infra.*

The pre-1997 classification rules. Under the classification regulations in effect before 1997, an unincorporated entity, such as a limited liability company or limited partnership, was considered an association taxable as a corporation if it had more than two of four specific corporate characteristics: centralized management, freely transferable interests, continuity of life, and limited liability. A venture that lacked at least two of these characteristics ordinarily was classified as a partnership. Because these rules apply to years before 1997, they are described in § 2.07, *infra.*

§ 2.02 Determining Tax Classification under the Regulations

[A] Overview of the Classification Regulations

Regulations that became effective January 1, 1997, provide a simple method for determining whether a venture is taxable as a partnership or subject to other tax rules.[1] Under these regulations, entities incorporated under state or federal statutes and certain other specified organizations are automatically taxable as corporations. Most other domestic business organizations that have more than one member, including limited liability companies, are taxable under the partnership rules,[2] unless the entity files an election to be classified as a corporation. Special classification rules apply to foreign organizations. The validity of these regulations, referred to as the "check-the-box" rules, has been upheld as a reasonable exercise of regulatory authority.[3]

[1] Domestic Ventures

The proper tax classification of a domestic[4] organization may be determined in the following manner:

(1) ***Determine whether the venture is an "entity" under the Federal tax rules.*** A joint undertaking may be an entity for tax purposes even though it is not treated as an entity under state law.[5] Conversely, an organization recognized as a separate entity under state law may not be considered an entity for tax purposes. (*See* § 2.03, *infra.*)

(2) ***Determine whether the entity is a "business entity."*** *An entity is a business entity unless it is a trust.*[6] Generally, trusts have neither associates nor an objective to carry on business for profit. An entity classified as a trust is taxed under the trust rules of Subchapter J.

(3) ***Determine whether the business entity is automatically classified as a corporation for tax purposes (a per se corporation).*** This group includes: (1) any organization actually incorporated under state, federal or Indian tribe law, and (2) any other organization specifically listed in the regulations. (*See* § 2.02[C][1], *infra.*) These business entities are taxable as corporations. Any

1. Treas. Reg. §§ 301.7701-1 through 301.7701-3.

2. The regulations define a partnership as a business entity that has at least two members and which is not a per se corporation under the regulations. Treas. Reg. § 301.7701-(2)(c)(1).

3. Littriello v. U.S., 484 F.3d 372 (6th Cir. 2007); *cert denied*, 128 S. Ct. 1290 (2008).

4. An entity is a domestic entity if it is created or organized in the United States or under the law of the United States or of any state, including the District of Columbia. Treas. Reg. § 301.7701-1(d), (e). However, the Treasury is authorized to issue regulations that may classify certain entities as foreign even though organized in the United States. I.R.C. § 7701(a)(4), as amended by the Taxpayer Relief Act of 1997.

5. Treas. Reg. § 301.7701-1(a)(2).

6. For definition of trust, *see* Treas. Reg. § 301.7701-4.

business entity that is not automatically classified as a corporation is referred to as an "eligible entity."

(4) ***Determine the tax classification if the eligible entity has only one member.*** A single member entity cannot be taxable as a partnership. If the sole member is an individual, the venture is taxed as a sole proprietorship (i.e., the entity is disregarded), unless the member elects to have the entity taxed as a corporation. If the sole member is not an individual (e.g., it is a corporation), the venture is treated as a branch or division of the owner (i.e., the entity is disregarded), unless the member elects to have the entity taxed as a corporation. (*See* § 2.02[F], *infra.*)

(5) ***Determine the tax classification if the eligible entity has at least two members.*** An eligible entity with more than one member automatically is classified as a partnership unless it files an election to be taxed as a corporation. (*See* § 2.02[F], *infra.*)

[2] Foreign Ventures

The regulations contain rules for determining the U.S. tax classification of business organizations created and governed by foreign law.[7] The classification of a foreign organization for tax purposes may be determined in the following manner:

(1) ***Determine if the regulations include this type of entity in the list of per se corporations.*** A foreign entity is automatically taxed as a corporation if the type of organization is included in an extensive list of foreign business forms set forth in the regulations. A venture that is not on the list is a "foreign eligible entity." (*See* § 2.02[E][2], *infra.*)

(2) ***Determine the tax classification if the foreign eligible entity has only one member.*** Generally, a foreign entity that provides limited liability for all its owners is classified as a corporation. If the sole member lacks limited liability, the entity is disregarded for tax purposes unless the member files an election to be taxed as a corporation. Partnership tax status is not available to single member entities. A member of a foreign entity has limited liability if the member lacks personal liability for the entity's debts and obligations by reason of being a member. (*See* § 2.02[E][1], *infra.*)

(3) ***Determine the tax classification if the foreign eligible entity has at least two members.*** If at least one member lacks limited liability, the entity is treated as a partnership unless it files an election to be taxed as a corporation. If all members have limited liability, the venture is taxable as a corporation unless it files an election to be classified as a partnership. (*See* § 2.02[F], *infra.*)

7. The Treasury is authorized to issue regulations that may classify certain entities as foreign even though organized in the United States. I.R.C. § 7701(a)(4), as amended by the Taxpayer Relief Act of 1997.

[B] Definition of Entity

A venture can be classified as a partnership or corporation for tax purposes only if it is an "entity" that is separate from its owners. Whether an organization is a separate entity is determined under federal tax law and does not depend upon whether it is recognized as an entity under local law.[8] For tax purposes, a joint venture or contractual relationship may be a separate entity if the participants carry on a trade, business, financial operation or venture and divide the realized profits.[9]

The regulations do not provide guidelines for determining whether an arrangement constitutes an entity. The sole example in the regulations states that a separate entity may be created when co-owners of an apartment building lease space and also provide services to the occupants either directly or through an agent.[10] A joint undertaking merely to share expenses, however, does not create a separate entity. For example, adjacent landowners who jointly construct a ditch to drain surface water from their properties do not create a separate entity. Similarly, co-owners who maintain, repair, rent or lease their property do not constitute an entity for tax purposes. Thus, no separate entity is formed when tenants in common merely lease property to a third party without providing significant services in connection with the lease.

Certain organizations may not be considered entities for tax purposes even though formed and recognized under local or federal law.[11] For example, an organization wholly owned by a state is not treated as a separate entity if it is an integral part of the state, nor are Native American tribes incorporated under specified federal statutes.[12] Similarly, an arrangement that is a "qualified cost sharing arrangement" as defined in the tax regulations[13] is not a separate entity for classification purposes.[14] Most important, a single owner organization that is considered a separate entity under state law, such as a one member limited liability company, is disregarded for tax purposes unless it elects to be classified as a corporation.[15]

[C] Definition of Business Entity

Once it is determined that a venture constitutes an entity for tax purposes, the next step is determine if it is a "business entity." An entity is a business entity unless it is trust (as defined in the regulations), or it is subject to special tax treatment under specific provisions of the Internal Revenue Code (e.g., a real estate investment trust).

8. Treas. Reg. § 301.7701-1(a)(1).
9. Treas. Reg. § 301.7701-1(a)(2).
10. *Id.*
11. Treas. Reg. § 301.7701-1(a)(3).
12. *Id.*
13. *See* Treas. Reg. § 1.482-7.
14. Treas. Reg. § 301.7701-1(c).
15. Treas. Reg. § 301.7701-1(a)(4). See discussion of single member organizations in § 2.02[D][2], *infra*.

The term business entity includes single owner entities, even though such entities may choose to be disregarded for tax purposes.

The exclusion of trusts from the definition of business entities applies only to "ordinary" trusts and certain "investment" trusts. A trust is an ordinary trust if its purpose is to make trustees responsible for protecting and conserving property for beneficiaries who cannot share in this responsibility.[16] In that case, the beneficiaries are not considered associates in a joint enterprise to conduct a business for profit. This kind of trust is taxable under Subchapter J of the Internal Revenue Code.

In an investment trust, the beneficiaries, referred to as certificate holders, form the trust to facilitate the management of their investments. Generally, this arrangement is classified as a trust if there is only one class of ownership interest representing undivided beneficial interests in the trust assets and the trust agreement does not allow the certificate holders to vary their investments. An investment trust is treated as a business entity rather than a trust if the trust agreement permits the certificate holders to vary their interests,[17] or if there are multiple classes of ownership interests.[18]

A third type of trust, called a "business" trust, is considered a business entity rather than a trust for tax purposes. Although called a trust because legal title to property is conveyed to trustees for beneficiaries, the purpose is to carry on a profit-making business that ordinarily would be conducted by a corporation or partnership.[19] This kind of business entity includes Massachusetts business trusts and the Illinois land trusts.

[D] Classification of a Domestic Business Entity

A domestic entity is an entity created or organized in the United States or under any Federal or state law.[20] The basic rules for classifying a domestic business entity are summarized as follows:

(1) Certain entities, called per se corporations, are automatically classified as corporations for tax purposes. A per se corporation may have one owner or multiple owners.

(2) A business entity that is not a per se corporation is an "eligible entity." An eligible entity may file an election to be classified as a corporation or it may accept the "default" classification provided in the regulations. The default classification available to an eligible entity depends upon whether it has a single owner or multiple owners.

16. Treas. Reg. § 301.7701-4(a).

17. Treas. Reg. § 301.7701-4(c). *See* Comm'r v. North American Bond Trust, 122 F.2d 545 (2d Cir. 1941), *cert denied*, 314 U.S. 701 (1942).

18. Treas. Reg. § 301.7701-4(c).

19. Treas. Reg. § 301.7701-4(b).

20. Treas. Reg. § 301.7701-1(d). This includes the District of Columbia. Treas. Reg. § 301.7701-1(e).

(3) The default classification for a single owner business entity is a sole proprietorship if the owner is an individual, or a branch or division of the owner if not an individual.

(4) The default classification for an entity with at least two owners is a partnership.

(5) An eligible entity that was in existence before 1997 retains its classification and need not make any election unless requesting a change in classification. However, a single-owner entity that was classified as a partnership before 1997 is considered an entity separate from its owner.[21]

[1] Per Se Corporations

The following domestic business entities are automatically classified as corporations for tax purposes:[22]

(1) an entity organized under a Federal or State statute, or a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated, a corporation, body corporate, or body politic;

(2) an association — this group includes any unincorporated entity that has elected to be taxable as a corporation. Certain entities are deemed to elect association status:

   (a) A tax-exempt entity (under I.R.C. Section 501(a)) is deemed to make an election to be classified as an association as of the first day for which the exemption is claimed or determined to apply. The deemed election remains in effect until exempt status is withdrawn, rejected, or revoked and a new classification is elected.[23]

   (b) An entity that elects to be treated as a real estate investment trust (REIT) under I.R.C. Section 856(c)(1) is deemed to elect association tax status as of the first day it is treated as a REIT.[24]

(3) an entity organized under a State statute that describes or refers to the entity as a joint-stock company or joint-stock association;

(4) an insurance company;

(5) a state-chartered bank if any of its deposits are insured under the Federal Deposit Insurance Act or a similar federal statute;

(6) a business entity wholly owned by a state or its political subdivision; and

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21. Treas. Reg. § 301.7701-3(b)(3).
22. Treas. Reg. § 301.7701-2(b).
23. Treas. Reg. § 301.7701-3(c)(v)(A).
24. Treas. Reg. § 301.7701-3(c)(v)(B).

(7) a business entity that is taxable as a corporation under any other specific provision of the Internal Revenue Code (e.g., a publicly traded partnership;[25] or a taxable mortgage pool[26]).

[2] Single-Owner Entities

A single-owner domestic business entity that is not a per se corporation is an "eligible entity" that may choose one of two tax classifications:

(1) The entity may choose to be disregarded for tax purposes. This is the "default" classification for domestic single member business entities, meaning that no election need be filed to obtain this status.[27] If the sole owner is an individual, the venture will be taxable as a sole proprietorship. If the owner is not an individual (e.g., it is a corporation), the venture is treated as a branch or division of the owner.

The default classification can be very advantageous for a single owner limited liability company. For an individual, an LLC provides limited liability without the operating restrictions applicable to S corporations. An individual can form separate LLCs for different enterprises to insulate the assets of one venture from the creditors of another. Because each LLC is disregarded for tax purposes, separate tax returns are not required.

A corporation that operates more than one enterprise may wish to form separate LLCs rather than subsidiary corporations. Because each LLC is considered a branch, or division for tax purposes, the parent corporation obtains limited liability for each business operation while avoiding the complexity of filing consolidated returns with subsidiaries. Indeed, the parent corporation may itself be an S corporation, thereby providing the shareholders with pass-through tax treatment for all the businesses the corporation operates.

An LLC may be preferable to a corporate subsidiary when the parent wishes to sell the business operation. Sale of an LLC subsidiary is treated as a sale by the parent of the LLC's assets. The parent recognizes gain on the appreciation in the LLC assets and the purchaser obtains a cost basis. In contrast, the sale of stock of a corporate subsidiary can result in multiple taxation to the seller or no cost basis to the purchaser unless the complex requirements of I.R.C. Sections 338 and 336 are satisfied.

(2) A single-owner eligible business entity that does not wish to be disregarded for tax purposes may file an election to be treated as an association taxable as a corporation. (*See* election procedure at § 2.02[F], *infra*.)

(3) Recent final regulations treat a domestic disregarded entity that is wholly-owned by one foreign person as a domestic corporation separate from its

25. I.R.C. § 7704.

26. I.R.C. § 7701(i).

27. Treas. Reg. § 301.7701-3(a).

owner for the limited purposes of the reporting and recordkeeping rules of IRC Section 6038A.[28]

[3] Entities with Two or More Owners

A domestic business entity that has two or more owners that is not a per se corporation is an "eligible entity" that may choose one of two tax classifications:

(1) The entity may choose to be taxable as a partnership. This is the "default" classification for domestic business entities with more than one owner, meaning that no election need be filed to obtain this status.[29]

(2) If the entity does not wish to be taxed as a partnership, it may file an election to be treated as an association taxable as a corporation. (*See* election procedure at § 2.02[F], *infra*.)

[E] Classification of a Foreign Business Entity

A foreign entity is an entity that is not created or organized in the United States or under any Federal or state law.[30] The basic rules for classifying a foreign business entity are summarized as follows:[31]

(1) Certain foreign entities are per se corporations that are automatically classified as corporations for tax purposes. A per se corporation may have one member or multiple members.

(2) A foreign business entity that is not a per se corporation is a "foreign eligible entity." A foreign eligible entity may accept the default classification provided in the regulations or it may elect the alternative classification. The default classification of a foreign eligible entity depends upon two factors: (a) whether it has a single member or more than one member, and (b) whether any member lacks limited liability under local law (as defined below).

(3) If the sole member of a foreign entity has limited liability, the default classification is an association taxable as a corporation. The sole member may elect to have the entity disregarded for tax purposes.

(4) If the sole member of the foreign entity lacks limited liability, the default classification is to disregard the entity for tax purposes. The sole member may elect association status; in that case, the venture is taxable as a corporation.

(5) If the entity has two or more members and all members have limited liability, the default classification is association taxable as a corporation. The entity may elect to be treated as a partnership for tax purposes.

28. T.D. 9796 (Dec 12, 2016).

29. Treas. Reg. § 301.7701-3(a).

30. Treas. Reg. § 301.7701-1(d).

31. Treas. Reg. § 301.7701-3(b)(2). In Legal Advice Memorandum 2021-002 (Mar. 25, 2021), the Service describes rules relating to the classification of a foreign eligible entity when its classification first becomes "relevant" for United States tax purposes.

(6) If the entity has two or more members and at least one member lacks limited liability, the default classification is taxation as a partnership. The entity may elect to be classified as an association taxable as a corporation.

[1] Limited Liability Defined

The regulations define limited liability as follows:

> [A] member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant.... [A] member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability ... even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.[32]

[2] Per Se Foreign Corporations

The regulations set forth an extensive list of foreign entities that are automatically treated as corporations for United States tax purposes. Apparently, the Treasury believes that the similarity between these entities and United States corporations warrants automatic classification. The list includes business entities of 90 different nations.[33]

[3] Grandfather Rule for Foreign Entities

Under a "grandfather" rule, a foreign entity included on the list of per se corporations need not change to corporate tax status if the entity was in existence on May 8, 1996, and satisfies a number of other conditions set forth in the regulations.[34]

[4] Single-Member Foreign Entities

A single-owner foreign business entity that is not a per se corporation is a "foreign eligible entity" that may choose one of two tax classifications:

(1) If the sole member of the foreign entity lacks limited liability, the entity may be disregarded for tax purposes. The venture is treated as a sole proprietorship if the owner is an individual, or as a branch or division of the owner if not an individual. This is the default classification, meaning that no election is required to obtain this tax status. The entity may elect to be considered an association taxable as a corporation.

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32. Treas. Reg. § 301.7701-3(b)(2)(ii).
33. Treas. Reg. § 301.7701-2(b)(8)(i).
34. Treas. Reg. § 301.7701-2(d).

(2) If the sole member has limited liability, the default classification is association taxable as a corporation. The member may elect to have the entity disregarded for tax purposes.

The fact that a wholly owned foreign entity may be disregarded for United States tax purposes can be advantageous in structuring foreign operations.[35] For example, a United States parent corporation may form a U.S. limited liability company or corporate subsidiary to own all the interests in a foreign entity. The foreign entity may be disregarded and treated as a division of the parent for U.S. tax purposes, either by default or by affirmative election. The domestic LLC or subsidiary insulates the parent from liability arising from foreign operations. Although the foreign earnings are currently included in the parent's income, that income is largely offset by the pass-through of the tax credit for taxes paid to the foreign country.

[5] Foreign Entities with Two or More Owners

A foreign business entity that has at least two owners and is not a per se corporation is a foreign eligible entity that may choose either of the following tax classifications:

(1) If all members have limited liability, the entity may be classified as an association taxable as a corporation. This is the default classification, meaning that no election is required to obtain this tax status. The entity may affirmatively elect to be treated as a partnership for tax purposes.

(2) If at least one member of the foreign entity lacks limited liability, the default classification is taxation as a partnership. The entity may elect to be classified as an association taxable as a corporation.

[6] Classification of Partnership That Divides

Subchapter K provides that if a partnership divides into two or more entities, a resulting partnership is considered a continuation of the prior partnership if its members owned more than 50 percent of the interests in the prior partnership.[36] The classification regulations state that if the former partnership elected partnership tax status, the continuing partnership retains that tax classification without filing a new election.[37]

[F] Election Procedures

A domestic or foreign eligible entity that is satisfied with its default tax classification need not file any election to obtain that status. If the entity desires a different initial classification or to change its current tax status, it must file Form 8832, "Entity Classification Election," with the service center designated on the form. The election must

35. *But see* Rev. Proc. 99-7, 1999-1 I.R.B. 226 (Service will not issue advance ruling on classification of foreign entity if classification is inconsistent with purposes of U.S. tax law).

36. I.R.C. § 708(b)(2)(B).

37. Treas. Reg. § 301.7701-3(e).

provide all the information required by the form and instructions, including the entity's taxpayer identification number.

An eligible entity that elects to change its classification cannot make another election during the 60 months following the first election's effective date. This limitation period does not apply to the election an existing entity made to change its classification as of the regulations' effective date (January 1, 1997). The Internal Revenue Service may waive the 60-month limitation by letter ruling, but only if 50 percent of the entity's ownership interests are held by persons that did not own any interests on the filing date or effective date of the prior election.

[G] Change in Classification or Number of Members

[1] Elective Change in Classification

The Treasury has issued rules addressing the tax consequences of elective changes in entity classification.[38] These rules minimize the tax consequences of these elective classification changes by characterizing the changes as follows:[39]

(1) An association that elects to be classified as a partnership is deemed to liquidate by distributing its assets and liabilities to its shareholders and then the shareholders are deemed to contribute all of the distributed assets and liabilities to the partnership.[40]

(2) A partnership that elects to be classified as an association is deemed to contribute all of its assets and liabilities to the association in exchange for stock and then the partnership is deemed to liquidate by distributing stock in the association to its partners.[41]

(3) An association that elects to be disregarded as an entity separate from its owner is deemed to liquidate by distributing its assets and liabilities to its sole owner.[42]

(4) An entity disregarded as separate from its owner that elects to be classified as an association is deemed to have its owner contribute all of the entity's assets and liabilities to the association in exchange for stock.[43]

Example:[44] Arlen is sole owner of Apco Company, which is classified as a disregarded entity for tax purposes. On January 1, 2000, Bea purchases a 50 percent interest in Apco from Arlen. Although a partnership is the default

38. Treas. Reg. § 301.7701-3(g).

39. Treas. Reg. §§ 301.7701-2, -3; T.D. 8844, 2001-12 I.R.B. 917, modified, 2002-2 I.R.B. 281.

40. Treas. Reg. § 301.7701-3(g)(1)(i). This characterization is consistent with Rev. Rul. 63-107 (1963-1 C.B. 71).

41. Treas. Reg. § 301.7701-3(g)(1)(ii). This does not affect Rev. Rul. 84-111 (1984-2 C.B. 88), in which the IRS ruled that it would respect the form used by the taxpayers when a partnership converts to a corporation.

42. Treas. Reg. § 301.7701-3(g)(1)(iii).

43. Treas. Reg. § 301.7701-3(g)(1)(iv).

44. Treas. Reg. § 301.7701-3(f)(4), Ex. (1).

classification for Apco when Bea acquires her interest, Arlen and Bea elect to have the entity classified as an association effective on January 1, 2000.[45] Arlen is treated as if he contributed all Apco's assets and liabilities to the newly formed Apco association on December 31, 1999. Bea is treated as if she purchased 50 percent of the shares of Apco stock from Arlen on January 1, 2000. Because Arlen does not retain control of the association as required for nonrecognition under I.R.C. Section 351, Arlen's contribution is taxable and he recognizes gain or loss as if he sold each asset for its fair market value. Apco's basis in the assets deemed contributed by Arlen is their fair market value and that is Arlen's basis in his Apco stock. Arlen has no additional gain upon the sale of stock to Bea, and Bea takes a cost basis in the stock purchased from Arlen.

Timing of elective changes. Under the regulations, an election to change an entity's classification is effective at the start of the day for which the election is effective.[46] Any transactions deemed to occur because of the classification change are considered to happen immediately before the close of the day before the election is effective. For example, if an association elects to convert to a partnership on January 1, the association's tax year closes on December 31 and the first day of the partnership's tax year is January 1.[47] Each person who was an owner on the date that a classification change is deemed to occur, and who is not an owner when the election is filed, must also sign the election.[48]

Basis adjustments. A partnership that elects to be taxed as an association is treated as if it contributed all its property to a newly formed corporation in a transaction that is nontaxable under I.R.C. Section 351. Generally, the corporate transferee's basis in the property deemed transferred to it by the partnership is the same as the partnership's basis in the property. Proposed regulations provide that a corporate transferee's basis in property transferred by a partnership in an I.R.C. Section 351 transfer includes any special basis adjustment under I.R.C. Section 743.[49] Any gain the partnership may recognize as a result of the deemed transfer of its property to the association is determined without reference to any special basis adjustment. However, the partner with the special basis adjustment can use the special basis adjustment to reduce its share of gain the partnership recognizes.[50] The special basis adjustment is also taken into account in determining the partner's basis in the stock received in the exchange.[51]

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45. This election is treated as a change in classification so that no classification change election is allowed during the 60 months succeeding the effective date of the election. *See* § 2.02[F], *infra*.

46. Treas. Reg. § 301.7701-3(c). The tax treatment of an elective change in an entity's classification is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Treas. Reg. § 301.7701-3(g)(2).

47. Treas. Reg. § 301.7701-3(g)(3).

48. Treas. Reg. § 301.7701-3(c)(2)(iii).

49. Prop. Treas. Reg. § 1.743-2(a).

50. Prop. Treas. Reg. § 1.743-2(b).

51. Prop. Treas. Reg. § 1.743-2(c).

Example: The AB Partnership owns Property X. AB's basis in Property X is $100. Partner A has a $5 special basis adjustment in Property X under I.R.C. Section 743(b). The partnership elects to be classified as an association for tax purposes. AB is deemed to contribute all of its assets and liabilities to the association in exchange for stock, and to immediately liquidate by distributing the stock to its partners. Under the proposed regulations, the association's basis in Property X is $105, which includes Partner A's $5 special basis adjustment. Partner A's basis in the association's stock also increases by the $5 special basis adjustment for Property X.

The Treasury Department has issued proposed regulations designed to prevent taxpayers from changing a foreign entity's classification in order to generate U.S. tax benefits that would otherwise be unavailable.[52] The proposed regulations are directed at classification changes that create disregarded entities and partnerships for the purpose of avoiding tax rules relating to international transactions.[53] Under the proposed regulations, a foreign entity's election to change its classification from association (taxable as a corporation) to disregarded entity may be retroactively invalidated in certain circumstances.[54]

[2] Change in Number of Members

Regulations address the consequences of a change in the number of members of the entity, holding that such membership changes do not affect the entity's classification. However, an entity initially classified as a partnership that subsequently has only one member (and continues to be an entity under local law), will be disregarded as an entity separate from its owner.[55] Additionally, a single-member disregarded entity that subsequently has more than one member will be classified as a partnership as of the date it has more than one member.[56] These automatic classifications can be changed by election if the entity is not subject to the 60-month limitation on elections (*see* § 2.02[F], *supra*).

Example (1):[57] On April 1, 2000, Dwight and Edith, both U.S. persons, form Detco, a foreign entity. Under the default rules for foreign entities, Detco is classified as an association and it does not elect to be classified as a partnership. Dwight subsequently purchases all of Edith's interest in Detco. Detco continues to be classified as an association and no classification election is deemed to occur. Detco may subsequently elect to be treated as a disregarded entity without regard to the 60-month limitation.

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52. Prop. Reg. §§ 301.7701-2, -3, 64 Fed. Reg. 66,591 (Nov. 29, 1999).

53. For example, I.R.C. §§ 861–865 (rules governing source of income), I.R.C. § 904 (foreign tax credit limitation categories), I.R.C. §§ 951–964 (disposition of ownership interests under Subpart F), and I.R.C. § 367 (outbound transfers).

54. Prop. Treas. Reg. § 301.7701-3(h). An invalid election is deemed not to have been made for purposes of the 60-month limitation on such elections. *See* § 2.02[F], *supra*.

55. Treas. Reg. § 301.7701-3(f)(2).

56. *Id.*

57. Treas. Reg. § 301.7701-3(f)(4), Ex. (2).

Example (2):[58] On April 1, 2000, Fran and Gary, U.S. persons, form Frago, a foreign entity. Under the default rules for foreign entities, Frago is classified as an association and it does not elect to be classified as a partnership. On January 1, 2001, Frago elects to be classified as a partnership effective on that date. Under the 60-month limitation, Frago cannot elect to be classified as an association until January 1, 2006 (i.e., 60 months after the effective date of the election to be classified as a partnership).

On June 1, 2001, Fran purchases all of Gary's interest in Frago. Because Frago has only one member, it is no longer classified as a partnership but, pursuant to the default rules, is treated as a disregarded entity. This is not considered a change in classification for purposes of the 60-month rule and Frago cannot elect to be classified as an association until January 1, 2006 (i.e., 60 months after the January 1, 2001, election to be classified as a partnership).

The Service has issued two rulings addressing the tax consequences of a change in classification resulting from an increase or decrease in the number of an entity's members. Revenue Ruling 99-5[59] describes the consequences when a single-member limited liability company that is disregarded as a separate entity transforms to a multi-owner entity classified as a partnership for tax purposes. Revenue Ruling 99-6[60] concerns the consequences when one person purchases all the interests in a limited liability company causing the LLC's partnership status to terminate.[61]

§ 2.03 Determining Whether a Partnership Exists

[A] Determining Whether an "Entity" Exists

As described in § 2.02, above, the regulations provide that an economic arrangement may be classified as a partnership only if it is a business "entity" that is separate from its owners. Whether an arrangement constitutes a separate entity is decided under federal tax law and not under state or local law.[62] The regulations do not establish criteria for determining whether an entity exists. The only guidance is the following paragraph:

> A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly

58. Treas. Reg. § 301.7701-3(f)(4), Ex. (3).
59. 1999-6 I.R.B. 8.
60. 1999-6 I.R.B. 6.
61. Under I.R.C. § 708(b)(1)(A). See § 14.03, *infra*.
62. Treas. Reg. § 301.7701-1(a)(1).

> or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.[63]

The term entity encompasses many economic arrangements that would not be taxable as partnerships under the former regulations. Although state law is not controlling, the vast majority of partnerships, limited partnerships and limited liability companies set up under state business organization statutes are entities for tax purposes. It is also likely that many economic ventures not formally organized under state law are taxable as partnerships under the default classification rules. A venture that is considered a partnership, whether by default or affirmative election, is subject to all partnership tax rules, including filing requirements and associated penalties.

Although the term entity is not well defined, evidence of its meaning is found in the tax cases and rulings defining the term "partnership." Under the pre-1997 classification rules, a venture was taxable under Subchapter K only if it met the tax definition of a "partnership" established by the former I.R.C. Sections 761 and 7701 regulations. (For discussion of the pre-1997 rules, *see* § 2.07, *infra*.) The definition of a partnership in those regulations is similar to the current description of an entity.[64] Presumably, determining if an arrangement is an entity under the current regulations involves criteria similar to those used for determining whether a partnership was created under the former rules.

Subsequent legislation clarifies that, for a capital interest in a partnership in which capital is a material income-producing factor, the determination of whether a person is a partner is made without regard to whether the interest was derived by purchase or by gift from another person.[65] The provision deletes former I.R.C. Section 704(e)(1) and changes the definition of partner in I.R.C. Section 761. Accordingly, the clarification of who is a partner is set forth in the Code section that provides definitions rather than the section relating to partners' distributive shares.

The explanation of the provision by the Staff of the Joint Committee on Taxation specifically refers to a long-running judicial controversy involving the Castle Harbor LLC.[66] In that case, the IRS argued that two foreign banks were not partners with the LLC because the facts showed they had not joined together in good faith and with a

63. Treas. Reg. § 301.7701-1(a)(2).

64. *See* former Treas. Reg. § 1.761-1(a).

65. Bipartisan Budget Act of 2015 (Public Law 114-74). The provision applies to partnership taxable years beginning after December 31, 2015.

66. Staff of the Joint Committee on Taxation, *General Explanation of the Tax Legislation Enacted in 2015*, (March 2016) (Blue Book).

business purpose to conduct an enterprise.[67] The District Court rejected this view, holding that the family partnership rules of former I.R.C. Section 704(e)(1) created an alternate test for determining who is a partner, under which the banks held capital interests in the partnership.[68] On appeal, the Second Circuit reversed the trial court, holding that the banks' interests in the partnership were in the nature of debt rather than a capital interest in a partnership.[69]

The intent of these statutory changes is to preclude any assertion that the Code provides an alternative test as to whether the holder of a capital interest is a partner, or whether the interest is a capital interest in a partnership. The law retains the current rules for determining whether the donor or donee is the real partner and does not affect the principle that the real owner of a capital interest is taxed on the income from that interest regardless of the motive for, or means of, the transfer. As under former law, the fact that an individual received a partnership interest by gift does not determine whether that individual is a partner.

[B] Sham Partnerships

A partnership is recognized for tax purposes only if the partners truly intended to join together for the purpose of carrying on a business and sharing in profits and losses.[70] Accordingly, a purported partnership may be disregarded as a "sham" for tax purposes if organized for a tax-motivated purpose that lacks "economic substance."[71] Generally, the economic substance doctrine provides that a taxpayer may not obtain tax benefits from a transaction that lacks a realistic possibility of profit and does not change the taxpayer's economic position independent of tax consequences.[72]

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67. Citing Comm'r v. Culbertson, 337 U.S. 733 (1949).

68. TIFD III-E, Inc. v. U.S., 342 F. Supp. 2d 94 (D. Conn. 2004). TIFD III-E, Inc. was tax matters partner for Castle Harbor, LLC. TIFD III-E, Inc. v. U.S., 459 F.3d 220 (2d Cir. 2006), *reversing and remanding*, 342 F. Supp. 2d 94 (D. Conn. 2004), *on remand*, 660 F. Supp. 2d 367 (D. Conn. 2009), *revd*, 666 F.3d 836 (2d Cir. 2012), *cert denied*, 136 S Ct 796 (2016).

69. TIFD III-E, Inc. v. U.S., 459 F3d 220 (2d Cir. 2006), *reversing and remanding*, 342 F. Supp. 2d 94 (D. Conn. 2004), *on remand*, 660 F. Supp. 2d 367 (D. Conn. 2009), *revd*, 666 F3d 836 (2d Cir. 2012), *cert denied*, 136 S Ct 796 (2016).

70. Comm'r v. Culbertson, 337 U.S. 733, 741, 69 S. Ct. 1210, 93 L. Ed. 1659 (1949).

71. If the transaction is a "sham," all tax benefits may be disallowed, including depreciation deductions attributable to the taxpayer's cash investment and recourse liabilities. Cooper v. Comm'r, 88 T.C. 84 (1987); Falsetti v. Commr, 85 T.C. 332 (1985); Grodt & McKay Realty, Inc v. Comm'r, 77 T.C. 1221 (1981); Rice's Toyota World v. Comm'r, 752 F'2d 89 (4th Cir 1985), *affirming in part*, 81 T.C. 184 (1983).

72. *See, e.g.*, Kearney Partners Fund v. U.S., 2014 U.S. Dist. LEXIS 29652, 113 AFTR 2d 2014-1220 (M.D. Fla. Mar 6, 2014), *affd*, 803 F3d 1280 (11th Cir 2015) (complex loss-generating program involving tiered partnerships/LLCs and straddle trades lacked economic substance where solely motivated by tax avoidance and no reasonable possibility of profit or legitimate business purpose existed); Blum v. Commr, 737 F.3d 1303 (10th Cir 2013) (loss disallowed for lack of economic substance where no reasonable profit expectation and taxpayer had no business purpose other than tax avoidance); Humboldt Shelby Holding Corporation v. Commr, T.C. Memo. 2014-47 (no economic substance where corporation contributed paired options to partnership to obtain artificially high basis in property later distributed by partnership); Shasta Strategic Investment Fund, LLC v. U.S., 2014 U.S. Dist. LEXIS

Economic Substance. Although the economic substance test was judicially created, Congress codified the rule in I.R.C. Section 7701(o) and added substantial penalties for taxpayers who claim tax benefits from transactions that lack economic substance.[73] New I.R.C. Section 7701(o) addresses a difference between the circuit courts of appeal regarding application of the doctrine. Prior to the statute, a majority of the courts applied a conjunctive test under which a transaction lacked economic substance if it did not satisfy either of two separate tests:[74]

- An objective economic substance test requiring a realistic possibility of a profit in the transaction; and
- A subjective business purpose test requiring that the taxpayer engaged in the transaction for a business purpose other than tax avoidance.

Several courts, however, applied a disjunctive test, holding that a transaction would be respected for tax purposes if it had either economic substance or a business purpose.[75]

The current statute clearly requires application of the conjunctive, two-pronged test, providing that tax benefits from a transaction are not allowed if the transaction does not have economic substance or lacks a business purpose.[76] Accordingly, avoidance of the economic substance doctrine requires a showing that (1) the transaction changed the taxpayer's economic position in a meaningful way and (2) the taxpayer had a substantial business purpose for entering into the transaction. Under the statute, the economic substance doctrine will continue to be applied in the same manner as if I.R.C. Section 7701(o) had never been enacted. Thus, the new section does not change existing standards other than to clarify that the test is conjunctive rather than disjunctive.

Business Purpose. Courts also have developed a "business purpose" test for recognition of a partnership. Under this test, a purported partnership may be disregarded for tax purposes if it lacks a nontax business purpose.[77] Thus, an entity organized

105722, 114 AFTR2d 2014-5571 (N.D. Cal. July 31, 2014) (purported loans lacked economic substance where evidence showed that no rational investor would pursue transactions for any business reason other than tax avoidance); CCA 201515020 (transaction lacked economic substance where profit potential was small relative to transaction costs and expected tax benefits); Curtis Investment Company, LLC v. Commr, TC Memo 2017-150, *aff'd*, 909 F3d 1339 (11th Cir 2018) (complex loss-generating transactions of partnership disregarded for tax purposes for lack of economic substance where no profit potential or economic effects except tax benefits and no rational taxpayer would enter such transactions); Greenberg v. Commr, TC Memo 2018-74 (no partnerships for tax purposes where actual purpose was to serve as conduits for options spread and as basis inflators in tax avoidance scheme).

73. The Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152 (June 30, 2010).

74. *See, e.g.*, Coltec Indus. v. U.S., 454 F3d 1340 (Fed Cir 2006); UPS of Am. v. Comm'r, 254 F.3d 1014 (11th Cir. 2001); ACM Pshp v. Comm'r, 157 F.3d 231 (3d Cir. 1998).

75. *See, e.g.*, Rice's Toyota World v. Comm'r, 752 F.2d 89 (4th Cir. 1985).

76. I.R.C. §7701(o)(5)(A), (B).

77. ASA Investerings Pship v. Comm'r, 201 F.3d 505 (D.C. Cir. 2000); Saba Pship v. Comm'r, T.C. Memo 2003-31; Boca Investerings Pship v. U.S., 314 F.3d 625 (D.C. Cir 2003).

solely to generate tax benefits may be disregarded as a sham.[78] A partnership exists for tax purposes if created to earn money through business activities and is not recognized if its sole aim and effect is to reduce taxes.[79] Tax considerations cannot be the only reason for forming a partnership—the venture must be operated with a profit motive.[80] The basic issue is whether the partners actually intended to carry on business and share the profits or losses.[81]

In determining whether a partnership exists for tax purposes, the Tax Court applies criteria set forth in its holding in *Luna v. Commissioner.*[82] In *Luna*, the court considered the following factors in determining whether a partnership existed among two or more parties:

- Their agreement and conduct in executing its terms;
- Their contributions to the venture;
- Their control over capital and income and rights to withdrawals;
- Their status as co-proprietors who share profits and losses, rather than agents or employees who receive compensation as a percentage of income;
- Their conduct of the business in joint names;
- Whether they filed partnership tax returns or informed the IRS or other persons that they were acting as a partnership or joint venture;
- Whether they maintained separate books of account for the venture; and
- Whether they had mutual control responsibilities for the venture.

Penalties. A key aspect of recent law are the penalties imposed on transactions that lack economic substance. Under amended I.R.C. Section 6662, a penalty of 20 percent is imposed on an underpayment of tax attributable to claimed tax benefits that are disallowed because a transaction lacked economic substance or failed to meet the requirements of a similar rule of law. The penalty is increased to 40 percent for an underpayment attributable to a transaction found to lack economic substance if the facts affecting the tax treatment of the transaction are not adequately disclosed in the return or in a statement attached to the return.

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78. *See* ACM Pshp v. Comm'r, 157 F.3d 231, 252 (3d Cir. 1998), *cert denied*, 526 U.S. 1017 (1999); Rovakat, LLC v. Comm'r, T.C. Memo. 2011-225.

79. Superior Trading, LLC v. Commr, 137 T.C. 70 (2011), *affd*, 728 F3d 676 (7th Cir 2013).

80. Southgate Master Fund, LLC v. U.S., 659 F.3d 466 (5th Cir. 2011) (purported partnership was sham where it served no function not assured by other means or that could be equally assured by less tax-beneficial means). ASA Investerings Pship v. Comm'r, 201 F.3d 505, 512 (D.C. Cir. 2000) (absence of a profit motive is fatal).

81. Comm'r v. Tower, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670 (1946); Comm'r v. Culbertson, 337 U.S. 733, 69 S. Ct. 1210, 93 L. Ed. 1659 (1949); TIFD III-E, Inc. v. U.S., 459 F.3d 220 (2d Cir. 2006). *See* Russian Recovery Fund, Ltd v. US, 851 F 3rd 1253 (Fed. Cir. 2017) (parties did not intend to form a bona fide partnership); New Millennium Trading, LLC v. Commr, TC Memo 2017-9 (partnership created exclusively for tax benefits not recognized for tax purposes).

82. 42 T.C. 1067 (1964). *See* Endeavor Partners Fund, LLC v. Commr, 943 F.3d 464 (D.C. Cir. 2019) (no partnership where transactions involving paired foreign currency options had no reasonable possibility of generating economic profit and lacked any other legitimate non-tax business purpose).

In determining the applicable penalty, amendments or supplements to an already-filed return are not taken into account if filed after the date the taxpayer is first contacted by the IRS regarding the examination of the return. In addition, the "reasonable cause" exception generally applicable to other penalties is not allowed for an understatement attributable to the lack of economic substance of a transaction.

§ 2.04 Publicly Traded Partnerships Taxed as Corporations

Before 1987, many entities were considered partnerships for tax purposes even though their interests were traded on securities markets in the same manner as corporate stock is traded. These ventures, often referred to as "master limited partnerships," were distinguished from associations taxable as corporations under the corporate resemblance test applied by the pre-1997 classification regulations.[83]

Congress determined that most publicly traded limited partnerships should be taxed as corporations without regard to the classification regulations. This action was deemed necessary to forestall the increasing use of these partnerships to avoid corporate-level taxation.[84]

I.R.C. Section 7704 was enacted in 1987 to ensure that a publicly traded partnership (PTP) is taxable as a corporation unless it comes under a specific exception in the statute, even though the entity would otherwise be classified as a partnership. I.R.C. Section 7704 applies to any domestic or foreign entity taxable as a partnership, including limited liability companies.[85]

A PTP subject to corporate taxation under I.R.C. Section 7704 is deemed to transfer all of its assets and liabilities to a newly formed corporation in exchange for stock which is then distributed to its partners in liquidation of the partnership.[86] These transactions are deemed to occur on the first day that the partnership is treated as a corporation under the statute.[87] The tax consequences of the constructive transfer and liquidation (including any recapture of tax benefits) are determined under the general tax rules of I.R.C. Sections 351, 731, and 732.[88] (For discussion of tax consequences of incorporating a partnership, *see* § 12.06, *infra.*)

I.R.C. Section 7704(c) provides a major exception for publicly traded partnerships that derive substantially all income from passive sources such as interest, dividends, and rent. Another major exception applies to certain PTPs that were in existence be-

83. Former Treas. Reg. § 301.7701-2. For discussion of the former regulations, *see* § 2.07, *infra.*

84. *See* H.R. Rep. No. 391, 100th Cong., 1st Sess. 1063 (1987). Earnings of a limited partnership are taxed only at the partner level while corporate earnings are taxed at the corporate level and again at the shareholder level when distributed as dividends.

85. Treas. Reg. § 1.7701-1 *et seq. See* Rev. Proc. 95-10, 1995-1 C.B. 501.

86. I.R.C. § 7704(f).

87. I.R.C. § 7704(f).

88. *See* H.R. Rep. No. 391, 100th Cong., 1st Sess. 1071 (1987).

fore December 17, 1987, the effective date of the statute.[89] However, partners in PTPs that are exempt from corporate taxation are subject to special limitations under the passive loss rules of I.R.C. Section 469.[90]

[A] Effective Date of Final Regulations

The rules described in the following sections are set forth in final regulations that generally are effective for tax years beginning in 1996 and thereafter.[91] Under a grandfather provision, a venture that was actively engaged in an activity before December 4, 1995 is not subject to these regulations until of the first tax year beginning in 2006, unless it adds a "substantial new line of business."[92] A grandfathered entity may rely on the earlier rules provided in Notice 88-75.[93] If the entity adds a substantial new line of business, however, the regulations apply to tax years beginning on or after the date new line is added.[94]

[B] Publicly Traded Partnership Defined

The publicly traded partnership (PTP) rules apply to any domestic or foreign entity that would be taxable as a partnership under the classification rules of I.R.C. 7701. (*See* § 2.02, *supra.*) This includes partnerships, limited liability companies and business trusts.[95] A venture is a PTP taxable as a corporation if its interests are publicly traded and no statutory exception applies. Interests in a partnership (or LLC) are publicly traded if they are (1) traded on an established securities market, or (2) readily tradable on a secondary market or on the substantial equivalent of a secondary market.[96]

[C] Publicly Traded Partnership with Qualifying Passive-Type Income Not Taxed as a Corporation

I.R.C. Section 7704(c) provides an important exception to the general rule that publicly traded partnerships (PTPs) are taxable as corporations.[97] Under the exception,

89. Revenue Act of 1987, Pub. L. No. 100-203, 100th Cong., 1st Sess., § 10211(c)(2)(A) (Dec. 22, 1987).

90. I.R.C. § 469(k).

91. Treas. Reg. § 1.7704-1(l).

92. As defined in Treas. Reg. §§ 1.7704-2(c), (d) (using 12/4/95 as the applicable date). Treas. Reg. § 1.7704-1(l)(3).

93. 1988-2 C.B. 386.

94. Treas. Reg. § 1.7704-1(l)(2).

95. Treas. Reg. § 1.7701-1 *et seq. See* Rev. Proc. 95-10, 1995-1 C.B. 501.

96. I.R.C. § 7704(b); Treas. Reg. § 1.7704-1(a).

97. The passive-type income exception is not available to a partnership that is registered under the Investment Company Act of 1940. I.R.C. § 7704(c)(3). This means that the exception does not apply to a partnership that would be a regulated investment company under I.R.C. § 851(a) if it was a domestic corporation. However, future regulations may permit this kind of a partnership to qualify for the passive-type income exception if one of its principal activities is buying and selling commodities,

a PTP is not treated as a corporation if 90 percent or more of its gross income is "qualifying" passive-type income.

The legislative history indicates that this exception was enacted to permit partnership status for ventures engaged in investment activities because the tax benefits their partners receive could also be obtained if the partners purchased the investments directly. In contrast, PTPs engaged in business activities are treated as corporations under I.R.C. Section 7704(a) because these ventures are normally conducted in corporate form and are subject to corporate-level taxation.

A PTP is exempt from corporate treatment if at least 90 percent of its gross income for the taxable year is "qualifying" as defined in I.R.C. Section 7704(d). The partnership must satisfy this gross-income test in the first tax year that it becomes a PTP and in every subsequent tax year.[98] For example, a partnership that first becomes a PTP in Year 1 cannot be exempt under the 90 percent test in Year 3 unless it satisfied the gross-income test in Years 1 and 2.

[D] Publicly Traded Foreign Partnerships

Temporary regulations have been issued to preclude the use of publicly traded foreign partnership to avoid application of the surrogate foreign corporation rules of I.R.C. Section 7874.[99] I.R.C. Section 7874 applies to "inversion" transactions in which a U.S. parent corporation of a multinational corporate group is replaced by a foreign entity. The section is intended to curtail transactions that utilize a minimal presence in the foreign country of incorporation to avoid U.S. tax.[100] In many cases, the new foreign entities conduct business in the same manner as before the inversion but the group that includes the inverted entity avoids U.S. tax on its foreign operations and may engage in various techniques to avoid U.S. tax on its U.S. operations.

Under I.R.C. Section 7874, a foreign corporation is treated as a surrogate foreign corporation if, pursuant to a plan or a series of related transactions, it acquires substantially all the properties of a domestic corporation or partnership and after the acquisition, at least 60 percent of the foreign corporation's stock is held by former shareholders of the domestic corporation. Income of a surrogate foreign corporation is subject to U.S. tax, in whole or part depending on the level of owner continuity.

The temporary regulations target transactions designed to avoid application of I.R.C. Section 7874 by using a foreign partnership with publicly traded interests, rather than a corporation, to acquire the properties of a domestic corporation or partnership. Certain publicly traded foreign partnership can utilize the same U.S. tax avoidance opportunities as a foreign corporation by avoiding classification as a cor-

options, futures or forward contracts with respect to commodities. *See* H.R. Rep. No. 495, 100th Cong., 1st Sess. 946 (1987).

98. I.R.C. § 7704(c)(1).

99. Temp. Treas. Reg. § 1.7874-2T, T.D. 9265 (June 6, 2006).

100. *See* H.R. Conf. Rep. No. 108-755, 108th Cong., 2d Sess., at 568 (Oct. 7, 2004); S. Rep. No. 108-192, 108th Cong., 1st Sess., at 142 (Nov. 7, 2003).

poration for U.S. tax purposes under the exception for partnerships that derive 90 percent or more of their gross income from passive income such as dividends.[101] The temporary regulations ensure that I.R.C. Section 7874 is not avoided in this manner by providing that a publicly traded foreign partnership not classified as a corporation under I.R.C. section 7704 will be treated as a foreign corporation for purposes of applying I.R.C. Section 7874 to determine if the acquiring foreign entity is a surrogate foreign corporation.

The regulations define a publicly traded foreign partnership as any foreign partnership that would, but for the application of I.R.C. Section 7704(c), be classified as a corporation at any time during the two-year period following the partnership's completion of an acquisition. In that case, the foreign partnership will be considered a foreign corporation in determining whether it is a surrogate foreign corporation, applying the ownership percentage tests of I.R.C. Section 7874. These rules apply to foreign entities considered partnerships under both foreign and U.S. law and foreign entities that are considered corporate entities under foreign law but treated as partnerships for U.S. tax purposes.[102]

§ 2.05 The Anti-Abuse Regulations

The "anti-abuse" regulations under I.R.C. Section 701 are intended to prevent taxpayers from using the partnership tax rules of Subchapter K for tax avoidance purposes.[103]

These regulations grant the Commissioner of Internal Revenue broad authority to disregard or recast transactions engaged in by an entity taxable under Subchapter K. In effect, the Commissioner is authorized to modify the operation and interpretation of any Code section or regulation relevant to a partnership transaction to prevent tax avoidance. Although the regulations assert that the anti-abuse rule will affect a relatively small number of partnership transactions,[104] the actual scope and impact of these rules is yet to be determined.

The anti-abuse rule consists of two parts, summarized below.

Intent of Subchapter K rule. The Commissioner may recast a transaction that reduces partners' aggregate tax liability in a manner that is "inconsistent with the intent of Subchapter K." The regulations describe the legislative intent for the partnership tax rules and set forth tests a partnership transaction must satisfy to be consistent with this intent. If the transaction is inconsistent, the Commissioner may disregard the partnership, disregard a taxpayer's status as a partner, adjust the partnership's

101. I.R.C. § 7704(c).

102. Temp. Treas. Reg. § 1.7874-2T(e).

103. Treas. Reg. § 1.701-2. Generally, the regulations are effective for transactions on or after May 12, 1994. The abuse of entity rule in Treas. Reg. § 1.701-2(e) is effective for transactions on or after January 3, 1995. Treas. Reg. § 1.701-2(g). The regulations apply only to income taxes under subtitle A of the Internal Revenue Code. Treas. Reg. § 1.701-2(h).

104. Treas. Reg. § 1.701-2 (preamble).

or partner's accounting method, reallocate partnership income or loss, or otherwise change the claimed tax treatment.

Abuse of entity rule. The Commissioner may treat a partnership as an aggregate of its partners, rather than as a separate entity, to the extent needed to carry out the purpose of any provision of the Code or regulations. This treatment may apply regardless of the taxpayer's intent in structuring the transaction. The Commissioner may not apply this rule, however, if a provision of the Code or regulations prescribes entity treatment and contemplates the ultimate tax results.

The anti-abuse regulations do not provide clear, unambiguous standards for determining when and how they will apply to a partnership transaction. Application of the regulations often requires a subjective analysis of the taxpayer's purpose or intent for forming a partnership or engaging in a particular transaction. Taxpayers and Service personnel also must make subjective determinations about whether the drafters of a statute or regulation clearly contemplated its application to a partnership and the ultimate tax consequences. The uncertainties created by these regulations are likely to continue until standards are developed through case law and administrative rulings (or the regulations are determined to be invalid).

[A] Transactions Inconsistent with Intent of Subchapter K

According to the regulations, "Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax."[105] To be consistent with this intent, the following three requirements must be satisfied:

(1) The partnership must be bona fide and each of its transactions must have a substantial business purpose.

(2) The form of each partnership transaction must conform with its substance.

(3) Each partner's tax consequences from partnership operations and from transactions with the partnership must accurately reflect the economic agreement among the partners and clearly reflect each partner's income (i.e., there must be a "proper reflection of income"). Income is deemed properly reflected if the application of a tax provision to a transaction and the ultimate tax results were clearly contemplated when the provision was enacted. Whether these factors were clearly contemplated in connection with a particular transaction is determined from all the facts and circumstances.

The premise of the regulations is that tax provisions are intended to reflect the true economic arrangement between parties unless Congress or the Treasury wished to effectuate some other policy. If the tax provision in question has a policy objective,

105. Treas. Reg. § 1.701-2(a).

the regulations do not require proper reflection of income if that outcome was "clearly contemplated" by the provision. The regulations provide little guidance as to how taxpayers must determine whether a tax provision "clearly contemplated" a particular outcome. Presumably, the determination is made by analyzing each provision's legislative history.

The regulations authorize the Commissioner to recast a partnership transaction for tax purposes if:

(1) the partnership was formed or availed of for a transaction having a principal purpose[106] to substantially reduce the present value of the partners' aggregate tax liability; and

(2) the transaction attains the tax reduction in a manner that is inconsistent with the intent of Subchapter K.[107]

A transaction may be recharacterized to obtain tax results that are consistent with the intent of Subchapter K, even though the transaction falls within the literal words of a statute or regulation. To obtain the appropriate tax results, the Commissioner may:[108]

(1) disregard the partnership, in whole or in part, and consider the partnership's assets and activities to be owned and conducted by one or more of its partners;

(2) disregard one or more person's tax status as a partner;

(3) adjust the partnership's or any partner's method of accounting to reflect clearly the partnership's or the partner's income;

(4) reallocate the partnership's items of income, gain, loss, deduction, or credit among the partners; or

(5) otherwise adjust or modify the claimed tax treatment.

[B] Facts and Circumstances Analysis

Whether a transaction violates the anti-abuse rule is determined from all of the facts and circumstances.[109] The most important analysis appears to involve a comparison of the purported business purpose for a transaction with the claimed tax benefits. The regulations list seven factors that are "illustrative" of when the anti-abuse rule may apply:[110]

106. The regulations apply if tax avoidance is one principal purpose even though other business purposes are more important to the transaction.

107. Treas. Reg. § 1.701-2(b).

108. *Id.*

109. Treas. Reg. § 1.701-2(c).

110. The regulations warn that these factors "may be indicative, but do not necessarily establish," that a partnership violated the anti-abuse rule. These are not the only factors taken into account and

(1) The present value of the partners' aggregate federal tax liability is substantially less than it would be if the partners directly owned partnership assets and conducted partnership activities.

(2) The present value of the partners' aggregate tax liability is substantially less than it would be if separate transactions designed to achieve a particular result are treated as steps in a single transaction.

(3) A partner who obtains the claimed tax results has a nominal interest in the partnership, bears no meaningful risk of loss, or has little participation in partnership profits other than a preferred return for the use of his capital.

(4) Substantially all of the partners are directly or indirectly related to one another.

(5) Partnership allocations literally comply with the regulations under I.R.C. Section 704(b) but the results are inconsistent with the rules' purpose. This is particularly important if income or gain is specially allocated to a partner that is effectively exempt from taxation (e.g., a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused carryovers for net operating losses, capital losses, or foreign tax credits).

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are substantially retained by the contributor or a related party.

(7) The benefits and burdens of ownership of partnership property are substantially shifted to a distributee.

[C] The Abuse of Entity Rule

Under the abuse-of-entity rule, the Commissioner may treat a partnership as an aggregate of its partners, rather than as a separate entity, as appropriate to carry out the purpose of any provision of the Code or regulations.[111] This authority does not exist if the Code or regulation specifically prescribes treating the partnership as an entity and clearly contemplated the ultimate tax results.[112]

It is unclear how to determine whether a statute or regulation outside of Subchapter K "clearly contemplated" its application to a partnership or the ultimate tax results. Presumably, the rules of Subchapter K are specifically designed to provide either entity or aggregate treatment in the partnership context and their intended application and tax results always are contemplated. Provisions outside of Subchapter K, however, are generally not drafted with partnerships in mind and their application and tax results in the partnership context are rarely contemplated.

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the weight given to any factor depends on all the facts and circumstances. The presence or absence of any does not create any presumption. Treas. Reg. § 1.701-2(c).

111. Treas. Reg. § 1.701-2(e).

112. Treas. Reg. § 1.701-2(e)(2).

§ 2.06 Electing to Be Excluded from Partnership Tax Rules

[A] Overview

In limited situations, I.R.C. Section 761(a) permits a venture classifiable as a partnership (e.g., a partnership or limited liability company) to elect to be excluded from all or some of the Subchapter K's partnership taxation provisions.[113] The election is restricted to organizations that are used for one of the following purposes:

(1) for investment purposes only and not for the active conduct of a business;

(2) for the joint production, extraction, or use of property, but not for selling services or property produced or extracted; or

(3) by securities dealers for a short period to underwrite, sell, or distribute a particular issue of securities.[114]

All members of the organization must agree to the election,[115] and it must be possible to adequately determine the members' incomes without first computing partnership taxable income.[116] No election is permitted by an entity that would be treated as a corporation for tax purposes under the classification regulations.[117]

A venture may wish to be excluded from the partnership tax rules for the following purposes:

- to avoid the restrictive rules governing the taxable years of a partnership and its partners[118] (*see* Chapter 3);
- to allow each investor to make certain elections separately rather than have elections at the partnership level bind all partners.[119] These elections include accounting methods (*see* Chapters 3, 8),[120] depreciation and cost-recovery methods (*see* Chapters 3, 8),[121] installment reporting (*see* Chapter 7),[122] and nonrecognition of gain on an involuntary conversion (*see* Chapters 8, 12);[123]

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113. I.R.C. § 761(a).

114. *Id.*

115. Treas. Reg. § 1.761-2(b)(2)(i).

116. Treas. Reg. § 1.761-2(a)(1).

117. *Id.*

118. *See* I.R.C. § 706(b).

119. *See* I.R.C. § 703(b); Treas. Reg. § 1.703-1(b)(1). Generally, elections required to be made by the partnership under Treas. Reg. § 1.703-1(b)(1) are made by the individual partners if an election is made. *See* Rev. Rul. 83-129, 1983-2 C.B. 105. *Cf.* Rev. Rul. 81-261, 1981-2 C.B. 60.

120. I.R.C. § 446.

121. I.R.C. §§ 167, 168.

122. I.R.C. § 453.

123. I.R.C. §§ 1031, 1033.

- to allow for a nontaxable like-kind exchange of property. Although the like-kind exchange rules of I.R.C. Section 1031 do not apply to exchanges of partnership interests, this limitation does not apply to an interest in a partnership that makes an election under I.R.C. Section 761(a); an interest in an electing partnership is treated as an interest in each of the partnership's assets and not as an interest in the partnership;[124]
- to provide certainty regarding the tax treatment of a venture where uncertainty exists as to whether it is a partnership for tax purposes. For example, a group of investors may wish to file an election if it is unclear whether their arrangement is a co-ownership or investment partnership; and
- to avoid the complexity and expense involved in maintaining partnership records and preparing and filing partnership tax returns.

[B] Entities Eligible for the Election

A partnership may not elect to be excluded from the partnership tax rules of Subchapter K, unless it is:

(1) an investment partnership;

(2) a partnership for the production, extraction, or use of property; or

(3) a partnership that is an organization of securities dealers.

124. I.R.C. § 1031(a), as amended by the Revenue Reconciliation Act of 1990.

NOTE

Under I.R.C. Section 761(f),[125] a qualified joint venture is not treated as a partnership for tax purposes if it is conducted by a husband and wife who file a joint return for the tax year. Under this provision, all items of income, gain, loss, deduction, and credit are divided between the spouses according to their interests in the venture and each spouse takes into account his or her share of these items as if they were attributable to a trade or business conducted by the spouse as a sole proprietor. Each spouse reports his or her share on the appropriate tax form (e.g., a Schedule C).

A qualified joint venture is a joint venture involving the conduct of a trade or business if:

- the only members of the joint venture are a husband and wife, both spouses materially participate[126] in the trade or business, and
- both spouses elect to apply this treatment. If the election is made, each spouse's share of income or loss from the qualified joint venture is taken into account under the above rules in determining the spouse's net earnings from self-employment and social security benefits.[127]

[1] Investment Partnerships

Partnerships used for investment purposes only and not for the active conduct of a business may elect to be excluded from the partnership tax rules. The participants must jointly purchase, retain, sell, or exchange investment property, and they must:[128]

(1) own the investment property as co-owners;

(2) reserve the right separately to take or dispose of their shares of any acquired or retained property; and

(3) not actively conduct a business or irrevocably authorize a representative to purchase, sell, or exchange the investment property; however, each participant can authorize a representative to deal with his share of the investment property for his account, but this authority cannot continue for more than one year.[129]

In many situations, this kind of venture would be considered a co-ownership rather than a partnership. If uncertainty about the venture's tax status exists, an election may be advisable.

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125. As amended by the Small Business and Work Opportunity Act of 2007 (Pub. L. No. 110-28) § 8215(a).

126. Under the passive loss rules of I.R.C. § 469(h), without regard to the rule considering participation by one spouse as participation by the other.

127. I.R.C. § 1402(a)(17).

128. Treas. Reg. § 1.761-2(a)(2).

129. Treas. Reg. § 1.761-2(a)(2)(iii).

[2] Partnerships for Production, Extraction, or Use of Property

An election is permitted by partnerships used for the joint production, extraction, or use of property, but not for selling services or property produced or extracted.[130] The participants in the joint production, extraction, or use of property must:

(1) own the property as co-owners either in fee or under lease or other form of contract granting exclusive operating rights;

(2) separately reserve the right to take in kind or dispose of their shares of any property produced, extracted, or used;[131] and

(3) not jointly sell services or the property produced or extracted.

Each participant may delegate authority to sell his share of the property for his account, but not for a period in excess of the minimum needs of the industry, and in no event for more than one year.[132] An organization that cycles, manufactures, or processes materials for persons who are not members of the organization may not elect to be excluded from partnership treatment.[133]

Special requirements apply to co-producers of natural gas subject to a joint operating agreement.[134] To make or maintain an election under I.R.C. Section 761, the co-producers must use one of two permissible methods described in the regulations in reporting income from gas sales and certain related deductions and credits.

[3] Organizations of Securities Dealers

An organization of securities dealers can elect exclusion from partnership treatment if it is established (1) for a short period of time, and (2) to underwrite sell, or distribute a particular issue of securities.[135] This provision was added to protect syndicates of securities dealers that were formed to underwrite the sale or distribution of a single issue from the I.R.C. Section 6698 penalty for not filing a partnership return.

[C] Effect of Election

A partnership that makes an election under I.R.C. Section 761(a) is exempt from the specific tax rules in Subchapter K. Thus, partnership income or loss need not be computed, and no partnership tax returns must be filed.

An election may have adverse tax consequences if it results in a deemed dissolution of an existing partnership. This may occur if the election is made for a venture that

130. I.R.C. §761(a)(2); Treas. Reg. §1.761-2(a)(3).

131. *See* Ltr. Rul. 8226014 (joint venture not eligible for election where only some participants had right to take share of production in kind and one participant had right of first refusal on organization's production).

132. Treas. Reg. §1.761-2(a)(3)(iii).

133. Treas. Reg. §1.761-2(a)(3).

134. Treas. Reg. §1.761-2(d).

135. I.R.C. §761(a)(3).

was taxable as a partnership in prior years. The dissolution may cause the partners to recognize gain under I.R.C. Section 731 if the amount of cash the partnership is deemed to distribute to them upon the dissolution exceeds the bases of their partnership interests. (*See* Chapter 8.) An election should be made for an existing partnership only after it is determined that the deemed cash distribution will not exceed any partner's basis.

An election is not considered a disposition or distribution of partnership property that triggers gain or loss under I.R.C. Section 704(c) to a partner who contributed property to the partnership in a pre-election year.[136] As discussed in Chapter 4, I.R.C. Section 704(c) requires that a partner recognize the gain or loss built into contributed property if the partnership (1) disposes of the property, or (2) distributes it to another partner within seven years of the contribution date.

Although an electing partnership is exempt from Subchapter K, it is treated as a partnership under all Code sections outside Subchapter K.[137] For example, the Service ruled that an electing joint venture was a partnership for purposes of limiting the investment tax credits that its partners were allowed.[138] The Tax Court took the same position in Bryant v. Commissioner,[139] holding that the I.R.C. Section 761(a) election is restricted by its own terms to Subchapter K and that it does not otherwise affect the treatment of an organization.

The Service has indicated that, in some cases, an I.R.C. Section 761(a) election may exempt a partnership from Code sections outside Subchapter K. Revenue Ruling 83-129 holds that partners of an electing partnership can make inconsistent elections, rather than a single election as a partnership, for mining development expenditures.[140]

The Service attempted to explain its position in this ruling by stating that it will determine the effect of an election in each case by ascertaining if a non-Subchapter K rule can apply "without doing violence to the concept of electing out of Subchapter K."[141] Apparently, the Service will treat each partner in an electing partnership as the

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136. H.R. Rep. No. 795, 100th Cong., 2d Sess. 1358 (1988); H.R. Rep. 101-247, 101st Cong., 1st Sess. 1358.

137. Bryant v. Comm'r, 46 T.C. 848 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968); Rev. Rul. 65-118, 1965-1 C.B. 30.

138. Rev. Rul. 65-118, 1965-1 C.B. 30. *See* Rev. Rul. 82-213, 1982-2 C.B. 31 (investment credit property owned by electing partnership used by partnership not partners); Rev. Rul. 80-219, 1980-2 C.B. 19 (investment credit recaptured). *But see* Madison Gas & Electric Co. v. Comm'r, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980), in which the Tax Court suggested that it based its holding in Bryant upon specific partnership limitations in the investment credit provisions, and that a different result may be reached when no specific reference to partnerships exists in the statute or regulations.

139. 46 T.C. 848 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968). *See* Cokes v. Comm'r, 91 T.C. 222 (1988) (individuals subject to self-employment tax as partners remain so if partnership elects out of Subchapter K).

140. 1983-2 C.B. 105. *But see* Madison Gas & Electric Co. v. Comm'r, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980), where the Service argued that an election does not preclude partnership treatment in determining whether a taxpayer may deduct a trade or business expense that would require capitalization at the partnership level.

141. GCM 39043.

direct owner of a proportionate share of partnership assets rather than as the owner of a separate partnership interest.[142]

[D] Procedure for Making the Election

The election to be completely excluded from the partnership tax provisions of Subchapter K is made by filing a properly executed partnership tax return (Form 1065) containing only the names, addresses, and taxpayer identification numbers of the organization and all its members and the following attached or incorporated statements:

(1) The organization qualifies for exemption as an investing partnership, operating partnership, or organization of securities dealers.

(2) All of its members elect to have the organization excluded from partnership treatment.

(3) If a copy of the organization's operating agreement is obtainable or, if the agreement is oral, the person from whom the provisions of the agreement can be obtained.[143]

The Service assumes that an election to be excluded from the partnership tax provisions is consented to by all members of an organization unless a member notifies the Service in writing that (1) he does not consent to the exclusion, and (2) he sent the same notification to all other members of the organization by registered or certified mail. This notice must be filed within 90 days after the organization is formed. Because a valid election requires the consent of all members, one member's properly filed objection precludes exclusion from partnership tax treatment.

[E] Election by Showing Intent

An organization that qualifies for, but fails to make, an effective election for complete exclusion from Subchapter K is deemed to have made an election if the facts and circumstances show that its members intended, at the time of its formation, to secure exclusion beginning with the organization's first taxable year.[144] Either of the following factors may demonstrate the necessary intent:

(1) at the time the organization was formed, the members agreed that it be excluded from partnership treatment; or

(2) beginning with the organization's first taxable year, the members owning substantially all of its capital interests report their shares of its income and other

142. The scope of this ruling is suggested by TAM 9214011, in which the Service treats the sale of an interest in a partnership that elected under I.R.C. § 761(a) as a sale of the partner's proportionate interest in each partnership asset.

143. Treas. Reg. § 1.761-2(b)(2)(i).

144. Treas. Reg. § 1.761-2(b)(2)(ii).

tax items on their returns in a manner consistent with the organization's exclusion from partnership treatment.[145]

[F] Election for Partial Exclusion

An organization may request to be excluded from only certain sections of the partnership tax provisions if (1) it qualifies for complete exclusion from these rules, and (2) all of its members consent to the requested exclusion.[146] The exclusion is not effective until approved by the Service, and it is subject to any conditions the Service imposes.[147] The Service will not approve an organization's election to be excluded from the rules governing the required partnership taxable year[148] or to the rule limiting a partner's loss deduction to the basis in his partnership interest.[149]

A request for partial exclusion must be made no later than 90 days after the beginning of the taxable year for which the partial exclusion is to begin. The request must:

(1) state that all of the organization's members consent to the election;

(2) state that the organization qualifies for complete exclusion from partnership treatment; and

(3) specify the partnership provisions from which exclusion is sought.[150]

[G] Effective Date and Revocation

An election for complete exclusion is effective beginning with the taxable year for which the election is filed.[151] For example, if an organization would otherwise be required to file a partnership tax return for the calendar year 1990 by April 15, 1991, an election filed on or before that date is effective for the 1990 taxable year. A deemed election for complete exclusion is effective with the organization's first taxable year.[152] An election for partial exclusion is effective only when approved by the Service.[153]

An election continues in effect until the organization no longer qualifies for the exclusion or until the election is revoked.[154] An election cannot be revoked without the Service's consent.[155] An application for permission to revoke is made to the Commissioner no later than 30 days following the beginning of the taxable year to which the revocation is to apply.[156]

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145. Treas. Reg. § 1.761-2(b)(2)(ii)(a), (b).
146. Treas. Reg. § 1.761-2(c).
147. *Id.*
148. Rev. Rul. 57-215, 1957-1 C.B. 208. *See* I.R.C. § 706(b).
149. Rev. Rul. 58-465, 1958-2 C.B. 376. *See* I.R.C. § 704(b).
150. Treas. Reg. § 1.761-2(c).
151. *See* Treas. Reg. § 1.761-2(b)(2)(i), (3).
152. *See* Treas. Reg. § 1.761-2(b)(2)(ii), (3).
153. *See* Treas. Reg. § 1.761-2(c).
154. Treas. Reg. § 1.761-2(b)(3).
155. *Id.*
156. *Id.*

Chapter 10

Liquidating Payments to a Retiring Partner/Member or a Decedent's Successor

§ 10.01 Overview of Liquidating Payments — I.R.C. Section 736

I.R.C. Section 736 provides rules for classifying payments a partnership or LLC makes to liquidate the interest of a retiring or deceased partner or member.[1] Congress enacted these rules in 1954 to ensure proper characterization of the portion of the payments attributable to the partner's share of partnership capital assets and the portion attributable to partnership ordinary income.[2]

Under I.R.C. Section 736, each liquidating payment is divided into two classes: (1) the portion that is a distribution for the partner's share of partnership property, and (2) the remaining amount of the payment. The statute only classifies the payments — it does not provide rules for determining the tax consequences of each class. Once the amount of the payment in each category is computed, the tax consequences are determined under the appropriate Code sections. The distribution portion is taxable under the rules governing liquidating distributions.[3] The treatment of the remaining portion depends on how the parties determine the amount the partner will receive: if the amount is computed as a percentage of partnership income, the payment is included in the partner's distributive share of partnership income;[4] if the amount is fixed, the payment is treated as a guaranteed payment.[5] (*See* Chapter 7.)

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1. *See generally*, Yuhas and Harris, *The Retiring LLC Member: Sale Versus Liquidation*, 124 J. TAXATION 23 (January 2016).

2. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. 71 (1954). Case law prior to the enactment of I.R.C. §736 in 1954 ordinarily did not divide liquidating payments into distribution and current income components. Instead, the courts tended to treat the payments as entirely distributions (*see, e.g.*, Brown v. Comm'r, 1 T.C. 760 (1943), *aff'd*, 141 F.2d 307 (2d Cir. 1944)) or as entirely income payments (*see, e.g.*, Coates v. Comm'r, 7 T.C. 125 (1946)).

3. I.R.C. §§731, 732, 733, 751(b).

4. I.R.C. §702.

5. I.R.C. §707(c).

I.R.C. Section 736 pertains only to payments made by a continuing partnership to a withdrawing partner.[6] Thus, I.R.C. Section 736 does not apply to distributions related to a partnership's complete liquidation, distributions that partially liquidate a partner's interest, or payments a partner receives when he sells his interest to other partners or third parties.[7]

[A] Payments Governed by I.R.C. Section 736

The I.R.C. Section 736 classification rules apply only to payments a continuing partnership makes to liquidate the entire partnership interest of a retiring partner or a deceased partner's successor. Thus, four conditions must exist:

(1) the partnership must continue to exist;

(2) the payment must be from the partnership and not from another partner or a third party;

(3) the payment must be made to a person who is completely withdrawing from the partnership; and

(4) the payments must be made to liquidate that partner's entire interest.

The following rules and definitions pertain to determining the applicability of I.R.C. Section 736:

(1) A partner is deemed to retire when he ceases to be a partner under local law.[8] The retirement may result from a voluntary withdrawal or an expulsion from the partnership.[9]

(2) A partner's interest is liquidated when it is terminated by a distribution or series of distributions by the partnership.[10] The distribution may be in the form of an actual payment, or it may be a constructive distribution (under I.R.C. Section 752(b)) resulting from a reduction in the withdrawing partner's share of partnership liabilities.[11] (*See* Chapter 8.)

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6. Treas. Reg. § 1.736-1(a)(2) refers to a retiring partner or the successor in interest to a deceased partner as the "withdrawing partner."

7. Treas. Reg. § 1.736-1(a)(1)(i).

8. Treas. Reg. § 1.736-1(a)(1)(ii).

9. Estate of Quirk v. Comm'r, 928 F.2d 751 (6th Cir. 1991), *aff'g and remanding on other issues* T.C. Memo. 1988-286 (partner ceases being partner under local law when he stops sharing in ongoing partnership business even if he institutes lawsuit against partnership relating to value of his interest); Holman v. Comm'r, 66 T.C. 809 (1976), *aff'd*, 564 F.2d 283 (9th Cir. 1977) (same); Milliken v. Comm'r, 72 T.C. 256 (1979), *aff'd in unpublished opinion* (1st Cir. 1979) (partner ceases being partner when he is expelled). Although a deceased partner's successor is not considered a partner under local law, he is treated as a partner for tax purposes. Treas. Reg. § 1.736-1(a)(1)(ii).

10. Treas. Reg. §§ 1.736-1(a)(1)(ii), 1.761-1(d).

11. Treas. Reg. § 1.736-1(a)(1)(ii). *See* Pietz v. Comm'r, 59 T.C. 207 (1972); Stilwell v. Comm'r, 46 T.C. 247 (1966).

(3) A withdrawing partner who receives a series of liquidating payments continues to be treated as a partner until he receives the final payment.[12]

The classification rules of I.R.C. Section 736 apply to each payment in a series of liquidating payments.[13]

(4) Although a two-person partnership terminates under local law when one partner retires or dies, the partnership continues for tax purposes until the withdrawing partner's interest is entirely liquidated by a distribution or series of distributions.[14] (See discussion of partnership terminations in Chapter 13.) Thus, I.R.C. Section 736 applies to payments a withdrawing partner receives from a two-person partnership until his interest is completely liquidated.

(5) I.R.C. Section 736 does not apply to payments made in connection with a partial liquidation of a partner's interest. These payments are taxable under the rules governing current distributions.

(6) I.R.C. Section 736 applies only to payments made by a partnership and not to payments partners make to each other.[15] Thus, the statute does not apply when a withdrawing partner sells his interest to the continuing partners, even though the transaction is economically equivalent to a liquidation.

[B] Classification of Liquidating Payments

Under I.R.C. Section 736, each liquidating payment is divided into the following two categories:

(1) The portion of the payment that is attributable to the partner's share of partnership property—which is treated as a distribution. This amount, called the I.R.C. Section 736(b) payment, is taxable under the rules governing liquidating distributions (I.R.C. Sections 731 through 735). The following items are excluded from the I.R.C. Section 736(b) payment if the retiring partner is a general partner and capital is not a material income producing factor in the partnership (e.g., it is a services partnership)—

(a) Amounts a withdrawing partner receives in exchange for his share of partnership unrealized receivables. For this purpose, unrealized receivables are limited to cash method accounts receivable for goods and services and do not include recapture items.[16]

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12. *See* Fuchs v. Comm'r, 80 T.C. 506 (1983). *See also* Findley v. Comm'r, T.C. Memo. 1991-339 (retired partners who assigned partnership interest to wholly owned corporation are taxable on liquidating payments under assignment of income doctrine). The partnership's tax year does not close for a withdrawing partner until his interest is fully liquidated by the partnership. I.R.C. § 706(c).

13. Treas. Reg. § 1.736-1(b)(5).

14. Treas. Reg. § 1.736-1(a)(6).

15. Treas. Reg. § 1.736-1(a)(1).

16. I.R.C. § 751(c).

(b) Amounts a withdrawing partner receives for his share of partnership goodwill unless the partnership agreement specifically provides for goodwill payments.

(2) The remaining portion of the payment—which is included in the partner's distributive share or is treated as a guaranteed payment. (*See* Chapter 7.) This portion consists of all amounts that are not considered to be for the partner's share of partnership property and includes amounts paid for partnership unrealized receivables and goodwill that are excluded from the I.R.C. Section 736(b) payment. This amount, called the I.R.C. Section 736(a) payment, is taxable in one of two ways—

(a) To the extent that the amount the partner receives is determined by reference to the partnership's income (i.e., as a percentage of its income), the payment is treated as the partner's distributive share of partnership income (under I.R.C. Section 702).

(b) To the extent that the amount the partner receives is not determined by reference to partnership income (i.e., it is a fixed amount), the payment is treated as a guaranteed payment—subject to I.R.C. Section 707(c).

[C] Payments for Partner's/Member's Interest in Partnership/LLC Property—I.R.C. Section 736(b) Payments

The tax consequences of the portion of a liquidating payment classified as an I.R.C. Section 736(b) payment (i.e., the payment for the partner's share of partnership property) are determined in two steps:

(1) the amount of the I.R.C. Section 736(b) payment is determined by establishing the value of the partner's share of partnership property; and

(2) that amount is treated as a distribution to the partner that is taxable under the rules governing liquidating distributions.

[1] Valuing Partner's/Member's Share of Partnership/LLC Property

The regulations state that the value the partners place on a withdrawing partner's share of property is generally deemed correct if it is the result of an arm's-length agreement.[17] Presumably, this means that the partners' valuation should be accepted unless the parties do not have adverse interests because of their relationship to each other (e.g., father and son), or because of their individual tax situations.[18] The partners

17. Treas. Reg. § 1.736-1(b)(1).

18. A partner must determine the value of his interest when he withdraws from the partnership even if he institutes a lawsuit against the partnership relating to the value of his interest. Estate of Quirk v. Comm'r, 928 F.2d 751 (6th Cir. 1991), *aff'g and remanding on other issues* T.C. Memo. 1988-286; Holman v. Comm'r, 66 T.C. 809 (1976), *aff'd*, 564 F.2d 283 (9th Cir. 1977) (same).

must determine the gross value, rather than net value, of the withdrawing partner's share of partnership property (i.e., the value undiminished by the partner's share of partnership liabilities).[19] This valuation is necessary because the withdrawing partner is deemed to receive a cash distribution equal to the decrease in his share of partnership liabilities resulting from the liquidation. Therefore, if the partners determine the net value of the partner's share of property (i.e., gross value less liabilities), the value must be adjusted to take into account the retiring partner's share of partnership liabilities.

[2] Limited Exclusion for Unrealized Receivables and Goodwill

Generally, the amount paid for a partner's share of any partnership asset is an I.R.C. Section 736(b) payment, including payments for the partner's share of unrealized receivables and goodwill. A limited exception applies to payments for certain partnership unrealized receivables and goodwill if:

(1) the withdrawing partner is a general partner; and

(2) capital is not a material income producing factor in the partnership (e.g., it is a services partnership).[20] Whether capital is a material income producing factor is determined under principals derived from other Code sections that use that term.[21] Generally, capital is not a material factor if substantially all business income is attributable to personal services provided by individuals (e.g., professional and other services partnerships).[22]

If these tests are met, payments for the partner's share of the following items are excluded from the I.R.C. Section 736(b) payment (and included under I.R.C. Section 736(a)):

(1) ***Unrealized receivables.*** For purposes of the exclusion, unrealized receivables include accounts receivable and other rights to receive payments for services rendered or to be rendered, or for non-capital assets delivered or to be delivered, that have not yet been included in income under the partnership's method of accounting.[23] An item is an unrealized receivable only to the extent that its value exceeds its basis in the partnership.[24] Thus, amounts a partner receives for his share of unrealized receivables are I.R.C. Section 736(b) payments up to that partner's share of the basis of the receivables; the rest of the payment is taxable under I.R.C. Section 736(a). The partnership's basis for its unrealized receivables includes any basis adjustments previously made to the withdrawing

19. Treas. Reg. § 1.736-1(b)(1).

20. I.R.C. § 736(b)(2), (3). Before 1993, the exclusions for unrealized receivables and goodwill applied to any partner of any partnership.

21. *See* I.R.C. §§ 401(c)(2), 911(d); former I.R.C. § 1348(b).

22. H.R. Rep. No. 213, 103rd Cong., 1st Sess. 241 (1993).

23. Defined in I.R.C. § 751(c).

24. Treas. Reg. § 1.736-1(b)(2).

partner's interest in partnership property under I.R.C. Section 743(b) (i.e., adjustments made when a partnership interest is sold, exchanged, or transferred at a partner's death).[25] (For discussion of basis-adjustment elections, *see* Chapters 5 and 8.) Basis also includes any costs or expenses attributable to generating the receivables that have not been taken into account under the partnership's accounting method (e.g., unpaid expenses of a cash-method partnership).[26]

Because the payment for the withdrawing partner's share of unrealized receivables under I.R.C. Section 736(a) is a fixed amount, it is treated as a guaranteed payment and taxed as ordinary income. If the payment is not excluded from I.R.C. Section 736(b) (i.e., the partner is a limited partner or capital is a material income producing factor), amounts received for the unrealized receivables also will be taxed as ordinary income under the distribution rules of I.R.C. Section 751. Accordingly, the exclusion of unrealized receivables from I.R.C. Section 736(b) does not provide any tax benefits.

(2) ***Goodwill.*** Payments to a withdrawing general partner in a services partnership are excluded from the I.R.C. Section 736(b) payment only if the partnership agreement does not specifically provide that the partner is to be paid for his share of goodwill. In that case, the partner's I.R.C. Section 736(b) payment includes only his share of any basis the partnership has in the goodwill (including any basis adjustments previously made for that partner under I.R.C. Section 743(b)).[27] If the partnership agreement does not contain such a provision, amounts the partner receives for his share of partnership goodwill are treated as I.R.C. Section 736(b) payments (i.e., as payments for partnership property).

Partners of a services partnership have some flexibility in determining the tax treatment of liquidating payments for a withdrawing partner's share of partnership goodwill. The partners may decide among themselves whether the payment will be an I.R.C. Section 736(b) distribution for the partner's share of partnership property or a distributive share or guaranteed payment under I.R.C. Section 736(a). If the amount is computed by reference to partnership income, the payment is treated as a distributive share. If the amount is fixed, the payment is treated as a guaranteed payment.

Treating the goodwill payment as a distribution generally results in a capital gain for the withdrawing partner and, therefore, no deduction for the partnership. In contrast, treating a fixed payment for goodwill as a guaranteed payment results in ordinary income to the withdrawing partner with a corresponding deduction for the partnership.

25. Treas. Reg. § 1.736-1(b)(2) refers to special basis adjustments to which the distributee is entitled. Because basis adjustments under I.R.C. § 734(b) apply to all partners, these adjustments are not taken into account.

26. Treas. Reg. §§ 1.736-1(b)(2), 1.751-1(c)(2).

27. Treas. Reg. § 1.736-1(b)(3). Ordinarily, a partnership has no basis in its goodwill. The goodwill can have basis, however, if the partnership acquired a business with pre-existing goodwill or if a basis increase previously occurred pursuant to an election under I.R.C. § 754.

Example: Tom receives an $80,000 cash payment to liquidate his one-third interest in the STV Legal Partnership. When the payment is made, the partners agree, after arm's-length negotiations, that the following balance sheet reflects the value of partnership assets:

Assets	Basis	Value
Cash	$90,000	$90,000
Accounts receivable	0	120,000
Goodwill	0	30,000
	$90,000	$240,000
Partners' Capital		
Steve	$30,000	$80,000
Tom	30,000	80,000
Veronica	30,000	80,000
	$90,000	$240,000

If the partnership agreement does not provide for payments for Tom's share of goodwill, only $30,000 (his share of partnership cash) is classified as a distribution under I.R.C. Section 736(b). Because the cash distribution equals Tom's basis in his partnership interest, he recognizes no gain or loss. The remaining $50,000 Tom receives is classified as a guaranteed payment under I.R.C. Section 736(a). Tom recognizes $50,000 of ordinary income and the partnership is allowed a $50,000 ordinary business expense deduction under I.R.C. Section 162. If the partnership agreement requires payments for Tom's share of goodwill ($10,000), his cash distribution under I.R.C. Section 736(b) is $40,000. Because the basis in his partnership interest is $30,000, Tom recognizes a $10,000 capital gain pursuant to I.R.C. Section 731(a) and the partnership may not deduct that amount. The remaining $40,000 Tom receives is classified as a guaranteed payment under I.R.C. Section 736(a). He reports that amount as ordinary income and the partnership is allowed a corresponding deduction.

Value of goodwill. The partners may determine the value of partnership goodwill either by specifying an amount or by providing a formula for computing the value.[28] The value the partners place on goodwill in an arm's-length agreement is generally considered correct.[29] However, a payment for a withdrawing partner's share of goodwill is treated as a distribution under I.R.C. Section 736(b) only to the extent that it is "reasonable."[30]

28. Treas. Reg. § 1.736-1(b)(3).
29. *Id.*
30. *Id.*

Provision in partnership agreement required. A payment for goodwill is classified as a distribution under I.R.C. Section 736(b) only if the partnership agreement specifically provides that the partnership will pay for the withdrawing partner's share of goodwill. In the absence of a provision, or if the partnership agreement specifically states that no value is assigned to goodwill, the payments are classified under I.R.C. Section 736(a).[31] The courts will not look beyond an unambiguous, written agreement to determine the actual intention of the parties.[32] However, if the partnership agreement is unclear about goodwill payments, the courts will consider other factors to discern the parties' intent.[33]

The provision on partnership goodwill may be in the initial partnership agreement or it may be added as an amendment before the partner withdraws.[34] The partnership agreement for a year is generally deemed to include any amendments adopted on or before the date the partnership return must be filed for that year (not including extensions).[35] Presumably, an amendment adopted after the filing date cannot change the treatment of payments to a partner who withdrew in the previous year.

The provision regarding payments for goodwill should be incorporated into the overall written partnership agreement and not relegated to a separate withdrawal agreement affecting one partner. The Tax Court refused to treat a withdrawal agreement as part of the partnership agreement because it dealt with only one partner and did not concern partnership operations.[36]

[3] Taxation of I.R.C. Section 736(b) Payments

I.R.C. Section 736(b) provides that the portion of a liquidating payment that a withdrawing partner receives in exchange for his share of partnership property is taxable under the rules governing liquidating distributions. These rules are summarized as follows:

(1) ***Under I.R.C. Section 731(a)(1), a partner recognizes capital gain on a liquidating distribution to the extent that the amount of cash he receives exceeds the basis in his partnership interest.*** The amount of cash the partner receives includes a deemed cash distribution equal to any decrease in his share of part-

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31. *See* Smith v. Comm'r, 37 T.C. 1033, *aff'd*, 313 F.2d 16 (10th Cir. 1962); Spector v. Comm'r, T.C. Memo. 1982-433; Miller v. U.S., 181 Ct. Cl. 331 (1967).

32. I.R.C. § 736(b)(2)(B); Treas. Reg. § 1.736-1(b)(3). *See* Smith v. Comm'r, 37 T.C. 1033, *aff'd*, 313 F.2d 16 (10th Cir. 1962).

33. Comm'r v. Jackson Inv. Co., 346 F.2d 187 (9th Cir. 1965), *rev'g and remanding* 41 T.C. 675 (1964); Jacobs v. Comm'r, T.C. Memo. 1974-196.

34. *See* Comm'r v. Jackson Inv. Co., 346 F.2d 187 (9th Cir. 1965), *rev'g and remanding* 41 T.C. 675 (1964).

35. I.R.C. § 761(c).

36. Jackson Investment Co. v. Comm'r, 41 T.C. 675 (1964), *rev'd and remanded*, 346 F.2d 187 (9th Cir. 1965). However, the Ninth Circuit Court reversed that decision, noting that I.R.C. Section 736 is designed to permit the partners to allocate tax burdens as they choose.

nership liabilities resulting from the liquidation. A distribution of marketable securities may be treated as cash.[37]

A partner who receives a series of cash liquidating distributions over more than one year does not recognize gain until the amount of cash he receives (including amounts he is deemed to receive) exceeds the basis in his partnership interest.[38]

However, if the partner will receive a fixed total amount for his interest, he may elect to report his gain pro rata as he receives payments.[39]

(2) ***Under I.R.C. Section 731(a)(2), a partner recognizes a capital loss on a liquidating distribution if the distribution consists solely of cash, unrealized receivables, and inventory, and the basis of his interest exceeds the amount of cash and the partnership's basis in the other property he receives.*** A partner may report his entire loss when he receives his final liquidating distribution.[40] or may elect to report the loss ratably as he receives payments.[41]

(3) ***Under I.R.C. Section 751(b), a portion of the distribution may be recharacterized as a sale between the partner and partnership, resulting in recognition of income or loss.*** This recharacterization occurs to the extent that the payment the partner receives is in exchange for his share of the partnership's I.R.C. Section 751 property (*see* Chapter 12). I.R.C. Section 751 property ordinarily includes a partnership's unrealized receivables and substantially appreciated inventory. However, payments for a general partner's share of accounts receivable from sales of goods and services (to the extent that their value exceeds basis) are not treated as distributions under I.R.C. Section 736(b) in a partnership where capital is not a material income producing factor (e.g., a services partnership).

Although unrealized receivables are not characterized as partnership property for I.R.C. Section 736(b), they are included in the partnership's inventory in determining whether the partnership's inventory is substantially appreciated under I.R.C. Section 751.[42]

A withdrawing partner who receives cash in exchange for an actual distribution of his share of substantially appreciated inventory is treated as if he received a distribution of the inventory and then sold it back to the partnership.[43] The partner recognizes ordinary income or loss on the deemed sale, and the partnership increases its basis in the inventory it is deemed to purchase from the partner.

Example (1): Donna receives a $110,000 cash payment to liquidate her one-third interest in the DEF Medical Partnership. Capital is not a material income producing factor in the partnership. The partnership agreement does not provide for a payment for a partner's share of partnership goodwill. When the

37. I.R.C. § 731(c). *See* § 8.02, *supra*.
38. Treas. Reg. § 1.736-1(b)(6), (7).
39. Treas. Reg. § 1.736-1(b)(6).
40. *See* Treas. Reg. § 1.736-1(b)(6).
41. *Id.*
42. Treas. Reg. § 1.751-1(d)(2)(ii). *But see* S. Rep. No. 1622, 83d Cong., 2d Sess. 404 (1954), suggesting that Congress did not intend to include unrealized receivables in determining the value of inventory.

payment is made, the partners agree, after arm's-length negotiations, that the following balance sheet reflects the value of partnership assets:

Assets	Basis	Value
Cash	$120,000	$120,000
Accounts receivable for service	0	120,000
Inventory	30,000	60,000
Goodwill	0	30,000
	$150,000	$330,000
Partners' Capital		
Donna	$50,000	$110,000
Edgar	50,000	110,000
Frank	50,000	110,000
	$150,000	$330,000

The liquidating payment is classified under I.R.C. Section 736 as follows:

	I.R.C.§736(b)	I.R.C. §736(a)
Cash	$40,000	$0
Accounts receivable	0	40,000
Inventory	20,000	0
Goodwill	0	10,000
	$60,000	$50,000

This classification is the sole function of I.R.C. Section 736. Once the amount of the I.R.C. Section 736(a) and I.R.C. Section 736(b) payments are determined, the tax consequences of each category are determined under other applicable Code sections as follows:

(1) ***The consequences of the I.R.C. Section 736(b) payment (i.e., the payment for Donna's share of partnership property) are determined under the rules governing distributions.*** The amount of Donna's I.R.C. Section 736(b) payment is $60,000–$80,000 share of cash plus $20,000 for her share of the inventory. Because the inventory is substantially appreciated, the constructive sale rules of I.R.C. Section 751(b) apply (*see* Chapter 12). Under these rules, Donna is treated as if she received a distribution of her share of the inventory worth $20,000 with a $10,000 basis, and then sold the inventory back to the partnership for the $20,000 in cash she actually received. Donna recognizes $10,000 of ordinary income on this constructive sale, and the partnership increases the basis in its inventory by $10,000 to reflect the deemed purchase price. The rest of the distribution consists of $40,000 in cash and the remaining basis in

Donna's partnership interest is $40,000 ($50,000 total basis less $10,000 basis of inventory deemed distributed to her). Because the cash distribution does not exceed the basis in Donna's interest, she does not recognize gain or loss on this part of the distribution.

(2) ***The consequences of the I.R.C. Section 736(a) payment are determined under the rules governing partners' distributive shares and guaranteed payments to partners.*** The amount of Donna's I.R.C. Section 736(a) payment is $50,000 (attributable to the value of her share of accounts receivable and goodwill). This amount is treated as a guaranteed payment because the amount is fixed rather than computed as a percentage of partnership income. (See discussion of I.R.C. Section 736(a) payments at § 10.01[D], *infra.*)

Example (2): Assume the same facts except that capital is a material income producing factor in the partnership and that the receivables are for sales of goods (hypothetically not yet realized). In that case, the entire $110,000 payment is an I.R.C. Section 736(b) payment. The unrealized receivables are included in the constructive sale under I.R.C. Section 751, resulting in $50,000 of ordinary income ($10,000 from deemed sale of inventory and $40,000 from deemed sale of zero basis receivables). The rest of the distribution consists of $50,000 in cash ($110,000 total – $60,000 attributed to the I.R.C. Section 751 assets). Because Donna's remaining basis in her interest is $40,000 ($50,000 initial basis – $10,000 attributable to her share of the basis for the inventory), she also recognizes a $10,000 capital gain.

A withdrawing partner recognizes ordinary income or loss under I.R.C. Section 751(b) only to the extent that the amount of money or other property he receives exceeds his share of the partnership's basis for the inventory. If the withdrawing partner is a successor to a deceased partner, the successor's share of the partnership's basis increases to its value on the date of the partner's death (or alternate valuation date) if the partnership had an I.R.C. Section 754 election in effect at that time.[44] Thus, the successor's ordinary income or loss under I.R.C. Section 751(b) is limited to changes in value occurring since that date. No basis increase occurs, however, for partnership items that are income in respect of a decedent under I.R.C. Section 691.[45] This precludes a basis increase for the deceased partner's share of accounts receivable. (See discussion of income in respect of a decedent in Chapter 11.)

If no I.R.C. Section 754 election was in effect when the successor acquired his interest from the deceased partner, similar treatment may be obtained through an election under I.R.C. Section 732 (d). An I.R.C. Section 732 (d)

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44. Treas. Reg. § 1.736-1(b)(4).

45. Treas. Reg. §§ 1.743-1(b), 1.755-1(b)(4).

election applies only to distributions made within two years of the date a partner receives his partnership interest by transfer (i.e., by purchase or as successor to a deceased partner). This election permits a partner to determine his basis in any property actually or constructively distributed to him within that two-year period as if the partnership had an I.R.C. Section 754 election in effect when he acquired the interest. Because the election would increase the basis of the successor's share of partnership inventory to its value on the date of the deceased partner's death (or alternate valuation date), the successor's ordinary income or loss under I.R.C. Section 751(b) is limited to changes in value occurring since that date. (See discussion of I.R.C. Section 732(d) in Chapter 11.)

(3) ***The partnership may not deduct any portion of the payment that is treated as a liquidating distribution to the withdrawing partner.***

(4) ***If the partnership has an I.R.C. Section 754 election in effect, the partnership adjusts the basis in its undistributed property by the amount of gain or loss the partner recognizes on the distribution.***[46] (*See* Chapter 8.)

[D] Payments Exceeding Partner's/Member's Interest in Partnership/LLC Property— I.R.C. Section 736(a) Payment

The tax consequences of the portion of a liquidating payment classified as an I.R.C. Section 736(a) payment are determined in two steps:

(1) The portion of the payment classified as an I.R.C. Section 736(a) payment is determined. This is the portion of the payment that is not an I.R.C. Section 736(b) payment (i.e., the amount that exceeds the payment for the partner's share of partnership property).

(2) To the extent that the amount of the I.R.C. Section 736(a) payment is computed as a percentage of partnership income, it is treated as the partner's distributive share under I.R.C. Section 702. If the amount is fixed, the payment is treated as a guaranteed payment under I.R.C. Section 707(c). The partnership may not deduct an I.R.C. Section 736(a) payment treated as a distributive share (although the continuing partners' distributive shares decrease by the amount allocated to the withdrawing partner). Amounts treated as guaranteed payments are deductible by the partnership as business expenses. (*See* Chapters 3, 7.)

46. I.R.C. §754.

PRACTICE NOTE

Payments in liquidation of a partnership interest may be taxable as ordinary income where the partnership agreement provides that the partner will receive amounts upon reaching a specific age or withdrawal from the partnership. In a recent case, the partnership agreement awarded each partner 50 "Schedule C" units per year valued at $300 per unit (a total of $15,000) to be paid quarterly each year after a partner died, became disabled, was expelled, or turned 68 years old.[47] Although the partnership deducted its payment for the Schedule C units on the partnership return, the taxpayer did not report the amount received as income. The Eleventh Circuit upheld the Tax Court holding that the payments were essentially a retirement benefit classified as a guaranteed payment under I.R.C. Section 736(a) and taxable as ordinary income. The appellate court also upheld imposition of an accuracy-related penalty under I.R.C. Section 6662(a).

[1] Determining the Amount of I.R.C. Section 736(a) Payments

Under I.R.C. Section 736(a), the portion of a liquidating payment that is not in exchange for a withdrawing partner's share of partnership property is included in the partner's distributive share or is treated as a guaranteed payment. The amount taxable under I.R.C. Section 736(a) includes:

(1) Payments a withdrawing general partner receives for his share of the partnership's unrealized receivables if capital is not a material income producing factor in the partnership (e.g., a services partnership). This is true only to the extent that the value of the partner's share of the receivables exceeds his share of the partnership's basis for these items. Amounts a partner receives for his share of unrealized receivables are I.R.C. Section 736(b) payments up to his share of the partnership's basis in the receivables.

(2) Payments a withdrawing general partner receives for his share of the partnership's goodwill. This is true only—

  (a) if capital is not a material income producing factor in the partnership;

  (b) to the extent that the value of the partner's share of the goodwill exceeds his share of the partnership's basis for it; and

  (c) to the extent that the partnership agreement does not provide that the partner is entitled to a reasonable payment for his share of partnership goodwill.

(3) All other liquidating payments in excess of the value of the withdrawing partner's share of the partnership's property. Presumably, these additional amounts

47. Wallis v. Comm'r, 106 A.F.T.R. 2d (RIA) 5755 (11th Cir. 2010) (unpub. op.).

that do not relate to goodwill represent some form of mutual insurance or retirement benefit payable out of partnership income.[48]

[2] Taxation of I.R.C. Section 736(a) Payments

Liquidating payments classified under I.R.C. Section 736(a) are taxable as though the withdrawing partner continues to own an interest in the partnership's income. The precise treatment depends upon how the amount of these payments is computed:

(1) If the amount the withdrawing partner receives is computed by reference to the amount of partnership income (i.e., as a percentage of partnership income), the payment is treated as the partner's distributive share of partnership income.[49] Under I.R.C. Sections 702 and 704, the character of amounts included in a partner's distributive share is determined from the partner's share of each item of partnership income or gain. For example, the withdrawing partner recognizes ordinary income to the extent of his share of partnership ordinary income items, and he recognizes capital gain to the extent of his share of partnership capital gain. Although the partnership cannot deduct these payments, they do reduce the amount of income and gain allocable to the continuing partners.

The withdrawing partner is taxable on amounts treated as a distributive share in his taxable year in which (or with which) the partnership's taxable year ends.[50] (*See* Chapter 3.) The partnership's tax year ends for a partner on the date that his interest is completely liquidated. (For discussion of rules when a partner receives a series of payments over more than one year, *see* § 10.02, *infra*.)

Example: Dave retires from the CDE Partnership on January 1, Year 1. (All parties use a calendar tax year.) At that time, the partnership pays Dave an amount of cash equal to his share of the value of the partnership's property (as determined under I.R.C. Section 736(b)) and agrees to pay him one-third of the net amounts the partnership earns during the year. For Year 1, the partnership earns $300,000 of ordinary income and has a $120,000 capital gain. Dave receives a $140,000 cash payment for his share of these amounts in January, Year 1.

The consequences of these payments are as follows:

(a) The payment Dave receives on January 1, Year 1 for his share of partnership property is classified as a distribution under I.R.C. Section 736(b). As discussed above, the tax consequences of this payment are determined under the rules governing liquidating distributions.

(b) All additional payments to Dave are classified as I.R.C. Section 736(a) payments. This includes the entire one-third net amount of partner-

48. Treas. Reg. § 1.736-1(a)(2).
49. I.R.C. § 736(a); Treas. Reg. § 1.736-1(a)(3).
50. Treas. Reg. § 1.736-1(a)(5).

ship income for Year 1. Because that amount is computed as a percentage of partnership income, it is taxable as Dave's distributive share of partnership income for Year 1.

(c) Under the rules governing taxation of distributive shares (I.R.C. Sections 702, 706(a)), Dave reports $100,000 as ordinary income and $40,000 as capital gain on his tax return for Year 1. Under I.R.C. Section 705(a)(1), Dave's basis in his partnership interest increases by $140,000 at the end of Year 1.

(d) The $140,000 payment to Dave in Year 2 is treated as a final liquidating distribution. Because the amount of cash he receives equals the basis in his partnership interest, he recognizes no gain or loss on receipt of the payment in that year.

A partner who desires assurance that his continued interest in partnership income will not diminish may ask for an allocation based on partnership gross, rather than net, income. For example, a partner retiring from a partnership that owns rental property may agree to receive a percentage of gross rental income for a period of years following his retirement. Although uncertainty about the treatment of this arrangement exists, it appears that the Service will treat payments based on gross income as guaranteed payments rather than as a distributive share.[51]

(2) If the amount the withdrawing partner receives is computed without reference to partnership income (i.e., a fixed amount), the payment is treated as a guaranteed payment.[52] Under I.R.C. Section 707(c), guaranteed payments are characterized as ordinary income to the recipient partner. The partnership may deduct the entire amount of the withdrawing partner's guaranteed payment from its ordinary income. This deduction decreases the amount of ordinary income allocated to the continuing partners. The partnership's deduction is permitted as a business expense under I.R.C. Section 162 and need not be capitalized.[53] The withdrawing partner is taxable on the guaranteed payment at the end of the partnership tax year in which the payment is deductible by the partnership.[54]

Example (1): On December 1, Year 1, the LMN Partnership agrees to pay Marie $70,000 in cash as a liquidating payment for her entire partnership interest. The amount of the payment that is for Marie's share of partnership property (the I.R.C. Section 736(b) payment) is $50,000, and the amount

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51. Rev. Rul. 81-300, 1981-2 C.B. 143; Rev. Rul. 81-301, 1981-2 C.B. 144. *But see* Pratt v. Comm'r, 64 T.C. 203 (1975), *aff'd*, 550 F.2d 1023 (5th Cir. 1977).

52. I.R.C. §736(a); Treas. Reg. §1.736-1(a)(3). *See* I.R.C. §707(c). *See, e.g.*, Estate of Quirk v. Comm'r, 928 F.2d 751 (6th Cir. 1991), *aff'g and remanding on other issues*, T.C. Memo. 1988-286 (amount of payment fixed if calculated as percentage of partnership assets).

53. Treas. Reg. §1.707-1(c). *But see* Banoff, *Determining the Character of Guaranteed Payments for Partners' Capital*, 67 J. TAX'N 284 (Nov. 1987).

54. Treas. Reg. §1.736-1(a)(5).

classified as an I.R.C. Section 736(a) payment is $20,000. The payment is made on March 1, Year 2. All parties use a calendar tax year.

Because the amount of the Section 736(a) payment is fixed, the entire $20,000 is a guaranteed payment. Under the guaranteed payment rules of I.R.C. Section 707(c), the partnership deducts the $20,000 in computing its ordinary income for Year 1. Marie reports the $20,000 guaranteed payment as ordinary income for Year 1 — the year that the partnership deducts the payment — even though she receives it in Year 2.

Example (2): The RST Limited Liability Company operating agreement provides that when Richard retires, the LLC will pay him the value of his interest in LLC property (as determined under I.R.C. Section 736(b)), plus an amount equal to his share of LLC income for the two years preceding his retirement. Since the amount of the payment in excess of the value of Richard's share of LLC property (I.R.C. Section 736(a) payment) is determined without reference to the LLC's income for the year it is paid, it is a guaranteed payment. Richard includes the entire amount in his ordinary income, and the LLC deducts that amount in computing its ordinary income.

[3] Summary — Steps in Determining Taxation of Lump-Sum Liquidating Payment

Step 1. Divide total payment into I.R.C. Section 736(a) payment and I.R.C. Section 736(b) payment portions.

Step 2. Determine tax consequences of I.R.C. Section 736(b) payment as follows:

(a) If partnership owns substantially appreciated inventory, compute amount recognized under I.R.C. Section 751(b). Partner is deemed to receive distribution of his share of the inventory and sell it back to the partnership for cash. Partner recognizes ordinary income on the sale and partnership increases basis in inventory to reflect deemed purchase.

(b) Compute consequences of cash distribution under I.R.C. Section 731. Amount of distribution equals amount of I.R.C. Section 736(b) payment not considered amount realized for substantially appreciated inventory.

(i) If distribution equals basis, no gain or loss is recognized.

(ii) If distribution exceeds basis, partner recognizes excess amount as capital gain.

(iii) If basis exceeds distribution, partner recognizes difference as capital loss.

Step 3. Determine tax consequences of I.R.C. Section 736(a) payment as follows:

(a) If amount partner will receive is computed as percentage of partnership income, payment is treated as partner's distributive share of partnership income. Character of payment is determined at partnership level.

(b) If amount partner will receive is fixed, payment is treated as guaranteed payment. Partner reports ordinary income and partnership may deduct same amount as trade or business expense.

§ 10.02 Series of Cash Liquidating Payments

Frequently, a withdrawing partner's interest is liquidated through a series of payments over a period of years. The tax consequences of these payments are determined as follows:

(1) The I.R.C. Section 736(b) payment and I.R.C. Section 736(a) payment portions of the amount received each year is determined.[55] The I.R.C. Section 736(b) payment is treated as a distribution and the I.R.C. Section 736(a) payment is included in the partner's distributive share or treated as a guaranteed payment.

(2) The tax consequences of the distribution (I.R.C. Section 736(b) payment), distributive share, or guaranteed payment (I.R.C. Section 736(a) payment) are determined under the appropriate Code sections. The regulations provide elections that allow partners to accelerate or defer recognition of gain or loss on the liquidating payments in a number of circumstances.

[A] Determining the I.R.C. Section 736(a) and I.R.C. Section 736(b) Portions of Each Payment

When a withdrawing partner's interest is liquidated through a series of payments over a period of years, part of the amount received each year is classified as a liquidating distribution under I.R.C. Section 736(b), and the remainder is treated as a guaranteed payment or distributive share under I.R.C. Section 736(a).[56] The following rules apply in determining the amount of the payment that is allocated to each class:

(1) If the total amount the withdrawing partner will receive is fixed, the amount treated as a liquidating distribution under I.R.C. Section 736(b) each year is computed by multiplying

(a) the total amount the partnership agreed to pay during the current year (not the amount he actually receives); by

(b) a fraction, with a numerator that is the total amount the partner will receive for his share of partnership property (total I.R.C. Section 736(b) payments), and a denominator that is the total amount of all payments he will receive (total I.R.C. Section 736(a) and I.R.C. Section 736(b) payments).[57] he amount paid during the year that exceeds the amount classified as an I.R.C. Section 736(b) payment is a guaranteed payment under

55. Treas. Reg. § 1.736-1(b)(5).

56. *Id.*

57. Treas. Reg. § 1.736-1(b)(5)(i), (ii).

I.R.C. Section 736(a).[58] If the amount the partner actually receives during the year is less than the amount computed as I.R.C. Section 736(b) payments under this formula, the entire amount received is treated as a distribution under I.R.C. Section 736(b). The amount of I.R.C. Section 736(b) payments not actually received is added to the amount treated as an I.R.C. Section 736(b) payment in the next year.

Example: Upon his retirement from the ABC Partnership, Allen is entitled to receive $60,000 in cash as a liquidating payment each year for five years. Of the total $300,000 ($60,000 × 5) Allen will receive, $200,000 is for his share of partnership property as determined under I.R.C. Section 736(b). When he retires, Allen's basis for his partnership interest is $100,000. The partnership does not own I.R.C. Section 751 property.

In Year 1—ABC pays Allen $60,000:

(a) $40,000 is classified under I.R.C. Section 736(b) as a distribution for Allen's share of partnership property ($60,000 × $200,000 Allen's share of partnership property/$300,000 total fixed payments). The distribution reduces Allen's basis in his partnership interest to $60,000 and he does not recognize any gain in Year 1 (I.R.C. Section 731(a)).

(b) The remaining $20,000 of the payment is classified as a guaranteed payment under I.R.C. Section 736(a). Allen includes that amount in his ordinary income, and the partnership is allowed a corresponding deduction.

In Year 2—ABC is able to pay Allen only $30,000:

The entire amount is classified under I.R.C. Section 736(b) as a distribution for Allen's share of partnership property. The distribution decreases Allen's basis in his partnership interest to $30,000 and he recognizes no gain or loss in Year 2.

In Year 3—Allen receives a $90,000 payment from the partnership:

$50,000 is classified under I.R.C. Section 736(b) as a distribution ($40,000 for the current year + $10,000 deficit from Year 2). Because the $50,000 cash distribution exceeds Allen's $30,000 basis in his partnership interest, Allen recognizes $20,000 of capital gain under I.R.C. Section 731(a).

$40,000 is classified under I.R.C. Section 736(a) as a guaranteed payment. Allen reports that amount as ordinary income and the partnership is allowed a corresponding deduction.

In Years 4 and 5—ABC pays Allen $60,000 each year:

The entire amount Allen receives each year is classified under I.R.C. Section 736(a) as a guaranteed payment. Allen reports these amounts as ordinary income, and the partnership is allowed corresponding deductions.

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58. Treas. Reg. § 1.736-1(b)(5)(i).

The following chart summarizes the allocation and taxation of ABC's payments to Allen:

Year	Total Payment	I.R.C. §736(b) Payment	I.R.C. §736(a) Payment	Amount Taxable	Character
1	$60,000	$40,000	$20,000	$20,000	ordinary income
2	$30,000	$30,000	$0	$0	
3	$90,000	$50,000	$40,000	$60,000	$20,000 capital gain, $40,000 ordinary income
4	$60,000	0	$60,000	$60,000	ordinary income
5	$60,000	0	$60,000	$60,000	ordinary income

(2) If the total amount the withdrawing partner will receive is contingent rather than fixed (e.g., the payments are based on a percentage of partnership income), all payments are classified as distributions under I.R.C. Section 736(b) until the total amount the partner receives equals the value of his share of partnership property.[59] All additional payments are classified as the partner's distributive share of partnership income under I.R.C. Section 736(a).

Example: Upon her retirement from the DEF Partnership, Dora is entitled to receive liquidating payments equal to 20 percent of partnership income each year for four years. When she retires, the agreed value of Dora's share of partnership property, determined under I.R.C. Section 736(b), is $100,000, and the basis of her partnership interest is $60,000. The partnership does not own I.R.C. Section 751 property.

In Year 1, Dora's share of partnership income is $50,000 and she receives a payment of that amount. The entire payment is classified under I.R.C. Section 736(b) as a distribution, which reduces Dora's basis for her partnership interest to $10,000 ($60,000 – $50,000). Dora recognizes no gain or loss.

In Year 2, Dora receives a $60,000 payment from the partnership. The first $50,000 is classified as a distribution under I.R.C. Section 736(b). Dora recognizes a $40,000 capital gain under I.R.C. Section 731(a) — the excess of the cash distribution over Dora's basis for her partnership interest ($50,000 distribution – $10,000 basis). The remaining $10,000 of the payment is classified under I.R.C. Section 736(a) as Dora's distributive share of partnership income.

59. *Id.*

Dora receives a $70,000 payment from the partnership in each of Years 3 and 4. These payments are classified under I.R.C. Section 736(a) as Dora's distributive share of partnership income.

Under I.R.C. Section 702(b), the character of a distributive share depends upon the source of the partnership's income during the year.

Year	Total Payment	I.R.C. §736(b) Payment	I.R.C. §736(a) Payment	Amount Taxable	Character
1	$50,000	$50,000	0	0	
2	$60,000	$50,000	$10,000	$50,000	$40,000 Capital gain, Remainder under I.R.C. §702
3	$70,000	0	$70,000	$70,000	Determined under I.R.C. §702
4	$70,000	0	$70,000	$70,000	Determined under I.R.C. §702

(3) If the withdrawing partner is to receive a fixed amount plus additional contingent amounts, the payments each year are allocated under the rules governing fixed payments until the partner receives the fixed amount the partnership agreed to pay in the current year.[60] This amount is treated as a distribution under I.R.C. Section 736(b) and a guaranteed payment under I.R.C. Section 736(a). Payments that exceed the fixed amount are classified as the partner's distributive share under I.R.C. Section 736(a).[61]

Example: Upon his retirement from the GHI Partnership, George is entitled to receive liquidating payments of $40,000 each year for five years ($200,000 total fixed amount) plus 20 percent of the partnership's net income above $80,000 in each of those years. When he retires, the agreed value of George's share of partnership property, determined under I.R.C. Section 736(b), is $120,000 and the basis for his partnership interest is $60,000. The partnership does not own I.R.C. Section 751 property.

In Year 1, the partnership pays George $50,000. Of this amount, $40,000 is George's fixed payment and $10,000 is for his share of partnership profits above $80,000. The payment is subject to the following treatment:

(a) $24,000 of the payment is classified under I.R.C. Section 736(b) as a distribution ($40,000 agreed payment for the year × $120,000 total fixed amount for property/$200,000 total fixed payments). George

60. *See* Treas. Reg. § 1.736-1(b)(5)(ii).
61. *See Id.*

recognizes no gain on that portion of the payment, and the basis for his partnership interest decreases to $36,000.

(b) $16,000 is classified under I.R.C. Section 736(a) as a guaranteed payment (the amount by which the $40,000 fixed payment exceeds the amount classified under I.R.C. Section 736(b)). This portion of the payment is treated as a guaranteed payment because the amount is determined without reference to the partnership's income.

(c) $10,000 is classified under I.R.C. Section 736(a) as George's distributive share of partnership income because the amount was determined as a percentage of partnership income.

The withdrawing and continuing partners may agree to use a different method for allocating annual payments between I.R.C. Sections 736(a) and 736(b).[62] The agreement is respected if the total amount to be treated as a distribution under I.R.C. Section 736(b) does not exceed the fair market value of the withdrawing partner's share of partnership property on the date he retires or dies.[63] Apparently, the agreement may be evidenced by consistency in the manner the partners report the transaction. It is prudent, however, for the partners to reduce their agreement to writing.

[B] Computing Gain or Loss Recognized on the I.R.C. Section 736(b) Portion

The following rules govern the recognition of gain or loss on the portion of each liquidating payment classified as a distribution under I.R.C. Section 736(b):

(1) A withdrawing partner recognizes gain (under I.R.C. Section 731(a)(1)) only if the amount of cash he receives as an I.R.C. Section 736(b) distribution exceeds the basis of his partnership interest. The partner decreases the basis of his interest as he receives each distribution. Thus, the partner recognizes gain only after the basis of his partnership interest is reduced to zero.[64]

Example: The LMO Limited Liability Company agrees to pay Leon $50,000 a year for three years in liquidation of his LLC interest: $40,000 of each payment is classified as a distribution under I.R.C. Section 736(b); the remaining $10,000 is a guaranteed payment under I.R.C. Section 736(a). The LLC does not own substantially appreciated inventory.[65] When Leon receives the first payment, the basis of his LLC interest is $60,000.

62. Treas. Reg. § 1.736-1(b)(5)(iii).

63. *Id.*

64. Treas. Reg. § 1.736-1(b)(6); I.R.C. § 731(a).

65. If the partnership owns substantially appreciated inventory, a portion of the distribution may be recharacterized as a sale under I.R.C. § 751(b). (*See* Chapter 8.) Although unrealized receivables are also subject to I.R.C. § 751(b), the receivables are not considered property under I.R.C. § 736(b). Thus, liquidating payments a partner receives for his share of unrealized receivables are classified as I.R.C. Section 736(a) payments.

In Year 1, Leon recognizes no gain under I.R.C. Section 731 (although he is taxable on the guaranteed payment), and the $40,000 distribution reduces the basis of his LLC interest to $20,000. The distribution in Year 2 exceeds Leon's remaining basis by $20,000, and he recognizes that amount as capital gain. In Year 3 Leon's basis in his LLC interest is zero; therefore, he recognizes $40,000 of capital gain on the distribution that year.

The allocation and taxation of these distributions is summarized as follows:

If the partnership liquidates a partner's interest through a series of cash payments that are treated as distributions under I.R.C. Section 736(b)(1),

Year	Total Payment	Leon's Basic	I.R.C. §736(b) Payment	I.R.C. §736(a) Payment	Amount Taxable	Character
1	$50,000	$40,000	$20,000	$10,000	$10,000	$10,000 ordinary income
2	$50,000	$40,000	0	$10,000	$30,000	$20,000 capital gain; $10,000 ordinary income
3	$50,000	$40,000	0	$10,000	$50,000	$40,000 capital gain; $10,000 ordinary income

any I.R.C. Section 734(b) basis adjustments to partnership property correspond in timing and amount with the gain or loss the retiring partner recognizes for those payments.[66]

(2) A withdrawing partner recognizes a loss under I.R.C. Section 731(a)(2) if the total amount of cash he receives as a distribution under I.R.C. Section 736(b) is less than the basis of his partnership interest. The partner recognizes the entire loss in the year in which he receives the final payment classified as a liquidating distribution.[67]

Example: The STU Partnership agrees to pay Sandra $40,000 a year for three years in liquidation of her partnership interest: $30,000 of each payment is classified as a distribution under I.R.C. Section 736(b) and the remaining $10,000 is a guaranteed payment under I.R.C. Section 736(a). The partnership does not own substantially appreciated inventory. The basis of Sandra's partnership interest is $100,000.

Sandra does not recognize any gain or loss on the distributions in Year 1 or Year 2 (although she is taxable on the guaranteed payment). When San-

66. Rev. Rul. 93-13, 1993-1 C.B. 126.
67. Treas. Reg. § 1.736-1(b)(6); I.R.C. § 731(a).

dra receives the $30,000 final distribution in Year 3, the basis of her partnership interest is $40,000 ($100,000 beginning basis – $60,000 total distributions). Therefore, Sandra recognizes a $10,000 capital loss in Year 3.

(3) A withdrawing partner who will receive a fixed amount for his interest in partnership property (I.R.C. Section 736(b) payments) over a period of years may elect to report the total gain or loss he will recognize ratably as he receives each distribution.[68]

The amount of gain or loss recognized each year equals the difference between:

(a) the amount treated as a distribution under I.R.C. Section 736(b) that year; and

(b) the portion of the partner's basis in his partnership interest attributable to the distribution he receives that year. This portion is computed by multiplying the partner's total basis by a fraction whose numerator is the distribution received during the year and whose denominator is the total I.R.C. Section 736(b) distributions he will receive.

The withdrawing partner makes the election by attaching a statement to his tax return for the year in which he receives the first liquidating payment.[69] The statement must indicate that an election is being made and show the computation of the partner's gain or loss.

Example: The RST Limited Liability company agrees to pay Richard a total of $300,000 over a three-year period for his interest in LLC property (i.e., I.R.C. Section 736(b) payments). In Year 1, Richard will receive $100,000; in Year 2, $150,000, and in Year 3, $50,000. The LLC does not own substantially appreciated inventory. The basis of Richard's LLC interest is $180,000.

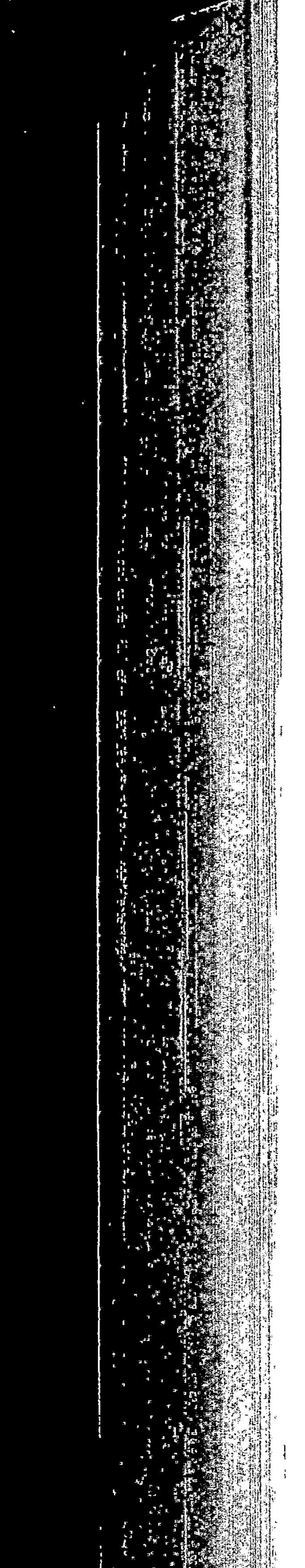
Richard may elect to report his gain on the distributions by attaching a statement, in the following form, to his tax return for Year 1:

ELECTION TO RECOGNIZE GAIN RATABLY UNDER REGULATIONS SECTION 1.736-1(b)(6)

Taxpayer Richard Simes retired from the RST Limited Liability Company on January 1, Year 1. Taxpayer elects to recognize gain each year under Regulations Section 1.736-1(b)(6). Taxpayer will receive total distributions of $300,000 and the basis of his LLC interest is $180,000.

68. Treas. Reg. § 1.736-1(b)(6). Any I.R.C. § 734(b) basis adjustments to partnership property correspond in timing and amount with the gain or loss the retiring partner recognizes for I.R.C. Section 736(b) payments. Rev. Rul. 93-13, 1993-1 C.B. 126.

69. Treas. Reg. § 1.736-1(b)(6).



The amount of gain the taxpayer will recognize each year is computed as follows:

60 percent ($180,000/$300,000) of the total cash distributed represents recovery of taxpayer's basis. Thus, 60 percent of each payment is treated as a return of capital and 40 percent is capital gain:

Year	Total Received	Return of Basis	Capital Gain
1	$100,000	$60,000	$40,000
2	150,000	90,000	60,000
3	50,000	30,000	20,000
	$300,000	$180,000	$120,000

Ordinarily, it is advantageous for a partner to elect to prorate a loss he will recognize on a distribution because it accelerates the time when the loss is reported. However, an election by the withdrawing partner also affects the partnership if an I.R.C. Section 754 basis-adjustment election is in effect. Under that election, the loss a partner recognizes on a distribution results in a corresponding decrease to the bases of undistributed partnership property.[70] Proration of the loss accelerates the time when the partnership's basis decrease occurs. This may be disadvantageous to the continuing partners because it may decrease allowable deductions or increase gain recognized on disposition of the property.

(4) Different timing rules apply if the partnership owns property subject to the rules of I.R.C. Section 751 (I.R.C. Section 751 property). If the withdrawing partner receives a cash liquidating distribution, a portion of the distribution is taxable under the disproportionate distribution rules of I.R.C. Section 751(b). The partner is treated as if he received a distribution of his proportionate share of the I.R.C. Section 751 property and then sold it back to the partnership for cash. The partner must determine the portion of each distribution that is treated as a sale under I.R.C. Section 751(b) and report the amount of ordinary income or loss he recognizes.

A withdrawing partner recognizes ordinary income (or loss) under I.R.C. Section 751(b) only to the extent that the amount of money or other property he receives exceeds (or is less than) his share of the partnership's basis for the I.R.C. Section 751 property. If the withdrawing partner is a successor to a deceased partner, the successor's share of the partnership's basis increases (or decreases) to its value at the date of the partner's death if the partnership had an I.R.C. Section 754 election in effect at that time.[71] The basis increase does not apply to the extent that the I.R.C. Section 751 property, such as unrealized receivables, represents income in respect of a decedent under I.R.C. 691.[72]

70. I.R.C. §§ 734, 743.
71. Treas. Reg. § 1.736-1(b)(4).
72. Treas. Reg. §§ 1.743-1(b), 1.755-1(b)(4).

[C] Computing Gain or Loss Recognized on the I.R.C. Section 736(a) Portion

When a partner receives a series of liquidating payments, the portion of each payment that is classified under I.R.C. Section 736(a) is taxable as follows:

(1) ***To the extent that the amount the partner receives is determined by reference to the partnership's income (i.e., a percentage of its income), the payment is treated as the partner's distributive share of partnership income (under I.R.C. Section 702).*** The partner reports his share of each item of partnership income with the same character that it has to the partnership.[73] Although the partnership is not allowed a deduction, the amount included in the retiring partner's distributive share reduces the continuing partners' distributive shares.[74]

Example: Don retires from the CDE Partnership on January 1, Year 1. (All parties use a calendar tax year.) At that time, the partnership pays Don an amount of cash equal to his share of the value of the partnership's property (as determined under I.R.C. Section 736(b)), and agrees to pay him one third of the net amounts the partnership earns during Year 1 and Year 2. In Year 1, the partnership earns $300,000 of ordinary income and has a $120,000 capital gain. In Year 2, the partnership has only a $150,000 capital gain. Don receives a $140,000 cash payment in January, Year 2 and a $50,000 cash payment in January, Year 3.

The consequences of these payments are as follows:

(a) ***I.R.C. Section 736(b) payment for Don's share of partnership property.*** The payment Don receives in Year 1 for his share of partnership property is classified as a distribution under I.R.C. Section 736(b). The tax consequences of this payment are determined under the rules governing liquidating distributions.

(b) ***I.R.C. Section 736(a) payment for Don's share of partnership income (Year 1).*** Don's total share of partnership income for Year 1 is $140,000 (1/3 of $420,000). He reports $100,000 ($300,000 × 1/3) as ordinary income and $40,000 ($120,000 × 1/3) as capital gain on his tax return for Year 1 as his distributive share. Under I.R.C. Section 705(a)(1), Don's basis in his partnership interest increases by $140,000 at the end of Year 1, and it decreases by that amount when he receives the actual $140,000 distribution in Year 2.

(c) ***I.R.C. Section 736(a) payment for Don's share of partnership income (Year 2).*** Don reports a $50,000 ($150,000 × 1/3) capital gain on his tax return for Year 2 as a distributive share of partnership income. Don's basis in his partnership interest increases by $50,000 at the end

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73. I.R.C. § 702. He includes the distributive share in his income for his taxable year in which (or with which) the partnership's year ends. Treas. Reg. § 1.736-1(a)(5).

74. Treas. Reg. § 1.736-1(a)(4).

of Year 2. Don's basis is reduced to zero when he receives the payment in Year 3.

(2) ***To the extent that the amount the partner receives is not determined by reference to partnership income (i.e., a fixed amount), the payment is treated as a guaranteed payment (subject to I.R.C. Section 707(c)).*** The partnership may deduct the entire guaranteed payment made to the withdrawing partner from partnership ordinary income. This deduction decreases the amount of ordinary income allocated to the continuing partners.[75] The withdrawing partner is taxable on the guaranteed payment at the end of the partnership tax year in which the payment is deductible,[76] even if the partner does not receive the payment until a later year.

Example: Ina retires from the GHI Partnership in December, Year 1. All parties use a calendar tax year. Ina is a cash-method taxpayer, and the partnership uses the accrual method. In December, Year 1, the partnership pays Ina cash equal to her share of the value of the partnership's property (as determined under I.R.C. Section 736(b)) and agrees to pay her an additional $50,000 in March, Year 2. The $50,000 amount is fixed and is treated as a guaranteed payment. Because the partnership can deduct the payment in Year 1, Ina reports that amount as ordinary income on her Year 1 tax return, even though she does not receive the payment until Year 2.

(3) ***If a partnership terminates before it has made all the guaranteed payments that are required to liquidate a retired partner's interest, other partners who individually assume liability for these payments may deduct them as business expenses.***[77] This deduction is permitted in situations when the partnership could have deducted the payments if it had continued.[78] Similarly, a corporate successor to a partnership may claim business expense deductions for payments to a retired partner if the corporation assumes the obligation for these payments.[79]

§ 10.03 Noncash Liquidating Payments

A partnership may liquidate all or a portion of a partner's interest by transferring property other than cash to him. However, I.R.C. Section 736 does not specifically address the treatment of noncash liquidating payments. Indeed, all the issues covered and examples provided in the regulations and administrative rulings focus on the

75. I.R.C. § 707(c).

76. Treas. Reg. § 1.736-1(a)(5).

77. Rev. Rul. 75-154, 1975-1 C.B. 186; Priv. Ltr. Ruls. 8332031, 8304078, 8213051, 7930089, 7748032.

78. Rev. Rul. 75-154, 1975-1 C.B. 186. *See* Sloan v. Comm'r, T.C. Memo. 1981-641; Flood v. U.S., 133 F.2d 173 (1st Cir. 1943).

79. Rev. Rul. 83-155, 1983-2 C.B. 38.

treatment of cash payments. Nevertheless, noncash liquidating payments to a withdrawing partner are not excluded from I.R.C. Section 736 and are subject to the same rules as cash payments. The application of the rules to in-kind payments, however, raises a number of confusing and unresolved issues.

In describing the tax consequences of noncash liquidating payments, the discussion below assumes that rules analogous to those governing cash payments apply. For the discussion, it is necessary to bear in mind the special treatment afforded payments to a withdrawing general partner for his share of unrealized receivables and goodwill under I.R.C. Section 736 if capital is not a material income producing factor in the partnership. As discussed above, amounts paid for the partner's share of certain unrealized accounts receivable (in excess of his share of the partnership's basis for the receivables) are not treated as distributions for his share of partnership property under I.R.C. Section 736(b) but are classified as I.R.C. Section 736(a) payments. Payments for goodwill (in excess of the partner's share of the partnership's basis for the goodwill) are not I.R.C. Section 736(b) payments unless specifically required by the partnership agreement.[80]

Noncash payments to a withdrawing partner that are treated as guaranteed payments under I.R.C. Section 736(a) (i.e., fixed amounts) may cause the partnership to recognize gain or loss. Because the partnership is obligated to pay a fixed value to the withdrawing partner, the partnership recognizes gain or loss when it transfers property to satisfy that obligation. The partnership's gain or loss equals the difference between the amount of its guaranteed payment obligation and the basis of the transferred property.[81] Under I.R.C. Section 736, noncash liquidating payments are treated as follows:

(1) ***The assets the withdrawing partner receives are allocated between the portion that is a distribution under I.R.C. Section 736(b) and the portion taxable under I.R.C. Section 736(a).*** The assets are treated as a distribution under I.R.C. Section 736(b) up to the value of the partner's share of partnership property. As noted above, amounts paid for the partner's share of the partnership's goodwill (unless provided in the partnership agreement) and payments for the partnership's unrealized receivables may be excluded from the I.R.C. Section 736(b) payments. No direct authority exists regarding the method for allocating noncash liquidating payments between I.R.C. Sections 736(a) and (b). Possible allocation methods include:

(a) ***Allocating a ratable portion of each asset the withdrawing partner receives, including cash, to each category of payment.***

Example (1): Charles and the CDE Partnership agree that Charles will receive cash and property worth $100,000 to liquidate his one-third partnership interest. The partnership agreement does not provide that withdrawing partners will receive payment for partnership goodwill. The partnership has the following balance sheet:

80. I.R.C. § 736(b).

81. *See* Rev. Rul. 75-498, 1975-2 C.B. 29; Treas. Reg. § 1.83-6(b).

Assets	Basis	Fair Market Value
Cash	$60,000	$60,000
Stock X	10,000	50,000
Stock Y	50,000	40,000
	$120,000	$150,000
Partners' Capital		
Charles	$40,000	$50,000
Dana	40,000	50,000
Edward	40,000	50,000
	$120,000	$150,000

The parties agree that the partnership will pay Charles $50,000 in cash and will also transfer Stock X to him. Because the value of Charles's share of partnership property is $50,000, $50,000 of the value of any assets he receives will be classified as a distribution under I.R.C. Section 736(b), and the remaining $50,000 value will be treated as a guaranteed payment under I.R.C. Section 736(a).

If the cash and property are allocated ratably as I.R.C. Section 736(a) and I.R.C. Section 736(b) payments, each category of payment consists of $25,000 worth of stock and $25,000 in cash. This allocation method has the following consequences:

(i) The partnership deducts the $50,000 guaranteed payment and Charles recognizes that amount as ordinary income. The partnership also recognizes a $20,000 capital gain when it discharges a portion of its guaranteed payment obligation with appreciated property ($25,000 value of Stock X – $5,000 basis in the stock). Because Charles acquired $25,000 of the Stock X in a taxable exchange for his right to a guaranteed payment, his basis in that portion of the stock is $25,000.

(ii) Because the $25,000 in cash Charles receives as an I.R.C. Section 736(b) distribution does not exceed the $40,000 basis in his partnership interest, he recognizes no gain on the distribution. The cash distribution reduces Charles's basis to $15,000 immediately before the stock is deemed distributed to him. Under I.R.C. Section 732(b), Charles's $15,000 basis in his partnership interest becomes his basis in the distributed stock.

(iii) Charles's total basis in Stock X is $40,000. This is the sum of:

- $25,000 "cost" basis he obtains in the portion of the stock he is deemed to receive in exchange for his right to the guaranteed payment; plus

- $15,000 attributable to his basis in the portion of the stock he received as a liquidating distribution for his share of partnership property.

(iv) If the partnership has an I.R.C. Section 754 basis-adjustment election in effect, its basis in the retained Stock Y decreases by $10,000 — the amount by which the distribution increased the basis of Stock X in Charles's hands.

(b) ***Treating noncash assets as distributions under I.R.C. Section 736(b), up to the value of the partner's share of partnership property before allocating any cash payments to that category.*** If the value of the noncash assets exceeds the value of the partner's share of partnership property, the additional value is classified under I.R.C. Section 736(a).

Example (2): Assume the facts in Example (1) except that the stock payment is first allocated to the I.R.C. Section 736(b) distribution portion of the transaction and the entire $50,000 cash distribution is allocated to the I.R.C. Section 736(a) guaranteed payment portion. In that case:

(i) Charles reports $50,000 of ordinary income and the partnership is allowed a corresponding deduction. Because the guaranteed payment is in cash, the partnership recognizes no gain or loss when it discharges this obligation.

(ii) The distribution under I.R.C. Section 736(b) consists solely of Stock X. Neither Charles nor the partnership recognize gain or loss, and Charles's basis in the stock is $40,000 — the basis in his partnership interest (I.R.C. Section 732(b)). Note that the distribution increases the basis of the stock from $10,000 in the partnership to $40,000 in Charles's hands.

(iii) If the partnership has an I.R.C. Section 754 basis-adjustment election in effect, its basis in the retained Stock Y decreases by $30,000 — the amount by which the distribution increases the basis of Stock X in Charles's hands.

(c) ***Treating all cash payments as distributions under I.R.C. Section 736(b), up to the value of the partner's share of partnership property before allocating any other assets to that category.*** To the extent that the value of the cash and noncash assets paid to the withdrawing partner exceed the value of his share of partnership property, the payments are classified under I.R.C. Section 736(a).

Example (3): Assume the facts in Example (1) except that the entire $50,000 cash payment is allocated to the I.R.C. Section 736(b) payment for Charles's share of partnership property.

(i) Because the $50,000 cash distribution Charles receives as an I.R.C. Section 736(b) payment exceeds the $40,000 basis in his partnership

interest, Charles recognizes a $10,000 capital gain under I.R.C. Section 731(a).

(ii) The I.R.C. Section 736(a) payment consists solely of the X Stock. The partnership recognizes $40,000 of capital gain on its transfer of the stock to satisfy its guaranteed payment obligation to Charles ($50,000 amount realized less $10,000 basis). Charles reports the $50,000 guaranteed payment as ordinary income and the partnership is allowed a corresponding deduction. Charles obtains a $50,000 "cost" basis in stock he is deemed to receive in exchange for his right to the guaranteed payment.

(2) ***The tax consequences of the portion of the payment treated as a liquidating distribution under I.R.C. Section 736(b) are determined.*** If no cash is included in this portion, the withdrawing partner does not recognize any gain, and his basis in the distributed property equals the basis in his partnership interest immediately before the distribution.[82] If the partner receives both cash and property, he first reduces the basis in his partnership interest by the amount of cash he receives (but not below zero) and recognizes gain to the extent that the cash received exceeds his basis.[83] In appropriate circumstances, the withdrawing partner may recognize a loss under I.R.C. Section 731(a)(2).

If the partnership owns substantially appreciated inventory, the disproportionate distribution rules of I.R.C. Section 751(b) may apply to the I.R.C. Section 736(b) payment. These rules apply if the partnership owns substantially appreciated inventory and the withdrawing partner receives more or less than his share of the inventory. In that case, a portion of the distribution is recharacterized as a sale.[84] (For discussion of I.R.C. Section 751(b), *see* Chapter 8.)

(a) ***If the withdrawing partner receives less than his proportionate share of the inventory, he is treated as if he received his share of the inventory and then exchanged a portion of it for the other partnership property actually distributed to him.*** The partner realizes ordinary income on the exchange, and the partnership obtains a basis in the inventory equal to its deemed purchase price.

(b) ***If the partner receives more than his share of the inventory, he is deemed to have received his share of other partnership property and exchanged it for the excess amount of partnership inventory actually distributed to him.*** The partnership realizes gain or loss on the exchange, and the partner obtains a basis equal to his deemed purchase price.

82. I.R.C. §§731, 732.
83. I.R.C. §731(a).
84. I.R.C. §751(b).

(3) ***The tax consequences of the portion treated as an I.R.C. Section 736(a) payment are determined. If the amount the partner receives is fixed, the payment is treated as a guaranteed payment.*** If it is measured by partnership income, it is treated as the partner's distributive share of partnership income.

A property transfer classified as a guaranteed payment may cause the partnership to recognize gain or loss. Because the partnership is obligated to pay a fixed value to the withdrawing partner, the partnership may recognize gain or loss when it transfers property to satisfy its guaranteed payment obligation. The partnership's gain or loss equals the difference between the amount of its obligation and the basis of the transferred property.[85] The recipient partner realizes ordinary income on the guaranteed payment and the partnership is allowed a corresponding deduction.[86]

(4) ***If a services partnership owns unrealized receivables, the tax consequences depend upon whether a withdrawing general partner receives more or less than his proportionate share of the receivables.*** A withdrawing general partner who receives less than his share is deemed to obtain other partnership property in exchange for his interest in the receivables. Property or cash a partner receives in exchange for his share of receivables is not treated as a distribution under I.R.C. Section 736(b); the property or cash is classified as an I.R.C. Section 736(a) payment.[87]

Example: Martha receives Stock X worth $50,000 and receivables worth $10,000 as a liquidating payment for her one-third interest in the MNO Services Partnership. The partnership's balance sheet is as follows:

Assets	Basis	Fair Market Value
Stock X	$30,000	$60,000
Receivables	0	120,000
	$30,000	$180,000
Partners' Capital		
Martha	$10,000	$60,000
Nathan	10,000	60,000
Olivia	10,000	60,000
	$30,000	$180,000

85. *See* Rev. Rul. 75-498, 1975-2 C.B. 29; Treas. Reg. § 1.83-6(b).
86. Treas. Reg. § 1.736-1(a)(4).
87. I.R.C. § 736(b)(2)(A).

Martha's share of partnership receivables is worth $40,000, and she receives $40,000 worth of Stock X in exchange for that share. Because the amount paid for the receivables is fixed at $40,000, this portion of the transaction is treated as a guaranteed payment under I.R.C. Section 736(a). Martha includes $40,000 in her ordinary income, and the partnership deducts that amount. The partnership satisfies its $40,000 guaranteed payment obligation with the distribution of two-thirds of its Stock X, which has a $20,000 basis (two-thirds of the basis for all the stock) and, therefore, the partnership recognizes a $20,000 capital gain. The remainder of the transaction, consisting of Stock X worth $10,000 and receivables worth $10,000 are treated as a liquidating distribution under I.R.C. Section 736(b). These transactions are summarized as follows:

	Martha's 1/3 share	§736(b)	§736(a)
Stock X	$20,000	$10,000	$0
Receivables	40,000	10,000	40,000
(2/3 Stock X)	$60,000	$20,000	$40,000

If the withdrawing partner receives more than his share of the partnership's unrealized receivables, the payment is divided into two parts:

(a) ***An amount of receivables equal to the withdrawing partner's proportionate share of the partnership's receivables.*** The partner is considered to receive this amount under I.R.C. Section 736(b) as a liquidating distribution for his share of partnership property. The partner's basis for the receivables is determined under I.R.C. Section 732(c), which provides that

(i) basis is first allocated to distributed unrealized receivables and inventory, and

(ii) the partner's basis in the receivables cannot exceed the partnership's basis immediately before the distribution.

The basis of unrealized receivables generally is zero, and the withdrawing partner recognizes ordinary income when he collects or sells the receivables.[88] (*See* Chapter 8.)

Arguably, the withdrawing partner may be considered to receive this portion of the receivables as a "payment" for his share of the partnership's unrealized receivables. Under that view, the transfer of the receivables would be treated as a guaranteed payment under I.R.C. Section 736(a). Because the partnership transfers the receivables to satisfy its guaranteed payment obligation, it recognizes gain or loss equal to the difference between the amount

88. I.R.C. §735.

of its obligation and its basis for the transferred receivables.[89] The withdrawing partner realizes ordinary income on the guaranteed payment, and the partnership is allowed a corresponding deduction.[90] This approach appears inappropriate because it requires an implausible interpretation of I.R.C. Section 736(b)(2) — that is, distribution of a partner's share of unrealized receivables is equivalent to a payment in exchange for the receivables.

(b) ***An amount of receivables in excess of the partner's share of the partnership's receivables.*** To the extent that this portion of the receivables is in exchange for the partner's interest in partnership property (i.e., a distribution under I.R.C. Section 736(b)), the transfer is subject to the disproportionate distribution rules of I.R.C. Section 751(b). (*See* Chapter 8.) The partner is treated as if he received a distribution of his proportionate share of the receivables and other property, and then he exchanged the other property for the excess amount of partnership receivables he actually received. This hypothetical exchange is a taxable transaction with the following consequences:

(i) The partnership recognizes ordinary income on the exchange of receivables for the withdrawing partner's other property.

(ii) The partnership increases or decreases the basis in the assets it is deemed to have received in the exchange — to reflect the value of the receivables transferred to the withdrawing partner.

(iii) The withdrawing partner's basis in the receivables increases-to reflect the value of the property he transferred to the partnership in the exchange.

Example: Jared receives partnership receivables worth $50,000 as a liquidating payment for his one-third interest in the JKL Partnership. The partnership's balance sheet is as follows:

Assets	Basis	Fair Market Value
Cash	$60,000	$60,000
Receivables	0	90,000
	$60,000	$150,000
Partners' Capital		
Jared	$20,000	$50,000
Karen	20,000	50,000
Lauren	20,000	50,000
	$60,000	$150,000

89. Rev. Rul. 75-498, 1975-2 C.B. 29; Treas. Reg. § 1.83-6(b).
90. Treas. Reg. § 1.736-1(a)(4).

Because the value of the property Jared receives equals the value of his share of partnership property, the entire payment is classified as a distribution under I.R.C. Section 736(b). (Because Jared does not receive any payment "in exchange for" his interest in partnership receivables, the distribution of the receivables is not an I.R.C. Section 736(a) payment.) Under I.R.C. Section 751(b), Jared is deemed to receive his share of receivables worth $30,000 and his $20,000 share of partnership cash. He is then deemed to pay the $20,000 in cash to the partnership for the $20,000 excess value of the receivables actually transferred to him. The partnership recognizes $20,000 of ordinary income on this sale, and Jared's basis in the receivables he purchased is $20,000.

Chapter 12

Foreign Partnerships, Foreign Partners, and Partnerships with Tax-Exempt Entities

§ 12.01 Introduction

Chapter 12 will focus on the problems created by the interrelationship of the rules applicable to entities taxed under Subchapter K with the U.S. rules relating to international taxation. Because the two areas are closely related, Chapter 12 will also cover the tax issues that arise in connection with partnerships that include tax-exempt entities. In addition, Chapter 12 will discuss the limitations placed upon the deductibility of losses (and the eligibility for like-kind exchange treatment) of certain partnerships with tax exempt or foreign partners.

§ 12.02 Foreign Partnerships

A. Classification

As discussed in Chapter 1, the classification of non-U.S. entities must start with the question of whether or not the entity is a business entity. The question is somewhat complicated, because the system of classification of entities in other countries is often different from that of the United States. The check-the-box Regulations provide a list of non-U.S. entities that will be treated as corporations and are not eligible to elect to be treated otherwise.[1] Thus, to discuss foreign partnerships from a U.S. tax perspective, one must first start with an entity that is not a *per se* corporation under the check-the-box Regulations.

If a non-U.S. business entity is not *per se* classified as a corporation under the check-the-box Regulations, an analysis is applied that is very similar to that applied to domestic unincorporated business entities; recall from Chapter 1, that the default classification in this case is corporate status if the owners have no personal liability for the obligations of the entity, and either partnership or disregarded entity status if at least one owner has such liability. It is far more common for owners to not

1. Treas. Reg. § 301.7701-2. For example, all Canadian companies are *per se* corporations, unless the liability of at least one member is not limited.

have liability for the obligations of the foreign entity.[2] Thus, in the typical case, a non-U.S. entity that is not a *per se* corporation may elect to be either a disregarded business entity or a partnership for U.S. tax purposes, depending upon whether the entity has one owner or more than one owner. If the entity shields its members from liability and no election is made, the entity will be treated as a corporation for U.S. federal income tax purposes. If the liability of any owner of the entity is not limited, as noted, the default classification of the entity is either as a disregarded entity, if the entity has only one owner, or as a partnership, if the entity has more than one owner.[3] Like domestic disregarded business entities and partnerships, such non-U.S. entities may elect to be treated as corporations for U.S. tax purposes.[4]

A complication in making this determination is that fact that check-the-box is gaining traction in foreign countries. For example, Germany is considering adopting a check-the-box system that would allow partnerships to choose to be taxed as (what we would call) C corporations. (Germany has no S corporation analogue.) One might have to know how the box is checked in Germany before it can be checked in the U.S.[5] At the present time, the rules have not been coordinated (just as most non-U.S. jurisdictions ignore the U.S. check-the-box election), but with increased sensitivity to hybrid entities (as discussed below), the issue may ripen.

For non-U.S. entities with U.S. taxpayers as owners, the availability of an election to choose between treatment as a corporation and treatment as a partnership has a different meaning in the context of a foreign partnership than it does in regard to a domestic partnership. In the context of a domestic partnership, the choice is generally between the flow-through treatment of Subchapter K and the entity level tax treatment of Subchapter C. In the context of a foreign partnership, the choice may be between the flow-through treatment of Subchapter K, the quasi-flow-through treatment of subpart F or the elective flow-through treatment provided for qualified electing funds under I.R.C. § 1295. For the purposes of this Chapter, we shall assume the choice has been made to elect to treat the foreign business entity as a partnership for U.S. tax purposes.

A "foreign" partnership is a partnership that is not created or organized in the United States or under the laws of the United States or any state thereof.[6] A business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity.[7]

2. Treas. Reg. §§ 301.7701-2, -3.

3. Treas. Reg. § 301.7701-3(b)(2).

4. Treas. Reg. § 301.7701-3(a).

5. *See* Koalitionsausschuss 3. Juni 2020 and https://www.ecovis.com/duesseldorf-koeln/neue-steuerliche-hilfen-in-der-corona-krise-regelungen-aus-dem-gerade-beschlossenen-konjunkturpaket-der-bundesregierung/. Maltese partnerships may elect to be taxed as companies. *See* https://www.fbsmalta.com/5485/malta-advantageous-tax.

6. I.R.C. § 7701(a)(5).

7. Treas. Reg. § 301.7701-5(a).

Example: P is an entity with more than one owner organized under the laws of Country A as an unlimited company. It is also an entity that is organized as a general partnership under the laws of U.S. State B. P has been classified as a partnership for federal tax purposes under the check-the-box Regulations. P in this example is treated as a U.S. partnership for U.S. federal tax purposes.[8]

If an entity is created or organized in more than one jurisdiction and Treas. Reg. § 301.7701-2 would classify the entity as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized, the entity is treated as a corporation for U.S. tax purposes.[9]

B. Foreign Tax Credit Rules in Regard to Foreign Partnerships

1. Generally

The United States employs a worldwide tax system under which U.S. individuals and domestic corporations generally are taxed on all income, whether derived in the United States or abroad; the foreign tax credit provided under I.R.C. § 901 allows some relief from double taxation. Subject to certain limitations, a U.S. taxpayer is allowed to claim a credit against its U.S. income tax liability for the foreign income taxes that it pays or accrues. (It is also possible to instead deduct foreign taxes from income, but, if the credit is not limited, a credit provides a greater after-tax benefit.) A "*foreign income tax*" is any income, war profits, or excess profits tax paid or accrued to any foreign country or to any U.S. possession. A "foreign income tax" includes any tax paid in lieu of such a tax within the meaning of I.R.C. § 903. A domestic corporation that owns at least 10% of the vote or value of the stock of a foreign corporation (a "*U.S. Shareholder*") is allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation that the U.S. Shareholder is deemed to have paid when the foreign corporation's earnings are included in the U.S. Shareholder's income under the provisions of subpart F.[10] Subpart F is the portion of the Code dealing with the conditions under which U.S. shareholders are required to currently include income recognized by a controlled foreign corporation. A foreign corporation is a controlled foreign corporation if more than 50% of (i) the total combined voting power of all classes of stock of such corporation entitled to vote, or (ii) the total value of the stock of such corporation, is owned or is considered as owned by United States shareholders on any day during the taxable year of such foreign corporation.[11] Controlled foreign corporations are sometimes referred to as "*CFCs*."[12]

8. Treas. Reg. § 301.7701-5(b), example 2.
9. Treas. Reg. § 301.7701-2(b)(9).
10. I.R.C. § 960.
11. I.R.C. § 957.
12. *Id. See* Treas. Reg. § 1.901-1(a).

Although partnerships cannot benefit directly from the foreign tax credit, their partners potentially are entitled to do so. The Regulations provide that a U.S. citizen, a resident alien, or a domestic corporation may claim a share of a partnership's taxes that are attributable to such person.[13] In addition, under I.R.C. § 703(b)(3), the election under I.R.C. § 901 (whether to take a credit in respect of the foreign taxes) is made by each partner separately. In Rev. Rul. 71-141,[14] the IRS held that two domestic corporations are entitled to a foreign tax credit on foreign taxes withheld on payments to a partnership which they jointly owned.

Regulations contain separate rules for allocating foreign tax credits and the expenses related to the income associated with the taxes.[15] If a domestic corporation owns an interest in a CFC through a domestic partnership, to the extent the domestic corporation is a United States shareholder with respect to the CFC, the domestic corporation is deemed to have paid foreign income taxes as if the domestic corporation had included the income from the CFC directly rather than as a distributive share of the partnership's income.[16] A domestic corporation that has a distributive share of a domestic partnership's subpart F inclusion and is also a United States shareholder with respect to the CFC that gives rise to a subpart F inclusion is treated as a subpart F inclusion of the domestic corporation for purposes of I.R.C. § 960(a).[17] Similarly, the domestic corporation's distributive share of a domestic partnership's receipt of previously taxed income is treated as a receipt by the domestic corporation directly for purposes of the tax credit rules.[18]

Allocations of creditable foreign taxes (and most other tax credits) do not have substantial economic effect within the meaning of the Regulations under I.R.C. § 704(b),[19] and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership.[20] An allocation of a creditable foreign tax expenditure ("*CFTE*") will be deemed to be in accordance with the partners' interests in the partnership if: (i) the CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) and reported on the partnership return in proportion to the distributive shares of income to which the CFTE relates; and (ii) allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs so allocated to a partner are valid.[21]

Under the so-called "technical taxpayer" rule of Treas. Reg. § 1.901-2(f)(1), the person by whom tax is considered to have been paid for purposes of I.R.C. §§ 901 and 903 is the person on whom foreign law imposes legal liability for the tax. This

13. Treas. Reg. § 1.901-1(a). See discussion at § 5.04.M.
14. 1971-1 C.B. 211.
15. Treas. Reg. § 1.861-8(e)(15); Prop. Reg. § 1.861-8(e)(6); Treas. Reg. § 1.960-3.
16. REG-105600-18, 83 Fed. Reg. 63200 (Dec. 7, 2018).
17. Treas. Reg. § 1.960-2(b)(4).
18. *See* Treas. Reg. § 1.960-3(b)(5).
19. Foreign taxes taken as credits do not reduce capital accounts.
20. Treas. Reg. § 1.704-1(b)(4)(viii)(a).
21. *Id.*

focus on legal liability applies even if another person, such as a withholding agent, actually remits the tax.[22] It also applies even if another person bears the economic burden of the tax, for example through a gross-up clause.[23]

Treas. Reg. § 1.901-2(f)(3) extends the technical taxpayer rule to situations in which more than one person is liable for a foreign income tax under the foreign law. That Regulation provides that if foreign income tax is imposed on the combined income of two or more related persons (such as a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the tax under foreign law, the foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.

In 2007, in *Guardian Industries*, U.S. Court of Appeals for the Federal Circuit held that a U.S. company that wholly owned a foreign hybrid entity (a Luxembourg company treated as a disregarded entity for U.S. tax purposes, but as a corporation for Luxembourg tax purposes) was entitled to claim a direct foreign tax credit under I.R.C. § 901 for Luxembourg taxes paid by the hybrid entity on behalf of a consolidated group of companies of which it was the parent.[24] The other Luxembourg entities that were part of the consolidated group were operating companies treated as corporations for U.S. tax purposes. The income earned by those companies was not subpart F income, and the U.S. company consequently had no current income inclusions from those other group members. However, because the Luxembourg parent company was disregarded for U.S. tax purposes, the income and expenses of the Luxembourg parent were treated as income and expenses of the U.S. corporate owner. The Luxembourg taxes paid by the hybrid entity thus were available for credit against U.S. income tax imposed on other foreign source income derived by the U.S. company.

2. Foreign Tax Credit Splitter Transactions

In reaction in part to the *Guardian Industries* case, Congress added I.R.C. § 909 to the Code in 2010. I.R.C. § 909 adopts a matching rule to prevent the separation of creditable foreign taxes from the associated foreign income.

In general, I.R.C. § 909 provides that when there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by the taxpayer, the foreign income tax is not taken into account for federal tax purposes before the taxable year in which the related income is taken into account by the taxpayer. You will recall, in the *Guardian Industries* case, the Luxembourg parent paid the taxes at a point when the U.S. parent did not have any subpart F income. Although it is

22. *See* Norwest Corp. v. Commissioner, 69 F.3d 1404 (8th Cir. 1995); Continental Illinois Corp. v. Commissioner, 998 F.2d 513 (7th Cir. 1993); Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765 (1987); Gleason Works v. Commissioner, 58 T.C. 464 (1972).

23. Treas. Reg. § 1.901-2(f)(2)(i); *cf.* Continental Illinois Corp. v. Commissioner, 998 F.2d at 516.

24. Guardian Industries Corp. v. United States, 477 F.3d 1368 (Fed. Cir. 2007).

beyond the scope of this text, a good portion of international planning is systemic arbitrage: planning to take the greatest advantage of the differences between two systems. The golden fleece is double non-inclusion: where both systems do not tax the income, but creating or using significant timing differences comes in as a close second. Because the U.S. parent was allowed to take a credit for the taxes paid by the Luxembourg parent, the U.S. parent was able to shelter other non-U.S. source income from U.S. tax. Of course, eventually, the income from the European group might have to be taken into income in the United States, but that might not be for quite some time.[25]

For purposes of the I.R.C. § 909, there is a "foreign tax credit splitting event" with respect to a foreign income tax if the related income is (or will be) taken into account for U.S. federal income tax purposes by a covered person.[26] "*Related income*" means, with respect to any portion of any foreign income tax, the income (or, as appropriate, earnings and profits), calculated under U.S. tax principles, to which such portion of foreign income tax relates. The legislative history to I.R.C. § 909 indicates that it is not intended that differences in the timing of when income is taken into account for U.S. and foreign tax purposes (*e.g.*, as a result of differences in the U.S. and foreign tax accounting rules) should create a foreign tax credit splitting event in cases in which the same person pays the foreign tax and takes into account the related income, but in different taxable periods.

A reverse hybrid (an entity that is a corporation for U.S. purposes but a flow-through for non-U.S. purposes) is a splitter arrangement when a payor pays or accrues foreign income taxes with respect to income of the reverse hybrid.[27]

An entity treated as a partnership by both jurisdictions may still create a splitter arrangement if the non-U.S. tax is attempted to be allocated differently from the income upon which it was imposed. An allocation of foreign income tax paid or accrued by a partnership with respect to an inter-branch payment is a splitter arrangement to the extent the inter-branch payment tax is not allocated to the partners in the same proportion as the distributive shares of income in the creditable foreign tax expenditure ("*CFTE*") category to which the inter-branch payment tax is or would be assigned under Treas. Reg. § 1.704-1(b)(4)(viii)(d) without regard to Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3).[28]

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25. This is one of the reasons why the GILTI rules, discussed below, were adopted.

26. With respect to any person who pays or accrues a foreign income tax (the "*payor*"), a "covered person" is: (1) any entity in which the payor holds, directly or indirectly, at least a 10% ownership interest (determined by vote or value); (2) any person that holds, directly or indirectly, at least a 10% ownership interest (determined by vote or value) in the payor; (3) any person that bears a relationship to the payor described in I.R.C. § 267(b) or 707(b) (including by application of the constructive ownership rules of I.R.C. § 267(c)); and (4) any other person specified by the Treasury. Accordingly, the Treasury may issue Regulations that treat an unrelated counterparty as a covered person in certain transactions deemed abusive.

27. Treas. Reg. § 1.909-2(b)(1).

28. Treas. Reg. § 1.909-2(b)(4).

In the case of a partnership, I.R.C. § 909's matching rule is applied at the partner level, and a similar rule applies in the case of any S corporation or trust.[29]

As mentioned before, allocations of creditable foreign taxes do not have substantial economic effect and, accordingly, such expenditures must be allocated in accordance with the partners' interests in the partnership.[30] An allocation of a CFTE will be deemed to be in accordance with the partners' interests in the partnership if (1) the CFTE is allocated (whether or not pursuant to an express provision in the partnership agreement) to each partner and reported on the partnership return in proportion to the partners' CFTE category shares of income to which the CFTE relates; and (2) allocations of all other partnership items that, in the aggregate, have a material effect on the amount of CFTEs allocated to a partner are valid.[31] A CFTE is related to income in a CFTE category if the income is included in the base upon which the foreign tax is imposed.[32]

C. U.S. Participation Exemption

Although historically, the foreign tax credit has been the primary method under the U.S. system for avoiding double taxation in international transactions and structures, the TCJA added a participation exemption to the Code, which may be of increasing importance in the future. Participation exemptions have been used in a number of countries to create or support a territorial or quasi-territorial system. Although prior to the TCJA, there was a great deal of discussion of the United States moving to a territorial system, the final approach of the TCJA was to layer the participation exemption on top of the existing U.S. worldwide system.

The participation exemption comes in the form of a deduction for dividends paid from non-U.S. corporations. Under the provision, a U.S. corporation that is a U.S. shareholder of a 10% owned non-U.S. corporation (other than a passive foreign investment company) may now take a deduction for the non-U.S. source portion of any dividend received from the 10% owned non-U.S. corporation.[33] A U.S. shareholder is a U.S. person that owns 10% or more of the vote or value of all classes of stock of the non-U.S. corporation after the application of certain attribution rules.[34] The non-U.S.-source portion of the dividends are dividends other than dividends attributable to a U.S. trade or business or dividends received from an 80% owned U.S. corporation.[35] The non-U.S. portion of the dividend is equal to the ratio of the undistributed non-U.S. earnings of the non-U.S. corporation compared to the

29. Treas. Reg. § 1.909-1(b).

30. Treas. Reg. § 1.704-1(b)(4)(viii)(a).

31. *Id.*

32. Treas. Reg. § 1.704-1(b)(4)(viii)(d).

33. I.R.C. § 245A(a). A deduction for the U.S. source portion is separately available. I.R.C. § 245.

34. I.R.C. § 951(b): Conference Report to Accompany H.R. 1, 115 Cong. 1st Sess., Rep. 115-466, p. 597 (15 Dec. 2017).

35. I.R.C. § 245A(c).

non-U.S. corporation's entire undistributed earnings multiplied by the amount of the dividend.[36]

For some purposes with regard to the participation exemption, if an I.R.C. § 245A shareholder or a U.S. tax resident is a direct or indirect partner in a domestic partnership that is a United States shareholder with respect to a CFC and includes in gross income its pro rata share of the CFC's subpart F income under I.R.C. § 951(a), then, solely for purposes of I.R.C. § 245A, a reference to the I.R.C. § 245A shareholder's or U.S. tax resident's pro rata share of the CFC's subpart F income included in gross income under I.R.C. § 951(a) includes such person's distributive share of the domestic partnership's pro rata share of the CFC's subpart F income.[37] A person is an indirect partner with respect to a domestic partnership if the person indirectly owns the domestic partnership through one or more specified entities (other than a foreign corporation).

However, the Treasury has expressed concern that partnerships may be used to avoid the purposes of the Regulations and indicated that further guidance will be provided on the application of I.R.C. § 245A to partnerships.

D. Controlled Foreign Corporations as Partners in Foreign Partnerships

U.S. shareholders of a foreign corporation of which more than 50% of the total combined voting power of all classes of stock, or more than 50% of the total value of the stock, of the corporation is held or is considered as held by U.S. shareholders (a "*CFC*") are generally required to include in their gross income their pro rata share of certain types of income of the foreign corporation in the year such income is earned, whether or not such income is distributed to the U.S. shareholder.[38]

A "*U.S. shareholder*" for these purposes is a shareholder that owns or is considered as owning 10% or more of the total combined voting power of all classes of stock of the relevant foreign corporation or 10% or more of the total value of shares of all classes of stock of such foreign corporation. Current Regulations would treat a U.S. partnership as an owner and, potentially, a 10% shareholder, so a partner in a U.S. partnership could potentially be required to include income from the CFC even though the partner's indirect interest was very small.[39] Non-U.S. partnerships, on the other hand, are given aggregate treatment.[40] In other words, a partner that only held 5% of a CFC (directly and indirectly) would not have income inclusions, because the partner would not be a U.S. shareholder (which requires 10%). Proposed

36. I.R.C. § 245A(c)(3).
37. Treas. Reg. § 1.245A-5T(g)(6).
38. I.R.C. § 951.
39. Treas. Reg. § 1.951-1(g). A U.S. partnership is a U.S. person. I.R.C. § 7701(a)(30).
40. Treas. Reg. § 1.958-1(b).

Regulations would also apply aggregate treatment to U.S. partnerships for the purposes of I.R.C. § 951, which requires U.S. shareholders to have income inclusions, but not for the purposes of determining whether a person was a U.S. shareholder or whether the corporation was a CFC.[41] Thus, a U.S. partnership that owned more than 10% of a CFC would still be a U.S. shareholder.

The income required to be included in the U.S. shareholder's income includes (among other things) insurance income, certain types of passive income (called foreign personal holding company income), foreign base company service income, and foreign base company sales income.[42]

Foreign personal holding company income includes (among other things) dividends, interest, royalties, rents, and annuities and the excess of gains over losses from the sale or exchange of property: (i) which gives rise to dividends, interest, royalties, rents, and annuities, (ii) which is an interest in a trust, partnership, or REMIC, or (iii) which does not give rise to any income.[43] In the case of any sale by a CFC of an interest in a partnership with respect to which such corporation is a 25% owner of an interest in the capital or profits of the partnership, such corporation is treated as selling the proportionate share of the assets of the partnership attributable to such interest.[44]

"*Foreign base company services income*" means income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services that are performed on behalf of any related person, and are performed outside the country in which the CFC is organized.[45]

"Foreign base company sales income" means income derived in connection with: (a) (i) the purchase of personal property from a related person and its sale to any person, (ii) the sale of personal property to any person on behalf of a related person, (iii) the purchase of personal property from any person and its sale to a related person, or (iv) the purchase of personal property from any person on behalf of a related person, if (b) (i) the property so purchased or sold was not manufactured in the country in which the CFC is organized, and (ii) the property is purchased or sold for use, consumption, or disposition outside of the country in which the CFC is organized.[46]

In some circumstances, branches of CFCs may be treated as separate corporations. If a CFC conducts sales or purchasing activity outside its country of organization through a branch, and the use of a branch for such operations has substantially the

41. Prop. Reg. § 1.958-1(d).
42. I.R.C. § 952.
43. I.R.C. § 954(c)(1).
44. I.R.C. § 954(c)(4)(A).
45. I.R.C. § 954(e).
46. I.R.C. § 954(d)(1).

same effect as the use of a separate corporation, the branch is treated as if it were a separate corporation.[47]

Although, as just noted, the CFC rules may treat a branch as a separate entity in some circumstances, in other situations, the CFC rules apply an aggregate theory of partnerships. A CFC's distributive share of any item of partnership income must be included in the income of a U.S. shareholder if the income would have been required to be included in the U.S. shareholder's income if the income had been received directly by the CFC.[48] Similarly, to determine whether an entity is a related person and whether an activity occurred within or outside the country under the laws of which the CFC is created or organized, the determination is made by reference to the CFC and not by reference to a partnership in which the CFC is a partner.[49] Also, a sale to or purchase from a partnership by a CFC will be treated as a transaction with a related entity if the CFC purchases the property from or sells the property to a person that is related to the CFC other than the partnership. A transaction will also be treated as being made with a related entity in the case where the partnership purchases personal property from (or sells personal property on behalf of) the CFC and the branch rule of I.R.C. § 954(d)(2) applies to treat the income of the CFC from selling personal property that the CFC has manufactured to the partnership (or a third party) as foreign base company income.[50]

Example: CFC, a CFC organized in Country A, is an 80 percent partner in MJK Partnership, a Country B partnership. CFC purchased goods from J Corp, a Country C corporation that is a related person with respect to CFC. CFC sold the goods to MJK Partnership. In turn, MJK Partnership sold the goods to P Corp, a Country D corporation that is unrelated to CFC. P Corp sold the goods to unrelated customers in Country D. The goods were manufactured in Country C by persons unrelated to J Corp. CFC's distributive share of the income of MJK Partnership from the sale of goods to P Corp will be treated as income from the sale of goods purchased from a related person for purposes of I.R.C. § 954(d)(1) because CFC purchased the goods from J Corp, a related person. Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of the income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to MJK Partnership will also be foreign base company sales income.[51]

In contrast with the applications of the aggregate theory of partnerships just described, in some places, the CFC rules apply a hybrid entity-aggregate theory. In

47. I.R.C. § 954(d)(2).

48. In other words, the test is applied as if the CFC owned the right to income directly rather than through the partnership. Treas. Reg. § 1.952-1(g)(1).

49. Treas. Reg. § 1.954-1(g)(1).

50. Treas. Reg. § 1.954-1(g)(2).

51. Treas. Reg. § 1.954-1(g)(3), example 3.

determining whether property sold by a partnership is considered to be manufactured, produced, or constructed by the CFC, the exclusion from foreign base company sales income for manufacturing, producing, or constructing personal property applies to exclude the income from foreign base company sales income if the CFC had earned the income directly, taking into account only the activities of, and property owned by, the partnership.[52]

> *Example*: CFC, a CFC organized under the laws of Country A, is an 80 percent partner in Partnership X, a partnership organized under the laws of Country B. Partnership X performs activities in Country B that would constitute the manufacture of Product O, if performed directly by CFC. Partnership X, through its sales offices in Country B, then sells Product O to Corp D, a corporation that is a related person with respect to CFC, within the meaning of I.R.C. § 954(d)(3), for use within Country B. CFC's distributive share of Partnership X's sales income is not foreign base company sales income because the manufacturing exception of Treas. Reg. § 1.954-3(a)(4) would have applied to exclude the income from foreign base company sales income if CFC had earned the income directly.[53]

The global intangible low-taxed income (GILTI) tax adds another layer of worldwide taxation to the U.S. system to provide a minimum tax for types of income that may have escaped subpart F.

Under I.R.C. § 951A, a U.S. shareholder of any CFC must include in gross income for a taxable year its GILTI in a manner generally similar to inclusions of subpart F income. GILTI means the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.[54]

Net CFC tested income means, with respect to any U.S. shareholder, the excess of the aggregate of the shareholder's pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a U.S. shareholder.[55] Pro rata shares are determined under the rules of I.R.C. § 951(a)(2).[56]

The tested income of a CFC means the excess (if any) of the gross income of a corporation — determined subject to certain exclusions — over deductions (including taxes) properly allocable to such gross income.[57] The exclusions to tested income are: (1) the corporation's items of income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States ("*ECI*") under I.R.C. § 952(b); (2) any gross income taken into account in determining the corporation's subpart F income; (3) any gross

52. Treas. Reg. § 1.954-3(a)(6).
53. Treas. Reg. § 1.954-3(a)(6)(ii).
54. I.R.C. § 951A(b)(1).
55. I.R.C. § 951A(c).
56. I.R.C. § 951A(e)(1).
57. I.R.C. § 951A(c)(2)(A).

income excluded from foreign base company income or insurance income by reason of the high-tax exception under I.R.C. § 954(b)(4); (4) any dividend received from a related person (as defined in I.R.C. § 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in I.R.C. § 907(c)(1)).[58]

The shareholder's net deemed tangible income return is an amount equal to 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("*QBAI*") of each CFC with respect to which it is a U.S. shareholder. QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under I.R.C. § 167.[59] Specified tangible property means any property used in the production of tested income.[60] If such property was used in the production of both tested income and income that is not tested income (*i.e.*, dual-use property), the property is treated as specified tangible property in the same proportion that the amount of tested gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.[61]

I.R.C. § 951A(d)(3)1 (the "*partnership QBAI paragraph*") states that if a CFC holds an interest in a partnership at the close of the CFC's taxable year, the CFC takes into account under I.R.C. § 951A(d)(1) its "distributive share of the aggregate of the partnership's adjusted bases (determined as of such date in the hands of the partnership)" in specified tangible property in computing its QBAI. The partnership QBAI paragraph further provides that a CFC's "distributive share of the adjusted basis of any property shall be the controlled foreign corporation's distributive share of income with respect to such property."

If a CFC has investments in U.S. property at the end of any quarter, a proportionate part of any earnings and profits of the CFC that are not otherwise required to be included in the U.S. shareholders' income may be required to be included in the income of the U.S. shareholders up to such shareholders' pro rata shares of such investment.[62] For the purposes of determining whether a CFC has an investment in U.S. property, if a CFC is a partner in a partnership that owns property that would be U.S. property if owned directly by the CFC, the CFC is treated as holding an

58. I.R.C. § 951A(c)(2)(A)(i).

59. I.R.C. § 951A(d)(1).

60. I.R.C. § 951A(d)(2)(A).

61. I.R.C. § 951A(d)(2)(B).

62. I.R.C. § 956(a). The Regulations allow a reduction of the I.R.C. § 956 inclusion to the extent that a recipient would have been allow a dividends received deduction from foreign income had the earnings actually been distributed. Treas. Reg. § 1.956-1(a)(2). See discussion of participation exemption, above. Regulations also deny a foreign tax credit for an I.R.C. § 956 inclusion. Reg. § 1.960-1(a)(1); TD 9882, 84 Fed. Reg. 69022, 69046 (Dec. 17, 2019).

interest in the property equal to its interest in the partnership and such interest is treated as an interest in U.S. property.[63]

> *S*, a wholly owned Country *X* subsidiary of *P*, a domestic corporation, is a CFC. *S* reports its income on a calendar year basis. *S* is not engaged in any United States business activity and does not earn any income that is effectively connected with a United States trade or business. *PRS*, an entity classified as a partnership for United States Federal tax purposes, is organized under the laws of Country *X*. *S* owns a 25 percent interest in the capital and profits of *PRS*, which it purchased in 1987. The remaining 75 percent interest in *PRS* is owned by an unrelated Country *X* corporation. In 1988, *PRS* purchased undeveloped land in the United States. The land is not subject to any mortgages or other liabilities.
>
> For purposes of I.R.C. § 956, *S* is considered to hold on the last day of its 1988 taxable year, a 25 percent interest in the undeveloped land that is owned by *PRS* on such date. The amount taken into account, for purposes of I.R.C. § 956, with respect to *S*'s 25 percent interest in the undeveloped land will be 25 percent of *PRS*'s adjusted basis in the land, limited by *S*'s total basis in *PRS*. The result would be the same if *PRS* were a domestic partnership.[64]

The Treasury has also proposed regulations that would treat the non-subpart F income of a CFC as subpart F income under certain circumstances if a hybrid branch payment is made that reduces a foreign tax and falls within a category of foreign personal holding company income.[65] A hybrid branch payment means the gross amount of any payment (including an accrual) that under the tax laws of any foreign jurisdiction to which the payor is subject is regarded as a payment between two separate entities, but is regarded under U.S. income tax rules as not income to the recipient because the payment is treated as being made between two parts of a single entity.[66] The rules relating to hybrid branches may also apply to payments between a partnership and a hybrid branch under certain circumstances.[67]

Regulations treat property acquired by a partnership that is controlled by a CFC as U.S. property held indirectly by the CFC if the property would be U.S. property if it had been held directly by the CFC and a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the partnership is the avoidance of the application of I.R.C. § 956.[68] For such purposes, a CFC controls a partnership if the CFC and the partnership are related for the purposes of I.R.C. § 267(b) or I.R.C. § 707(b).

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63. Treas. Reg. § 1.956-2(a)(3); Rev. Rul. 90-112, 1990-2 C.B. 186.
64. Rev. Rul. 90-112, 1990-2 C.B. 186.
65. Prop. Reg. § 1.954-9(a).
66. Prop. Reg. § 1.954-9(a)(6).
67. Prop. Reg. § 1.954-9(a)(2)(ii).
68. Treas. Reg. § 1.956-1(b)(1)(iii).

In addition, in general, for purposes of I.R.C. §956, an obligation of a foreign partnership is treated as a separate obligation of each of the partners in the partnership to the extent of each partner's share of the obligation.[69] However, this rule does not apply if neither the lending CFC nor any person related to the lending CFC is a partner in the partnership.[70]

E. U.S. Source of Income Rules in Regard to Foreign Partnerships

I.R.C. §861 generally defines payments of interest by noncorporate residents to be from U.S. sources.[71] Residents, for these purposes, generally include a foreign partnership that at any time during its taxable year is engaged in a trade or business in the United States.[72] However, in the case of a foreign partnership that is predominantly engaged in the active conduct of a trade or business outside of the United States, any interest paid by such partnership that is not paid by a trade or business engaged in by the partnership in the United States, and is not allocable to income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, is not treated as being from U.S. sources.[73]

Historically, the amount of U.S. withholding on payments to foreign partnerships, after the application of the hybrid entity rules discussed below, turned on the delivery of a U.S. Form W-8IMY by the partnership and U.S. Forms W-8BEN by the partners.

In 2010, Congress added I.R.C. §§1471 through 1474 (the Foreign Account Tax Compliance Act or "FATCA rules"), which add an alternative system of withholding on payments to foreign partnerships. The FATCA rules may impose a 30% withholding tax on withholdable payments made to non-U.S. persons (including foreign partnerships). The details of the FATCA rules are discussed in greater detail in §12.04.C, below. In part to simplify the documentation that investors need to provide, the U.S. Form W-8 series has been substantially revised so that they now include disclosures both for traditional U.S. withholding and for FATCA withholding. A foreign partnership would still, generally, provide a U.S. Form W-8IMY, but its non-U.S. partners would provide Form W-8BEN-E, if they are not individuals, or Form W-8BEN, if they are individuals, in most situations.

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69. Treas. Reg. §1.956-4(c)(1).
70. Treas. Reg. §1.956-4(c)(2).
71. I.R.C. §861(a).
72. Treas. Reg. §1.861-2(a)(2).
73. I.R.C. §861(a)(1)(C).

F. The Hybrid Entity Treaty Rules

The U.S. tax imposed on payments to foreign persons of items of income received by an entity that is fiscally transparent under the laws of the United States and/or any other jurisdiction is eligible for a reduction of U.S. tax under the terms of a U.S. income tax treaty only if the item of income is derived by a resident of the applicable treaty jurisdiction.[74] For these purposes, an entity is treated as being fiscally transparent if a holder of an equity interest in the entity is required to take into account the income of the entity on a current basis (whether or not the income is distributed) and the character and source of the income is determined as if the income were realized directly by the interest holder from the source of the income to the entity.[75] An item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity, or both. An item of income is considered to be derived by the entity only if the entity is not fiscally transparent under the laws of the entity's jurisdiction. An item of income paid to the entity is considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction, and the entity is fiscally transparent in the interest holder's jurisdiction.

An income tax treaty may not apply to reduce the amount of U.S. federal income tax on U.S.-source payments received by a domestic reverse hybrid entity. A domestic reverse hybrid entity is a domestic entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the interest holder's jurisdiction, with respect to the item of income received by the domestic entity.[76] The foreign interest holders of a domestic reverse hybrid entity are not entitled to the benefits of a reduction of U.S. income tax under an income tax treaty on items of income received from U.S. sources by such entity.

For example, if A and B, both residents of Canada, formed a Delaware limited partnership AB, and AB elected to be taxed as a corporation in the United States, AB would not be fiscally transparent for U.S. tax purposes, but would be fiscally transparent for Canadian tax purposes. A and B would not be eligible for treaty benefits on payments to AB.

Similarly, subject to some exceptions, an item of income paid by a domestic reverse hybrid entity to an interest holder in such entity has the character of such item of income under U.S. law and is considered to be derived by the interest holder, provided the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income. In determining whether the interest holder is fiscally transparent with respect to the item of income for treaty purposes, the determination is

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74. Treas. Reg. §1.894-1(d)(1). In some cases, these rules are modified by the treaty itself. *See, e.g,* Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital as entered into force August 16, 1984, and as amended by Protocols signed June 14, 1983, March 28, 2984, July 29, 1997, and September 21, 2007.

75. Treas. Reg. §1.894-1(d)(3).

76. Treas. Reg. §1.894-1(d)(2).

to be made based on the treatment that would have resulted had the item of income been paid by an entity that is not fiscally transparent under the laws of the interest holder's jurisdiction with respect to any item of income.

Separately, as discussed in §12.04.D, below, payments to a hybrid entity may not be deductible under U.S. domestic law.

G. Transfers to Partnerships with Related Foreign Partners

1. General Rules

In Chapter 2, we discussed the general rule under I.R.C. §721(a) that a transfer to partnership in exchange for a partnership interest does not result in gain or loss to the partnership or the contributing partner. Treas. Reg. §1.721(c)-2 provides a rule that overrides I.R.C. §721(a) nonrecognition of gain upon a contribution of I.R.C. §721(c) property to an I.R.C. §721(c) partnership.[77] In general, I.R.C. §721(c) property is property with built-in gain that is contributed to a partnership by a U.S. transferor.[78] Certain property is excluded: Cash equivalents, securities, tangible property with a book value that exceeds the adjusted tax basis by no more than $20,000, and a "section 465(c)(2) security." Also excluded is an interest in a partnership in which 90% or more of the property (measured by value) held by the partnership (directly or indirectly) consists of excluded property.[79]

Except as allowed under the gain deferral method, described below, Treas. Reg. §1.721(c)-2(b) provides that nonrecognition under I.R.C. §721(a) will not apply to gain realized upon a contribution of I.R.C. §721(c) property to an I.R.C. §721(c) partnership. An I.R.C. §721(c) partnership is any U.S. or non-U.S. partnership if there is a contribution of I.R.C. §721(c) property to the partnership and, after the contribution and all transactions related to the contribution, (a) a non-U.S. person related to the U.S. transferor is a direct or indirect partner in the partnership, and (b) the U.S. transferor and related persons own 80% or more of the interests in partnership capital, profits, deductions, *or* losses.[80] Nonrecognition under I.R.C. §721(a) continues to apply—to a direct contribution of I.R.C. §721(c) property by an "unrelated" U.S. transferor (in other words, a U.S. transferor that does not, together with related persons with respect to it, satisfy the ownership requirement).

Treas. Reg. §1.721(c)-2(c) provides a de minimis exception to the general rule. Under the de minimis exception in the Regulations, contributions of I.R.C. §721(c) property will not be subject to immediate gain recognition if the sum of all built-in

77. *See* Thomas Horst, *Using Partnerships to Avoid U.S. Tax on the Expatriation of Intangibles*, 167 Tax Notes 2257 (June 29, 2020).

78. Treas. Reg. §1.721(c)-1(b)(15).

79. Treas. Reg. §1.721(c)-1(b)(6).

80. Treas. Reg. §1.721(c)-1(b)(14).

gain for all I.R.C. § 721(c) property contributed to an I.R.C. § 721(c) partnership during the partnership's taxable year does not exceed $1 million.

Treas. Reg. § 1.721(c)-2(d)(1) provides a look-through rule for identifying an I.R.C. § 721(c) partnership when an upper-tier partnership in which a U.S. transferor is a direct or indirect partner contributes property to a lower-tier partnership. For purposes of determining if the lower-tier partnership is an I.R.C. § 721(c) partnership, the U.S. transferor will be treated as contributing to the lower-tier partnership its share of the property actually contributed by the upper-tier partnership to the lower-tier partnership. If the lower-tier partnership is an I.R.C. § 721(c) partnership, the upper-tier partnership will recognize the entire built-in gain in the I.R.C. § 721(c) property under the general gain recognition rule, because the entire property will be I.R.C. § 721(c) property (absent application of the gain deferral method by the lower-tier partnership to the entire property and by the upper-tier partnership to the partnership interest in the lower-tier partnership).

2. *Gain Deferral Method*

Treas. Reg. § 1.721(c)-3 describes the gain deferral method, which generally must be applied in order to avoid the immediate recognition of gain upon a contribution of I.R.C. § 721(c) property to an I.R.C. § 721(c) partnership. There are five general requirements under Treas. Reg. § 1.721(c)-3(b) for applying the gain deferral method to an item of I.R.C. § 721(c) property. First, the I.R.C. § 721(c) partnership must adopt the remedial allocation method for the purposes of I.R.C. § 704(c)[81] and allocate I.R.C. § 704(b) items of income, gain, loss, and deduction with respect to the I.R.C. § 721(c) property in a manner that satisfies the consistent allocation method, described below. Second, the U.S. transferor must recognize gain equal to the remaining built-in gain with respect to the I.R.C. § 721(c) property upon an acceleration event, or an amount of gain equal to a portion of the remaining built-in gain upon a partial acceleration event or certain transfers to foreign corporations described in I.R.C. § 367. Third, certain procedural and reporting requirements are satisfied. Fourth, the U.S. transferor extends the period of limitations on assessment of tax. Fifth, the rules for tiered partnerships are also applied.

Treas. Reg. § 1.721(c)-3(c)(1) describes the consistent allocation method, which, like the gain deferral method, applies on a property-by-property basis. The consistent allocation method requires an I.R.C. § 721(c) partnership to allocate the same percentage of each book item of income, gain, deduction, and loss with respect to the I.R.C. § 721(c) property to the U.S. transferor.

81. *See* § 5.05.

3. *Acceleration Events*

Treas. Reg. § 1.721(c)-4 provides rules regarding acceleration events, which, like the gain deferral method, apply on a property-by-property basis. When an acceleration event occurs with respect to I.R.C. § 721(c) property, remaining built-in gain in the property must be recognized, and the gain deferral method no longer applies. An acceleration event with respect to I.R.C. § 721(c) property is any event that either would reduce the amount of remaining built-in gain that a U.S. transferor would recognize under the gain deferral method if the event had not occurred or could defer the recognition of the remaining built-in gain.[82] An acceleration event includes a contribution of I.R.C. § 721(c) property to another partnership by an I.R.C. § 721(c) partnership and a contribution of an interest in an I.R.C. § 721(c) partnership to another partnership.

§ 12.03 U.S. Partnerships with Foreign Partners

A. General Rules Relating to U.S. Taxation of Foreign Persons

The United States taxes the income of nonresident foreign persons if the income is fixed, determinable, annual or periodic ("*FDAP Income*") from U.S. sources, or is effectively connected with the conduct of a trade or business in the United States.[83] FDAP Income includes, among other things, interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. Capital gains of nonresident foreign individuals (other than from the disposition of a U.S. real property interests) are taxed in the United States only if the person is in the United States for 183 days or more or the gains are effectively connected with a U.S. trade or business.[84]

U.S.-source FDAP Income is generally subject to tax at a rate of 30% of the gross amount of the payment.[85] However, the amount of the tax is subject to change by any applicable tax treaty, and a number of items have independent exceptions that may cause FDAP Income to be excluded from U.S. tax. For example, although interest earned by a foreign person is nominally subject to a 30% tax, interest (other than effectively connected interest) is generally excluded from U.S. tax by the exceptions for portfolio debt investments. Interest that is effectively connected to a U.S. trade or business is subject to tax at the regular graduated tax rates.[86]

82. Treas. Reg. § 1.721(c)-4(b).
83. I.R.C. §§ 871, 881, 882.
84. I.R.C. § 871(a)(2).
85. I.R.C. §§ 871(a), 881(a).
86. I.R.C. §§ 871(h), 881(c).

In contrast, foreign persons engaged in a U.S. trade or business are generally taxable on the taxable income (as opposed to gross income) effectively connected with the U.S. trade or business at the graduated rates provided in I.R.C. §§1 and 11. Tax treaties may also exclude from U.S. tax income of a foreign person that is effectively connected to a U.S. trade or business, but the treaty exclusions would generally only apply if the foreign person does not have a permanent establishment in the United States, such as an office or other fixed place of business.[87] If a foreign person is a partner in a partnership that is engaged in a U.S. trade or business, the foreign person will also be viewed as being engaged in a U.S. trade or business.[88]

For example: P is a service partnership that is organized under the laws of Delaware. P has offices in Germany and the United States. Its U.S. office is a permanent establishment for purposes of the applicable treaty. P is comprised of two partners: A, a nonresident alien individual who is a resident of Germany under Article 4 of the Treaty, and B, a U.S. resident. A performs services solely at P's office in Germany and B performs services solely at P's office in the United States. A and B agree to divide the profits of the partnership equally.

A is treated as having a permanent establishment regularly available to him in the United States and is subject to U.S. net income taxation on his allocable share of income from P to the extent that such income is attributable to P's fixed base in the United States, without regard to whether A performs services in the United States.[89]

The effecting of stock or securities transactions through a resident broker, commission agent, custodian, or other independent agent does not generally cause a taxpayer to be treated as engaging in a trade or business in the United States.[90] Similarly, trading in stocks or securities by a taxpayer for the taxpayer's own account is not generally engaging in a trade or business in the United States.[91] The latter statement is true also if the taxpayer is a partner in a partnership that effectuates trades for its own account.[92]

However, whether foreign investors in a U.S. real estate partnership are viewed as engaged in a U.S. trade or business may be not entirely clear during the life of the

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87. For these purposes, the permanent establishment of a partnership in the United States is attributable to foreign partners. Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962).

88. I.R.C. §875.

89. Rev. Rul. 2004-3, 2004-1 C.B. 486.

90. I.R.C. §864(b)(2)(A)(i). This exclusion does not apply if the taxpayer has an office or other fixed place of business in the United States through which, or by direction of which, the transactions are effected. I.R.C. §864(b)(2)(C).

91. I.R.C. §864(b)(2)(A)(ii). This exception does not apply in the case of a dealer in stocks or securities.

92. Treas. Reg. §1.864-2(c)(2)(ii).

partnership.[93] Where real estate is leased, but not on a net lease basis,[94] some courts have been able to infer trade or business activity. One court found that the activity of being a lessor (other than on a net lease) necessarily:

> involved alterations and repairs commensurate with the value and the number of buildings cared for and such transactions as were necessary to constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind of which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business.[95]

However, the rule that a lease (other than a net lease) will constitute a U.S. trade or business has not been applied uniformly. For example, in *Herbert v. Commissioner*,[96] the court found that an elderly English woman was not engaged in a U.S. trade or business in spite of the fact that the lease of the U.S. property that she owned obligated her to make major repairs, and pay insurance, taxes, and interest. The court cited *Pinchot* but relied primarily on a prior case dealing with another elderly English woman who (in regard to a net lease) had been found not to be engaged in a U.S. trade or business.[97]

In regard to net leases, a more general rule of not treating the lessor as engaged in a U.S. trade or business has developed. In Rev. Rul. 73-522,[98] where a foreign taxpayer owned rental property situated in the United States that was subject to long-term net leases, and the taxpayer was in the United States for only one week, the taxpayer was not engaged in a trade or business in the United States.

U.S. partnerships must generally withhold on FDAP Income from U.S. sources under I.R.C. §§ 1441, 1442, and 1443.[99] Withholding in respect of dispositions of U.S. real property interests is generally governed by I.R.C. § 1445.[100] Income that is effec-

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93. On the ultimate sale or disposition of the U.S. real property interests held by the venture, I.R.C. § 897 will statutorily cause any gain to be treated as if it were effectively connected with a U.S. trade or business.

94. A net lease is a lease in which the tenant is responsible for some or all of the expenses of maintaining and operating the property, usually including taxes, interest, insurance, and maintenance.

95. Pinchot v. Commissioner, 113 F.2d 718, 719 (2d Cir. 1940).

96. 30 T.C. 26 (1958).

97. Neill v. Commissioner, 46 B.T.A. 197 (1942).

98. 1973-2 C.B. 226.

99. Treas. Reg. § 1.1441-5.

100. The withholding obligations under I.R.C. § 1445 are not discussed in this chapter because the Regulations under I.R.C. § 1446 provide that satisfaction of the rules under such Regulations satisfy the obligations under I.R.C. § 1445. A disposition of a partnership interest by a foreign partner may still be subject to withholding under I.R.C. § 1445, because no I.R.C. § 1446 withholding would occur on such a transaction. *See* I.R.C. § 897(g).

tively connected with a U.S. trade or business is, on the other hand, subject to withholding by the partnership under I.R.C. § 1446.

B. Withholding Obligations in Regard to FDAP Income

U.S. partnerships are required to withhold 30% of the gross amount of a nonresident foreign partner's distributive share of fixed or determinable annual or periodic income, whether or not such income is distributed,[101] unless the partner qualifies for a specific exception in the Code or the Regulations. Such withholding is not required in respect of income to the extent such income is exempt from withholding or subject to reduced withholding because of a treaty.[102]

As to the withholding obligation on interest payments, the Code provides for a broad exception from withholding if the recipient of the interest is not a bank, a controlled foreign corporation related to the borrower or a 10% shareholder of the borrower.[103] The IRS and Treasury have clarified that for the purposes of the 10% shareholder rule, if the debt is held by a partnership, the 10% shareholder exclusion is tested at the level of the partner rather than the level of the partnership.[104] This means that a partnership that was widely held could theoretically own 100% of the stock of a borrower from the partnership and still qualify for the portfolio interest exception.

C. Withholding in Regard to Income Effectively Connected with a U.S. Trade or Business

As mentioned above, I.R.C. § 1446, in general, requires a partnership that has income that is effectively connected with a U.S. trade or business to withhold on the portion of such income that is allocable to any foreign partner. The withholding obligation applies to any income that is treated as effectively connected income, including partnership income subject to a partner's election under I.R.C. § 871(d) or I.R.C. § 882(d) to treat real property income as effectively connected with a U.S. trade or business, or income from the disposition of interests in U.S. real property.[105] A foreign partner's allocable share of partnership effectively connected income does not include income or gain that is excluded from U.S. tax by reason of a provision of the Code.[106] Similarly, withholding under I.R.C. § 1446 does not apply to income or gain that is exempt from U.S. tax by operation of any U.S. income tax treaty or other

101. Treas. Reg. § 1.1441-5(b)(2).
102. Treas. Reg. § 1.1441-6.
103. I.R.C. §§ 871(h), 881(c).
104. Treas. Reg. § 1.871-14(g)(3).
105. Treas. Reg. § 1.1446-2(b)(2)(ii); *see* I.R.C. § 897. A partner that makes an election under I.R.C. § 871(d) or I.R.C. § 882(d) is required to furnish the partnership a statement that the election has been made. Treas. Reg. § 1.1446-2(b)(2)(ii).
106. Treas. Reg. § 1.1446-2(b)(2)(iii).

reciprocal agreement. In calculating a foreign partner's share of effectively connected income for purposes of determining the withholding obligation of the partnership, certain deductions, losses, and credits ordinarily allowable are not included or are required to be recalculated.[107]

The Code provides that the withholding on effectively connected income of foreign partners will be applied at the highest rate specified in I.R.C. § 1 or I.R.C. § 11, as applicable.[108] The Regulations interpret this requirement to generally permit the partnership to apply the highest rate of tax applicable to a particular type of income or gain.[109] The partnership is required to pay such withholding on a quarterly basis,[110] and the payment of the tax is treated as an advance against the foreign partner's share of partnership profits.[111]

Although I.R.C. § 1445 normally applies to withholding on the amount realized from dispositions of U.S. real property, the Regulations provide that a U.S. partnership that satisfies its withholding obligations under I.R.C. § 1446 will be deemed to have also satisfied its obligations under I.R.C. § 1445.[112]

In general, where a partnership (a "*lower tier partnership*") that has effectively connected income has a partner that is itself treated as a partnership for U.S. tax purposes (an "*upper tier partnership*"), the lower tier partnership is not required to withhold tax with respect to the upper tier partnership's allocable share of net income if the upper tier partnership is domestic, regardless of whether the upper tier domestic partnership's partners are foreign.[113] If the upper tier partnership is foreign, the lower tier partnership generally computes its withholding obligation based upon documentation provided to it relating to the identity and nationality of the partners of the upper tier partnership.[114] Such look-through rules do not apply, however, if the upper tier partnership is publicly traded.[115]

A partnership normally only takes into account certain specified partnership level deductions and losses in calculating partnership's effectively connected taxable income.[116] Under certain circumstances, partnership may also consider partner level

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107. Treas. Reg. § 1.1446-2(b)(3), (4). Oil and gas depletion allowances are required to be recalculated. Charitable deductions, net operating losses, capital loss carryovers, personal exemptions, and partnership credits are not included in the calculation of the withholding obligation.

108. I.R.C. § 1446(b).

109. Treas. Reg. § 1.1446-3(a)(2). A partnership is only allowed to take into consideration rates that depend upon the corporate or noncorporate status of the recipient if the partnership has documentation establishing such status.

110. Treas. Reg. § 1.1446-3(b)(1).

111. Treas. Reg. § 1.1446-3(d)(2)(v).

112. Treas. Reg. § 1.1446-3(c)(2)(i).

113. Treas. Reg. § 1.1446-5(a).

114. Treas. Reg. § 1.1446-5(c).

115. Treas. Reg. § 1.1446-5(d)(1).

116. Treas. Reg. § 1.1446-2(b).

deductions and losses in computing its I.R.C. § 1446 tax obligation.[117] A partnership may only consider such partner level deductions and losses if: (i) a foreign partner has submitted valid documentation as to the partner's identity and nationality; and (ii) the foreign partner submits a certificate to the partnership that sets forth the deductions and losses that such partner reasonably expects to be available for the partner's taxable year to reduce the partner's U.S. income tax liability on the partner's allocable share of effectively connected income or gain from the partnership. A foreign partner must submit a separate certificate for each partnership taxable year.

The foreign partner against whose share the tax has been withheld is entitled to apply the withholding tax as a credit against the partner's other U.S. income tax liabilities.[118]

D. Branch Profits Tax

Foreign corporations are subject to U.S. tax on income that is effectively connected with the conduct of a U.S. trade or business. In addition, foreign corporations engaged in a U.S. trade or business may be subject to a second tax, a "branch profits tax" under I.R.C. § 884. Generally, the branch profits tax is a tax imposed on a foreign corporation's post-1987 U.S. business profits that are not reinvested in U.S. branch operations. The tax is imposed at 30% of a calculated "dividend equivalent amount."[119] In effect, the branch profits tax is a substitute for a tax on dividends that would be imposed if the U.S. branch were a separately incorporated domestic subsidiary. A U.S. tax treaty may apply to reduce the rate of the branch profits tax applied to qualified residents of the country whose treaty is applied.[120]

The dividend equivalent amount is based in part upon increases and decreases in a foreign corporation's U.S. assets over U.S. liabilities. A foreign corporation that is a partner in a partnership must take into account its interest in the partnership (and not the partnership assets) in determining its U.S. assets.[121] For purposes of determining the proportion of the partnership interest that is a U.S. asset, a foreign corporation may elect to use either the asset method or the income method as described in the Regulations.[122] Calculation of the branch profits tax requires, among other things, a determination of the partnership's items of income, gain, loss, and deduction.[123]

117. Treas. Reg. § 1.1446-6(a). This procedure is not available to publicly traded partnerships. Treas. Reg. § 1.1446-6(b)(1).

118. I.R.C. § 1446(d)(1).

119. I.R.C. § 884(a).

120. I.R.C. § 884(e). However, a foreign corporation is exempt from the branch profits tax for the taxable year in which it completely terminates its U.S. trade or business. Temp. Reg. § 1.884-2T(a).

121. Treas. Reg. § 1.884-1(d)(3)(i).

122. *Id.*

123. Treas. Reg. § 1.884-1(d)(6)(iii).

E. Disposition of Interests in U.S. Partnerships by Non-U.S. Persons

In general, the disposition of a partnership interest results in gain or loss treated as gain or loss from the sale or exchange of a capital asset, except as provided in I.R.C. § 751, relating to unrealized receivables and inventory items.[124] Gain or loss recognized by a nonresident, foreign person is generally not subject to tax in the United States, unless the gain is effectively connected with a U.S. trade or business.[125]

Under Rev. Rul. 91-32, a foreign partner's gain or loss from the disposition of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be effectively connected income, gain or loss to the extent such gain or loss is attributable to effectively connected income property of the partnership.[126] The gain or loss attributable to the effectively connected income property of the partnership is an amount that bears the same ratio to the gain or loss realized by the foreign partner from the disposition of its partnership interest as the foreign partner's distributive share of partnership net effectively connected income gain or loss would have borne to the foreign partner's distributive share of partnership net gain or loss if the partnership had itself disposed of all of its assets at fair market value at the time the foreign partner disposes of its partnership interest. In computing the foreign partner's distributive share of net gain or loss of the partnership, net effectively connected income gain or loss, and net non-effectively connected gain or loss are computed independently of one another. Thus, net non-effectively connected loss will not offset effectively connected gain, and net effectively connected loss will not offset net non-effectively connected gain.

If the consideration received on the disposition of a partnership interest is attributable to a U.S. real property interest, the consideration may be considered as an amount received in exchange for the U.S. real property interest.[127] Regulations provide that if 50% or more of the value of an interest in a partnership is attributable to U.S. real property interests, the partnership interest may be treated as being entirely a U.S. real property interest.[128]

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124. I.R.C. § 741; *see* Chapter 6.

125. I.R.C. §§ 871, 881. This rule is subject to some exceptions. For example, non-U.S. individuals who are present in the United States for 183 days or more are subject to U.S. tax on U.S. source gains.

126. Rev. Rul. 91-32, 1991-1 C.B. 107. The rule established by Rev. Rul. 91-32 does not apply to effectively connected property that is a U.S. real property interest. Dispositions of partnerships that hold U.S. real property interests are governed by I.R.C. § 897(g). *Id.*

127. I.R.C. § 897(g).

128. Temp. Reg. § 1.897-7T. This rule only applies if the percentage of gross assets of the partnership that are comprised of U.S. real property interests and cash equals or exceeds 90%.

E. Disposition of Interests in U.S. Partnerships by Non-U.S. Persons

In general, the disposition of a partnership interest results in gain or loss treated as gain or loss from the sale or exchange of a capital asset, except as provided in I.R.C. § 751, relating to unrealized receivables and inventory items.[124] Gain or loss recognized by a nonresident, foreign person is generally not subject to tax in the United States, unless the gain is effectively connected with a U.S. trade or business.[125]

Under Rev. Rul. 91-32, a foreign partner's gain or loss from the disposition of an interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be effectively connected income, gain or loss to the extent such gain or loss is attributable to effectively connected income property of the partnership.[126] The gain or loss attributable to the effectively connected income property of the partnership is an amount that bears the same ratio to the gain or loss realized by the foreign partner from the disposition of its partnership interest as the foreign partner's distributive share of partnership net effectively connected income gain or loss would have borne to the foreign partner's distributive share of partnership net gain or loss if the partnership had itself disposed of all of its assets at fair market value at the time the foreign partner disposes of its partnership interest. In computing the foreign partner's distributive share of net gain or loss of the partnership, net effectively connected income gain or loss, and net non-effectively connected gain or loss are computed independently of one another. Thus, net non-effectively connected loss will not offset effectively connected gain, and net effectively connected loss will not offset net non-effectively connected gain.

If the consideration received on the disposition of a partnership interest is attributable to a U.S. real property interest, the consideration may be considered as an amount received in exchange for the U.S. real property interest.[127] Regulations provide that if 50% or more of the value of an interest in a partnership is attributable to U.S. real property interests, the partnership interest may be treated as being entirely a U.S. real property interest.[128]

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124. I.R.C. § 741; *see* Chapter 6.

125. I.R.C. §§ 871, 881. This rule is subject to some exceptions. For example, non-U.S. individuals who are present in the United States for 183 days or more are subject to U.S. tax on U.S. source gains.

126. Rev. Rul. 91-32, 1991-1 C.B. 107. The rule established by Rev. Rul. 91-32 does not apply to effectively connected property that is a U.S. real property interest. Dispositions of partnerships that hold U.S. real property interests are governed by I.R.C. § 897(g). *Id.*

127. I.R.C. § 897(g).

128. Temp. Reg. § 1.897-7T. This rule only applies if the percentage of gross assets of the partnership that are comprised of U.S. real property interests and cash equals or exceeds 90%.

In *Grecian Magnesite*, the Tax Court concluded in 2017 that Rev. Rul. 91-32 was invalid,[129] allowing a non-U.S. person to dispose of a partnership interest in a partnership that was engaged in a U.S. trade or business without the income on the disposition being treated as income effectively connected with a U.S. trade or business through an office in the United States. However, for dispositions of partnership interests after November 27, 2017, I.R.C. § 864(c)(8) effectively frustrates the conclusion of *Grecian Magnesite*.[130] In addition, the new provision requires withholding on the payments for the partnership interest for dispositions after December 31, 2017.

Under I.R.C. § 864(c)(8), gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. However, the amount of gain or loss on the transaction is limited to the gain or loss otherwise recognized under the Code.[131] The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss. This portion of the provision applies to dispositions of partnership interests after November 27, 2017.

As a result of I.R.C. § 864(c)(8), non-U.S. partners would be subject to a return filing requirement in the United States from the disposition of the partnership interest, and, potentially be subject to tax in the United States.[132] Prop. Reg. § 1.864(c)(8)-2(b) requires a partnership engaged in a U.S. trade or business to furnish a notifying transferor of the information necessary for the transferor to comply with the transferor's reporting requirements.

I.R.C. § 1446(f) also requires the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

The IRS has indicated that it will defer application of I.R.C. § 1446(f) in respect of a disposition of an interest in a publicly traded partnership until Regulations or other guidance is issued.[133] However, Proposed Regulations would apply to publicly traded partnerships when finalized. Under the Proposed Regulations, if a transfer of an interest in a publicly traded partnership is effected through a broker, then

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129. Grecian Magnesite Mining v. Commissioner, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (D.C. Cir. 2019). The ruling has not been withdrawn.

130. One could say that the Code provision "overruled" *Grecian Magnesite*, but the Code provision actually went beyond the position of Rev. Rul. 91-32, so "overruled" is probably not adequate in this situation.

131. Treas. Reg. § 1.864(c)(8)-1(b)(2)(ii).

132. Treas. Reg. §§ 1.6012-1, -2.

133. Notice 2018-8, 2018-7 I.R.B. 352.

the broker rather than the transferee has the withholding obligation.[134] There are exceptions and modifications similar to those for non-publicly traded partnerships, discussed below.

As to non-publicly traded partnerships, Proposed Regulations under I.R.C. §1446(f) repeat the statutory exception for U.S. persons and provide five non-statutory exceptions. First, if the transferee receives a certification that the transferor is a U.S. person, no withholding is required (unless the transferee has actual knowledge that the certification is false).[135] Second, if the transferee receives a certification that no gain will be realized, no withholding is required (unless the transferee has actual knowledge that the certification is false).[136] However, a transferor may not provide the certificate if I.R.C. §751 would cause the transferor to recognize ordinary income, even if the transferor recognizes an overall loss. Third, if the transferee receives a certificate that the transferor's share of income from the partnership for the three preceding taxable years was comprised of less than 10% income effectively connected to a U.S. trade or business, no withholding is required.[137] Fourth, if the transferee receives a certificate that, if the partnership sold all of its assets, less than 10% of the gain would be income effectively connected to a U.S. trade or business, no withholding is required.[138] Fifth, no withholding is required if the transferor realizes gain but is not required to recognize gain because the transfer is a non-recognition transaction.[139] If only a portion of the transaction is subject to a nonrecognition provision, an adjustment to the amount required to be withheld may be permitted.[140] Finally, the Proposed Regulations provide an exception to withholding when a transferor certifies that it is not subject to tax on any gain from the transfer pursuant to an income tax treaty in effect between the United States and another country.[141]

In determining the transferor's share of partnership liabilities (for the purposes of determining the amount realized on the transfer), a transferor may rely upon the most recent Form K-1 received by the transferor, if the partnership year for the Form K-1 was within 22 months of the transfer.[142] If a transferor's share of liabilities would cause the withholding obligation to exceed the cash or other consideration given in the transaction, a transferee may ignore the liabilities of the partnership in determining the amount to withhold, but this is not the general rule.[143]

134. Prop. Reg. §1.1446(f)-4(a)(1).
135. Prop. Reg. §1.1446(f)-2(b)(2).
136. Prop. Reg. §1.1446(f)-2(b)(3)(i).
137. Prop. Reg. §1.1446(f)-2(b)(5)(i).
138. Prop. Reg. §1.1446(f)-2(b)(4).
139. Prop. Reg. §1.1446(f)-2(b)(6).
140. Prop. Reg. §1.1446(f)-2(c)(4).
141. Prop. Reg. §1.1446(f)-2(b)(7)(i).
142. Prop. Reg. §1.1446(f)-2(c)(2)(ii)(B).
143. Prop. Reg. §1.1446(f)-2(c)(3).

§ 12.04 Other International Issues

A. Base Erosion and Anti-Abuse Tax

I.R.C. § 59A imposes a tax on certain corporations (*"applicable taxpayers"*) in addition to any other regular tax liability the taxpayer may have. Liability for this additional tax is generally limited to those taxpayers with substantial gross receipts and is determined, in part, by the extent to which the taxpayer has made deductible payments to foreign related parties. Taxpayers potentially liable for this additional tax have three-year average gross receipts in excess of $500 million and a "base erosion percentage" exceeding a specified threshold. The base erosion percentage is generally determined by dividing "base erosion tax benefits" by the amount of deductions allowable to the taxpayer for the taxable year. The taxpayer's additional tax is computed by comparing 10% of the taxpayer's "modified taxable income" to the taxpayer's regular tax liability (as defined in I.R.C. § 26(b)) after the regular tax liability has been reduced by certain credits against tax. Modified taxable income is the taxpayer's regular taxable income increased by any base erosion tax benefit with respect to any "base erosion payment" and an adjustment for the taxpayer's NOL deduction, if any. The taxpayer has an additional tax liability equal to the difference between 10% of the taxpayer's modified taxable income and the taxpayer's regular tax liability after adjustment has been made to account for certain credits against the taxpayer's regular tax liability.

A base erosion payment is any amount which is allowable by the payor as a deduction or included in the basis of an amortizable or depreciable asset.[144] The Regulations clarify this definition by providing that a base erosion payment means (i) any amount paid or accrued by a taxpayer to a non-U.S. related party and with respect to which a deduction is allowable under the U.S. income tax; (ii) any amount paid or accrued by the taxpayer to a non-U.S. related party in connection with the acquisition of property by the taxpayer from the non-U.S. related party if the character of the property is subject to the allowance for depreciation (or amortization in lieu of depreciation); (iii) any premium or other consideration paid or accrued by the taxpayer to a non-U.S. related party for any reinsurance payments; or (iv) any amount paid or accrued by the taxpayer that results in a reduction of the gross receipts of the taxpayer if the amount paid or accrued is with respect to *(x)* a non-U.S. corporation that is the result of an inversion transaction if at least 60% of stock of the non-U.S. corporation is owned by U.S. shareholders;[145] or *(y)* a non-U.S. person that is a member of the same expanded affiliated group as a corporation described in *(x)*.[146]

144. I.R.C. § 59A(d).

145. I.R.C. § 59A(d)(4)(C)(i). This only applies if the inversion occurred after November 9, 2017. This does not apply to a non-U.S. corporation that is treated as a U.S. corporation under I.R.C. § 7874(b).

146. Treas. Reg. § 1.59A-3(b)(1).

A partnership is not an "applicable taxpayer", as defined in I.R.C. § 59A; only corporations can be applicable taxpayers. In general, a partnership also is not subject to the income tax. Instead, partners are liable for income tax only in their separate capacities. Each taxpayer that is a partner in a partnership takes into account separately the partner's distributive share of the partner's income or loss in determining its taxable income. Accordingly, an item of income is subject to federal income taxation based on the status of the partners, and not the partnership as an entity. Similarly, a partnership does not itself benefit from a deduction. Instead, the tax benefit from a deduction is taken by the taxpayer that is allocated the deduction under I.R.C. § 704. I.R.C. § 702(b) provides that the character of any item be taken into account as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership. I.R.C. § 702(b) acknowledges that differences in partner tax characteristics (for example, whether the partner is a corporation or an individual, or domestic or foreign) may result in differences in the tax consequences of items the partnership allocates to its partners.

The Regulations generally provide that partnerships are treated as an aggregate of the partners in determining whether payments to or payments from a partnership are base erosion payments.[147] For purposes of determining whether a payment or accrual by a partnership is a base erosion payment, any amount paid or accrued by the partnership (including any guaranteed payment described in I.R.C. § 707(c)) is treated as paid or accrued by each partner based on the partner's distributive share of the item of deduction with respect to that amount.[148] However, rather than relying upon the rules regarding the determination of a partner's distributive share in the under I.R.C. § 704(b), which provides the statutory basis for determining a partner's distributive share, a partner's distributive share is determined on a property-by-property basis and the amounts are not netted.[149] The rules and exceptions for base erosion payments and base erosion tax benefits then apply accordingly on an aggregate basis.

B. Covered Asset Acquisitions

In general, certain elections or transactions can result in the creation of additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the basis of such assets for foreign tax purposes. These include: (i) a qualifying stock purchase of a foreign corporation or domestic corporation with foreign assets for which an I.R.C. § 338 election is made; (ii) an acquisition of an interest in a partnership holding foreign assets for which an I.R.C. § 754 election is in effect; and (iii) certain other transactions involving an entity classification (*"check-the-box"*)

147. Treas. Reg. § 1.59A-7(b).
148. Treas. Reg. § 1.59A-7(c)(1).
149. Treas. Reg. § 1.59A-7(e)(1).

election in which a foreign entity is treated as a corporation for foreign tax purposes and as a partnership or disregarded entity for U.S. tax purposes.[150]

As we have previously discussed, a partnership does not generally adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made an election under I.R.C. § 754 for such purposes.[151] If an election is in effect (or if such adjustments are otherwise required), adjustments to the basis of partnership property are made with respect to the transferee partner to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest. Because an I.R.C. § 754 election has relevance only for U.S. tax purposes, to the extent that the underlying assets of the partnership include assets generating income subject to foreign tax, the basis adjustments made to these assets may also result in permanent differences between: (i) the foreign taxable income upon which foreign income tax is levied, and (ii) the U.S. taxable income (or earnings and profits, depending upon the context) upon which U.S. tax is levied (whether currently or upon repatriation) and with respect to which a foreign tax credit may be allowed for any foreign income taxes paid.

Similar permanent differences between foreign taxable income and U.S. taxable income (or earnings and profits) may also be achieved as a result of making a check-the-box election. Since a check-the-box election generally has no effect for foreign tax purposes, a sale of a wholly owned foreign corporation for which an election to be disregarded is in effect will be respected as the sale of the stock of the corporation for foreign tax purposes, but treated as the sale of branch assets for U.S. tax purposes. If the purchaser is a U.S. taxpayer or a foreign entity owned by a U.S. taxpayer, the U.S. taxpayer may have additional asset basis eligible for cost recovery for U.S. tax purposes without a corresponding increase in the tax basis of such assets for foreign tax purposes. In this case, there would be a permanent difference between U.S. and foreign income, as described above.

When differences are created between U.S. and foreign income, I.R.C. § 901(m) denies a foreign tax credit for the disqualified portion of any foreign income tax paid or accrued in connection with a "covered asset acquisition."

A "*covered asset acquisition*" means: (i) a qualified stock purchase (as defined in I.R.C. § 338(d)(3)); (ii) any transaction that is treated as the acquisition of assets for U.S. tax purposes and as the acquisition of stock (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction; (iii) any acquisition of an interest in a partnership that has an election in effect under I.R.C. § 754; and (iv) to the extent provided by the IRS, any other similar transaction.

150. Treas. Reg. §§ 301.7701-1 *et seq.*

151. I.R.C. § 743(a). *But see* I.R.C. § 743(d) (requiring a reduction to the basis of partnership property in certain cases where there is a substantial built-in loss). *See also* § 6.07.

The disqualified portion of any foreign income taxes paid or accrued with respect to any covered asset acquisition, for any taxable year, is the ratio (expressed as a percentage) of: (i) the aggregate basis differences allocable to such taxable year with respect to all relevant foreign assets, divided by (ii) the income on which the foreign income tax is determined. For this purpose, the income on which the foreign income tax is determined is the income as determined under the law of the relevant jurisdiction. If the taxpayer fails to substantiate such income, then such income is determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction.

For purposes of determining the aggregate basis difference allocable to a taxable year, the term "basis difference" means, with respect to any relevant foreign asset, the excess of: (i) the adjusted basis of such asset immediately after the covered asset acquisition, over (ii) the adjusted basis of such asset immediately before the covered asset acquisition.[152] Thus, it is the tax basis for U.S. tax purposes that is relevant, and not the basis as determined under the law of the relevant foreign jurisdiction.

In general, the amount of the basis difference allocable to a taxable year with respect to any relevant foreign asset is determined using the applicable cost recovery method under U.S. tax rules. If there is a disposition of any relevant foreign asset before its cost has been entirely recovered or of any relevant foreign asset that is not eligible for cost recovery (*e.g.*, land), the basis difference allocated to the taxable year of the disposition is the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset that has been allocated under I.R.C. § 901(m) to all prior taxable years. Thus, any remaining basis difference is captured in the year of the sale, and there is no remaining basis difference to be allocated to any subsequent tax years.

An asset is a "relevant foreign asset" with respect to any covered asset acquisition, whether the entity acquired is domestic or foreign, only if any income, deduction, gain, or loss attributable to the asset (including goodwill, going concern value, and any other intangible asset) is taken into account in determining foreign income tax in the relevant jurisdiction. For this purpose, the term "foreign income tax" means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States, including any tax paid in lieu of such a tax within the meaning of I.R.C. § 903.

152. A built-in loss in a relevant foreign asset (*i.e.*, in cases in which the fair market value of the asset is less than its adjusted basis immediately before the asset acquisition) is taken into account in determining the aggregate basis difference; however, a built-in loss cannot reduce the aggregate basis difference allocable to a taxable year below zero.

C. FATCA

In addition to the regular rules relating to withholding on payments to non-U.S. persons under I.R.C. §§1441–1446, the United States has a second-tier withholding system designed to force non-U.S. persons (primarily financial institutions) to disclose the identities of U.S. persons having economic relations with the payee.

I.R.C. §§1471 and 1472 impose a 30% withholding tax on withholdable payments to non-U.S. persons if the non-U.S. person does not comply with U.S. disclosure requirements. In general, a withholdable payment includes: (i) any payment of interest (including original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic gains, profits, and income if such payment is from U.S. sources, and (ii) any gross proceeds from the sale or other disposition of any property of a type that can produce interest or dividends from U.S. sources.[153]

Withholdable payments do not include any item of income that is effectively connected with a U.S. trade or business that is taken into account under I.R.C. §§871(b) or 882, dealing with income that is effectively connected income with a U.S. trade or business.[154]

Gross proceeds from the sale of stocks and securities may be withholdable payments without regard to whether U.S. source rules would characterize any gain or loss generated by the sale as U.S.-source income or loss. For example, U.S. source rules would generally treat the income from the sale of U.S. stock and securities by a non-U.S. person as not being U.S.-source income.[155] However, the distribution of the gross proceeds of the sale of stock and securities may be a withholdable payment even though the income would not be U.S. source. The distribution of proceeds from the sale of stocks or securities may be a withholdable payment even if there is no gain. In other words, the withholding may apply even if a loss is recognized.

As mentioned above, I.R.C. §1471 will impose 30% withholding on withholdable payments to non-U.S. financial institutions if the financial institution does not agree to comply with certain U.S. due diligence and reporting requirements. A financial institution is any entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) as a substantial portion of its business, holds financial assets for the account of others, or (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.[156] An investment entity is a financial institution if (A) the entity primarily conducts as a business one

153. I.R.C. §1473(1)(A). Proposed Regulations would eliminate the requirement to withhold on gross proceeds. *See* REG-132881-17, 83 Fed. Reg. 64757 (Dec. 18, 2018).

154. I.R.C. §1473(1)(B).

155. I.R.C. §865(a)(2).

156. Treas. Reg. §1471-5(e).

or more of the following activities or operations for or on behalf of a customer (1) trading in money market instruments (checks, bills, certificates of deposit, derivatives, etc.); foreign currency; foreign exchange, interest rate, and index instruments; transferable securities; or commodity futures; (2) individual or collective portfolio management; or (3) otherwise investing, administering, or managing funds, money, or financial assets on behalf of other persons; (B) the entity's gross income is primarily attributable to investing, reinvesting, or trading in financial assets (as defined in paragraph (e)(4)(ii) of this section) and the entity is managed by another financial institution; or (C) the entity functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buyout fund, or any similar investment vehicle established with an investment strategy of investing, reinvesting, or trading in financial assets.[157]

A financial institution would, thus, include a hedge fund or a private equity fund.

In general, each financial institution will need to determine and disclose information concerning the identity and amounts of depository accounts, custodial accounts, and equity or debt investments (other than interests that are regularly traded on an established securities market) in the financial institution of specified U.S. persons[158] or U.S.-owned non-U.S. entities.[159] Withholding is generally not required if an agreement is in effect between the non-U.S. financial institution and the Treasury under which the institution agrees to collect and disclose taxpayer information about its depositors, shareholders, and investors.[160]

In some cases, non-US law would prevent a non-U.S. financial institution from reporting directly to the IRS the information required by FATCA statutory provisions and the Regulations, thus potentially exposing the non-U.S. financial institution to withholding. Such an outcome would be inconsistent with FATCA's declared objective to address offshore tax evasion through increased information reporting. To overcome these legal impediments, the Treasury Department has negotiated with non-U.S. governments to develop two alternative model intergovernmental agreements that facilitate the effective and efficient implementation of FATCA in a manner that removes domestic legal impediments to compliance. As of February, 2020, 96 IGAs have come into force or effect. In addition, 17 other jurisdictions are treated as having an IGA in effect because they have an IGA signed or agreed upon

157. Treas. Reg. § 1.1471-5(e)(4).

158. A specified U.S. person is any person other than a publicly traded corporation, an affiliate of a publicly traded corporation, an exempt organization or retirement plan, the United States, a state or any political subdivision thereof, a bank, a real estate investment trust, a common trust fund, and certain other exempt trusts.

159. A U.S.-owned non-U.S. entity is any non-U.S. entity that has one or more substantial U.S. owners. A substantial U.S. owner is a specified U.S. person that directly or indirectly owns more than 10% of the stock of a corporation, 10% of the profits or capital of a partnership, or 10% of the beneficial interests of a trust.

160. I.R.C. § 1471(b)(1).

in substance. A complete list can be found on the website of the U.S. Treasury.[161] If a non-U.S. financial institution complies with an applicable intergovernmental agreement, it may not be required to enter into an agreement with the IRS to avoid FATCA withholding.

I.R.C. § 1472 requires a withholding agent to deduct and withhold a tax equal to 30% of any withholdable payment made to a non-financial non-U.S. entity if the beneficial owner of such payment is a non-financial non-U.S. entity that does not meet specified disclosure requirements.[162] A non-financial non-U.S. entity is any non-U.S. entity that is not a financial institution under the new rules. Withholding under I.R.C. § 1472 may not be required if the payee or the beneficial owner of the payment either provides the withholding agent with a certification that the non--U.S. entity does not have a substantial U.S. owner or provides the withholding agent with the name, address, and taxpayer identification number of each substantial U.S. owner.[163] Additionally, the withholding agent must not know or have reason to know that the certification or information provided regarding substantial U.S. owners is incorrect, and the withholding agent must report the name, address, and taxpayer identification number of each substantial U.S. owner to the U.S. Treasury.

I.R.C. § 1472 does not apply to any payment beneficially owned by a publicly traded corporation or a member of an expanded affiliated group of a publicly traded corporation (defined without the inclusion of partnerships or other non-corporate entities).[164] In addition, I.R.C. § 1472 does not apply to any payment beneficially owned by any: (i) entity that is organized under the laws of a possession of the United States and that is wholly owned by one or more bona fide residents of the possession, (ii) non-U.S. government, political subdivision of a non-U.S. government, or wholly owned agency or instrumentality of any non-U.S. government or political subdivision of a non-U.S. government, (iii) international organization or any wholly owned agency or instrumentality of an international organization, (iv) non-U.S. central bank of issue, or (v) any other class of persons identified by the IRS for purposes of I.R.C. § 1472, or to any class of payments identified by the IRS as posing a low risk of U.S. tax evasion.[165]

D. Hybrid Transactions and Hybrid Entities

I.R.C. § 267A denies a deduction for any "disqualified related party amount" paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) such amount is not included in the income of the related party

161. *See* http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.
162. I.R.C. § 1472.
163. I.R.C. § 1472(b).
164. I.R.C. § 1472(c)(1)(A), (B)
165. I.R.C. § 1472(c)(1)(C), (D), (E), (F), (G).

under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax,[166] or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.[167] A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under I.R.C. § 951(a).[168] A related party for these purposes is determined under the rules of I.R.C. § 954(d)(3), except that such section applies with respect to the payor of the payment that is being tested as a potential hybrid transaction as opposed to the CFC otherwise referred to in such section.

A disqualified related party does not include a partnership because a partnership generally is not liable for a tax and therefore is not the person allowed a deduction. However, a partner of a partnership may be a disqualified related party. For example, in the case of a payment made by a partnership a partner of which is a domestic corporation, the domestic corporation may be a disqualified related party (if the partner is related to the recipient of the payment), and its allocable share of the deduction for the payment is subject to disallowance under I.R.C. § 267A.

A hybrid transaction is any transaction, series of transactions, agreement, or instruments, one or more payments with respect to which are treated as interest or royalties for U.S. federal income tax purposes and which are not so treated for purposes of the tax law of the non-U.S. country of which the recipient of such payment is resident for tax purposes or is subject to tax.[169] This could occur when the instrument itself is treated as debt for U.S. tax purposes but treated as equity for purposes of the jurisdiction in which the related party is tax resident.[170] It could also occur when the U.S. tax system deems payments to include interest, such as occurs with a notional principal contract with substantial non-periodic payments, but the jurisdiction in which the related party is tax resident treats the instrument according to its terms.[171]

A hybrid entity is any entity which is either: (1) treated as fiscally transparent for U.S. federal income tax purposes but not so treated for purposes of the tax law of the non-U.S. country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for U.S. federal income tax purposes.[172]

166. I.R.C. § 267A(b)(1)(A).
167. I.R.C. § 267A(b)(1)(B).
168. *See* discussion of controlled foreign corporations in § 12.02.D.
169. I.R.C. § 267A(c).
170. *See, e.g.,* Hewlett-Packard Co. & Consolidated Subsidiaries v. Commissioner, T.C. 2012-135, *aff'd*, 120 A.F.T.R.2d 2017-6542 (investment in the form of preferred stock recharacterized as debt).
171. *See* Treas. Reg. § 1.446-3(f)(2)(iii)(B).
172. I.R.C. § 267A(d).

I.R.C. § 267A further provides that the Treasury will issue guidance as may be necessary to carry out the purposes of the provision, including Regulations or other guidance providing rules for: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity, (2) the application of this provision to branches or domestic entities, (3) applying I.R.C. § 267A to certain structured transactions, (4) denying a deduction claimed for interest or a royalty that is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25%, (5) denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount, (6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country, (7) exceptions to the general rule, and (8) requirements for record keeping and reporting.[173]

Although Regulations cover many of these issues, of particular relevance to the topic of this text is the treatment of hybrid and reverse hybrid entities. A reverse hybrid is an entity that is fiscally transparent for purposes of the tax law of the country in which it is established but not for purposes of the tax law of its owner.[174] An entity is treated as being fiscally transparent if, under the laws of the entity's jurisdiction, an interest holder's respective share of an item of income is required to be taken into account by an interest holder in the entity on a current basis without regard to whether the item is distributed.[175] Thus, payments to a reverse hybrid may result in a deduction/non-inclusion ("*D/NI*") outcome because the reverse hybrid is not a tax resident of the country in which it is established, and the owner does not include the payment in income under its tax law.[176] Because this D/NI outcome may occur regardless of whether the establishment country is a non-U.S. country or the United States, the Regulations provide that both U.S. and non-U.S. entities may be reverse hybrids. A U.S. entity that is a reverse hybrid for this purpose differs from a "domestic reverse hybrid entity" under Treas. Reg. § 1.894-1(d)(2)(i), which defines a domestic reverse hybrid entity as a U.S. entity that is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of an interest holder's jurisdiction. Thus, under the Regulations, a U.S. LLC that is treated as partnership or a disregarded entity for U.S. tax purposes, but treated as a corporation under laws of the jurisdiction of the owners. would be a U.S. reverse hybrid. In contrast, under Treas. Reg. § 1.894-1(d)(i), a U.S. limited partnership that has elected to be taxed as corporation would be a domestic reverse hybrid if it has non-U.S. owners. An investor means a tax resident or taxable branch that directly or

173. I.R.C. § 267A(e).

174. Treas. Reg. § 1.267A-2(d)(2). Although the focus of the statute is on hybrid entities, the focus of the Regulations is on reverse hybrids.

175. Treas. Reg. § 1.894-1(d)(3)(ii).

176. Treas. Reg. § 1.267A-2(d)(1).

indirectly owns an interest in the entity. If an investor views the entity as not fiscally transparent, the investor generally will not be currently taxed under its tax law on payments to the entity.

When a specified payment is made to a reverse hybrid, it is generally a disqualified hybrid amount to the extent that an investor does not include the payment in income.[177] For this purpose, whether an investor includes the specified payment in income is determined without regard to a distribution or a right to a subsequent distribution by the reverse hybrid.[178]

§ 12.05 Partnerships with Tax-Exempt Entities

Exempt organizations, like foreign taxpayers, worry about engaging in a trade or business as that can cause the associated income to be taxable and can also cause an exempt organization to lose its exempt status. Exempt organizations, like foreign taxpayers, have significant categories of income that are not subject to tax. For this reason, it is not uncommon for investment structures to combine foreign taxpayers and exempt organizations, but there are also significant differences in the U.S. tax treatments of the two groups of investors that raise issues when the two are combined.

A. Impact on the Organization's Exempt Status

Where exempt organizations enter into joint ventures with for-profit organizations to conduct active trades or businesses rather than just collect investment income, the structure and operation of the joint venture may impact both the taxability of the income derived by the charity from the joint venture and the charity's tax-exempt status. The creation of unrelated business taxable income is discussed in greater detail below. The charity's tax-exempt status is implicated because, to maintain its status, the charity must be operated exclusively for charitable purposes.[179] If a business activity of the organization is substantial, the activity may destroy the exempt status of the organization even if the organization is undertaking other activities with valid charitable purposes.[180]

The fact that a charity undertakes a trade or business does not itself cause a loss of the charity's exempt status, if the trade or business furthers the exempt purpose of the charity.[181] Since *Plumstead Theatre Society v. Commissioner*,[182] the IRS has per-

177. Treas. Reg. § 1.267A-2(d)(1).

178. Treas. Reg. § 1.267A-3(a)(3).

179. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(1).

180. *See* Better Business Bureau, Inc. v. United States, 326 U.S. 279, 283 (1945).

181. *See* Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687, 691 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980).

182. 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

mitted joint ventures between charities and for-profit entities, in limited situations, without causing the exempt status of the charity to be jeopardized.

Where the operations of the joint venture in reality comprise the total operations of the charity, the IRS will allow the creation of the joint venture to not terminate the charity's tax-exempt status if: (i) the charity controls the governing body of the joint venture without regard to the percentage of the joint venture held by the charity, (ii) any management company and the joint venture executives are independent of the for-profit joint venturers, and (iii) the members of the joint venture's governing body have a legally enforceable duty to promote charitable purposes that takes precedence over the duty of such persons to operate the venture for the benefit of the owners.[183] The standards applied by the IRS have continued to be controversial, and the final resolution of the standards by the courts is uncertain at this time.[184] An example of where things went awry is *Redlands Surgical Services*,[185] where an erstwhile nonprofit surgical center lost its nonprofit status. The court held that its sole activity was to participate as co-general partner with a for-profit corporation in a partnership that was general partner of an operating partnership that owned and operated an ambulatory surgery center. The court concluded that the surgical center had ceded effective control over the operations of the partnership and the surgery center to private parties, conferring an impermissible private benefit.

The IRS has applied somewhat more liberal standards where the operations of the joint venture are insubstantial in comparison to the total operations of the charity.[186] Where the activity is insubstantial, the charity's participation in the joint venture, taken alone, will not affect the charity's tax-exempt status.[187]

B. Unrelated Business Taxable Income

Like foreign taxpayers, exempt organizations that are determined to be engaged in a trade or business may be subject to U.S. tax without regard to their normally exempt status.

Tax-exempt organizations are, in general, taxable on unrelated business taxable income ("*UBTI*").[188] If a trade or business that would generate UBTI to an exempt organization is conducted by a partnership, an exempt organization that is a partner in the partnership includes its share of the UBTI of the partnership whether or

183. Rev. Rul. 98-15, 1998-1 C.B. 718.

184. *See* Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001); St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003).

185. Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001).

186. Rev. Rul. 2004-51, 2004-1 C.B. 974.

187. *Id.* In addition, the IRS ruled that if the activities of the joint venture contribute importantly to the accomplishment of the charity's exempt purpose, the income will not be subject to unrelated business income tax.

188. I.R.C. § 511(a).

not such UBTI is distributed.[189] UBTI starts with gross income from any unrelated trade or business that is regularly carried on.[190] From this gross income, some types of income are subtracted. Deductions directly related to the unrelated trade or business may also be subtracted.[191]

An activity does not constitute an unrelated trade or business if the activity relates to the organization's exempt purpose. An activity relates to an organization's exempt purpose when the activity makes an important contribution to achieving the exempt purpose. A trade or business does not relate to an exempt purpose solely because the organization needs money for its exempt purpose.[192]

Entering an unrelated business with another exempt organization will not make the business a related activity. For example, renting to an exempt organization will not always relate to the landlord's exempt purpose. It will relate only if the tenant uses the property in an activity related to the landlord's exempt purpose.[193]

An activity in which almost all the work is done without pay is not an unrelated trade or business.[194] An activity primarily for the convenience of members, students, patients, officers, or employees is not an unrelated trade or business.[195] Selling donated goods is not an unrelated trade or business.[196] "Trade or business" does not include the distribution of low-cost items as part of asking for contributions.[197]

"*Trade or business*" includes most activities carried on for the production of income. It includes the sale of goods and the performance of services.[198] An activity may still be a trade or business even if it does not make a profit.[199] However, if an organization does not intend to make a profit from an activity and the activity is run at a loss, the activity is not a trade or business.[200]

A business is still a business even if it is part of a larger activity.[201] For example, selling advertising is a business even though an exempt organization publishes the advertising with material related to the exempt purpose of the organization.[202] Similarly, a flower shop run by a tax-exempt hospital could generate UBTI if operated to

189. I.R.C. § 512(c).

190. Unrelated trade or business income also includes unrelated debt-financed income, discussed below.

191. Calculated with certain modifications. I.R.C. § 512(a)(1).

192. I.R.C. § 513(a).

193. Rev. Rul. 58-547, 1958-2 C.B. 275.

194. Treas. Reg. § 1.513-1(e)(1).

195. Treas. Reg. § 1.513-1(e)(2).

196. Treas. Reg. § 1.513-1(e)(3).

197. Treas. Reg. § 1.513-1(b).

198. *Id.*

199. *Id.*

200. Iowa State University of Science and Technology v. United States, 500 F.2d 508 (Ct. Cl. 1974); Rev. Rul. 81-69, 1981-1 C.B. 351.

201. Treas. Reg. § 1.513-1(b).

202. *Id.*

make a profit.[203] Rev. Rul. 73-104[204] held that the sale of greeting card reproductions of art works by a tax-exempt art museum did not give rise to UBTI. The Revenue Ruling concluded that the card sales contributed importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest, and appreciation of art. Rev. Rul. 73-104 also stated that the fact that the cards were promoted and sold in a clearly commercial manner at a profit, and in competition with commercial greeting card publishers, did not alter the activities' relatedness to the museum's exempt purposes.

In general, an activity is *"regularly carried on"* by an exempt organization if its frequency and length are like the activities of for-profit groups in the same business.[205] If an exempt organization periodically engages in an activity, without the competitive and promotional efforts typical of for-profit groups, the activity will not be "regularly carried on."[206]

UBTI generally excludes: (i) dividends, interest, certain security loan payments, and annuities; (ii) royalties based upon income; (iii) most rents from real property; (iv) capital gains; and (v) some types of research income.

In general, I.R.C. § 512(b)(3) excludes from UBTI rents from real property. However, Treas. Reg. § 1.512(b)-1(c)(5) provides that payments for the use of space where services are also rendered to the occupant do not constitute rent from real property. The Regulation clarifies, though, that services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of space. The supplying of maid service, for example, constitutes a service provided for the convenience of the occupant that is not customary. On the other hand, furnishing heat and light, cleaning public areas, collecting trash are not considered services rendered to the occupant because they are customarily rendered in connection with the rental of space.[207]

The Regulation also provides that payments for the use or occupancy of offices in any office building are generally rent from real property.[208] Also, rent from real property may not depend upon the income derived by any person from the property.[209]

203. *See* I.R.C. § 501(e).

204. 1973-1 C.B. 263. *See also* The Hope School v. United States, 612 F.2d 298 (7th Cir. 1980), in which the court found that the exempt organization was not in a trade or business when it gave away greeting cards with a request for a donation.

205. Treas. Reg. § 1.513-1(c)(1).

206. Treas. Reg. § 1.513-1(c)(2)(ii).

207. Treas. Reg. § 1.512(b)-1(c)(5).

208. *Id.*

209. Treas. Reg. § 1.512(b)-1(c)(2)(iii)(b).

C. Debt-Financed Income

Debt-financed income is an area in which the treatment of exempt organizations diverges significantly from the treatment of foreign taxpayers. Foreign taxpayers have no special treatment of debt-financed income. Exempt organizations, on the other hand, are taxable on otherwise excludable income if the income is unrelated debt-financed income. Unrelated debt-financed income includes income from property subject to acquisition indebtedness.[210] Acquisition indebtedness includes: (i) indebtedness incurred before the acquisition of the property if such indebtedness would not have been incurred but for such acquisition and (ii) indebtedness incurred after the acquisition of the property if such indebtedness would not have been incurred but for such acquisition and the indebtedness was reasonably foreseeable at the time of such acquisition.[211]

Excluded from unrelated debt-financed income is income from property used in the exempt purpose of the organization.[212] If an organization acquires real property for the principal purpose of using the land (within 10 years of the acquisition) in a manner substantially related to the exempt purpose of the organization and the property is in the neighborhood of other property owned by the organization and used in a manner related to its exempt purpose, the real property acquired for future use is not be treated as debt-financed property so long as the organization does not abandon its intent to use the property in a manner related to its exempt purpose.[213] However, this exception will apply after the fifth year only if the organization establishes to the satisfaction of the IRS that it is reasonably certain that the land will be used in a manner related to the organization's exempt purpose before the expiration of the tenth year. If the exception is inapplicable because either: (i) the land was not in the neighborhood of other land owned by the organization, or (ii) the organization was unable to establish to the satisfaction of the IRS that it was reasonably certain that the land would be used in a manner related to the organization's exempt purpose, but (iii) the land is converted to a use related to the exempt purpose of the organization within the 10-year period, then (iv) the land will not be treated as debt-financed property during the 10-year period (even prior to the conversion).[214]

The 10-year related use exception does not apply to structures that are on the land when acquired unless the intended use of the land requires that the structure

210. I.R.C. § 514(a).

211. I.R.C. § 514(c).

212. I.R.C. § 514(b).

213. I.R.C. § 514(b)(3)(A). Churches have a 15-year period rather than a 10-year period and are not required to meet the neighborhood test.

214. I.R.C. § 514(b)(3)(B); Treas. Reg. § 1.514(b)-1(d)(2). From a practical perspective, the organization in this case would generally treat the income from property as debt-financed income until the conversion and then seek a refund of the taxes paid after the actual use condition is satisfied. *See* Treas. Reg. § 1.514(b)-1(d)(4).

be demolished.[215] The exception also does not apply to structures erected on the property after it is acquired. The exception also does not apply to a "business lease."

Certain exempt organizations (schools, trusts of qualified pension and profit-sharing plans, and certain title holding companies) will not be considered to have acquisition indebtedness in regard to indebtedness incurred to acquire or improve any real property if: (i) the property is acquired for a fixed price, (ii) the timing and amounts of payments are not contingent upon the income of the property, (iii) the property is not leased to a related party, (iv) the property is not acquired from certain related parties, and (v) the financing of the purchase was not provided by a related party.[216]

If certain conditions are met, debt allocated to an exempt organization of the type described in the preceding paragraph by a partnership that holds real estate will also be excluded from "acquisition indebtedness."[217] To qualify for this exclusion, the partnership must meet all the tests in the preceding paragraph and: (i) all partners must be exempt organizations, (ii) all allocations must be consistent over the life of the partnership, or (iii) the allocations of income to any exempt organization must not be greater than the allocations of loss to such exempt organization for any year of the partnership and each allocation with respect to the partnership has substantial economic effect within the meaning of I.R.C. § 704(b)(2).[218] In determining an exempt organization's share of allocations of income, certain chargebacks, reasonable preferred returns, and reasonable guaranteed payments are disregarded.[219]

§ 12.06 Limitations on Deductions Allocable to Property Used by Tax-Exempt Entities

A. General Rule on Limitation on Losses

I.R.C. § 470 expands the loss limitation approach in I.R.C. § 469 to tax-exempt use losses. Under I.R.C. § 470(a), a taxable entity is not permitted to deduct any loss from tax-exempt use property in excess of the taxpayer's gross income from the property for that taxable year. Under I.R.C. § 470(b), any such excess non-deductible tax-exempt use loss with respect to any tax-exempt use property is suspended and treated as a deduction with respect to such property in the next taxable year. A taxable partner may use a suspended tax-exempt use loss when the taxpayer disposes of its entire interest in the tax-exempt use property (under rules similar to those in

215. I.R.C. § 514(b)(3)(C).

216. I.R.C. § 514(c)(9)(B).

217. I.R.C. § 514(c)(9)(B)(vi).

218. I.R.C. § 514(c)(9)(E). The Regulations interpret "substantial economic effect" to include, for these purposes, allocations that are deemed to be in accordance with the partners' interests in the partnership. Treas. Reg. § 1.514(c)-2(b)(1)(ii).

219. Treas. Reg. § 1.514(c)-2(d), (e).

I.R.C. § 469(g)).[220] Thus, if a partnership has any tax-exempt use property, the portion of any loss that is a suspended tax-exempt use loss will generally not be deductible by a taxable partner until the property is sold.

A "*tax-exempt use loss*" is defined as the amount by which the sum of the aggregate deductions (other than interest) directly allocable to a tax-exempt use property plus the aggregate deductions for interest properly allocable to such property exceed the aggregate income from such property.[221] "*Tax-exempt use property*" is generally defined for purposes of I.R.C. § 470 by reference to I.R.C. § 168(h), which provides (in I.R.C. § 168(h)(1)(A)) that tax-exempt use property means that portion of any tangible property (other than nonresidential real property) leased to a tax-exempt or foreign entity.

In the case of nonresidential real property, I.R.C. § 168(h)(1)(B)(i) provides that tax-exempt use property means the portion of the property leased to a tax-exempt or foreign entity in a "*disqualified lease.*" A disqualified lease is defined in I.R.C. § 168(h)(1)(B)(ii) as any lease of the property to a tax-exempt entity, but only if: (i) part or all of the property was financed (directly or indirectly) by tax-exempt debt, (ii) under such lease there is a fixed or determinable purchase or sale option, (iii) the lease has a term in excess of 20 years, or (iv) there is a sale-leaseback with respect to the property. There are a number of exceptions in I.R.C. § 168(h)(1), including an exception where the property is used in an unrelated trade or business of the tax-exempt entity. Also, under I.R.C. § 168(h)(1)(B)(iii), nonresidential real property is not treated as tax-exempt use property unless more than 35% of the property is leased to tax-exempt entities.

Although I.R.C. § 470 generally defines "*tax-exempt use prop*erty" by reference to I.R.C. § 168(h), it makes several important exceptions as well. First, the exceptions in I.R.C. § 168(h) for short-term leases and leases of high technology equipment do not apply for purposes of I.R.C. § 470.[222] Second, for purposes of applying I.R.C. § 470, any I.R.C. § 197 intangible, or any property described in I.R.C. § 167(f)(1)(B) (computer software) or I.R.C. § 167(f)(2) (intangible assets that are separately acquired), is treated as if it were tangible property, so that the utilization of such property by a tax-exempt entity could give rise to a lease.[223] However, I.R.C. § 470 does not apply to property that is treated as tax-exempt use property solely because the property is owned by a partnership that has tax-exempt partners.[224]

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220. I.R.C. § 470(e)(2). I.R.C. § 470 generally applies to leases of tax-exempt use property entered into after March 12, 2004. *See* § 4.07.C.

221. I.R.C. § 470(c)(1).

222. I.R.C. § 470(c)(2)(A).

223. I.R.C. § 470(c)(2)(B).

224. I.R.C. § 470(c)(2).

B. Special Application to Partnerships

Included in the cross-reference to I.R.C. § 168(h) in the definition of "tax-exempt use property" in I.R.C. § 470 are the provisions of I.R.C. § 168(h)(6), which particularly apply to partnerships with tax-exempt or foreign partners. I.R.C. § 168(h)(6) provides that if: (i) any property which would otherwise not be tax-exempt use property is owned by a partnership which has both a tax-exempt or foreign entity and a person who is not a tax-exempt or foreign entity as partners, and (ii) any allocation to the tax-exempt or foreign entity of partnership items is not a "qualified allocation," an amount equal to such tax-exempt entity's proportionate share of such property is treated as tax-exempt use property. A qualified allocation is any allocation to a tax-exempt entity which has substantial economic effect and which is consistent with such entity being allocated the same distributive share of each item of income, gain, loss, deduction, credit and basis, and such share remains the same during the entire period the entity is a partner in the partnership.[225] The proportionate share of the tax-exempt entity is such entity's largest proportionate share of income or gain of the partnership (excluding gain allocated under I.R.C. § 704(c)), and if allocations vary during the period in which the tax-exempt entity is a partner, only the highest share is taken into account.[226] Similar rules apply in the case of any pass-through entity other than a partnership and to tiered partnerships.

A "qualified allocation" requires a pro rata allocation that never varies — a preferred return, incentive allocations, or any type of carried interest would not be consistent with a "qualified allocation." As you learned in Chapter 5, the requirement that qualified allocations have substantial economic effect could also be interpreted to exclude allocations of nonrecourse deductions, because such deductions do not have economic effect.[227] Regulations under I.R.C. § 514(c)(9) interpret "substantial economic effect" to include allocations that are deemed to be in accordance with the partners' interests in the partnership (and, thus, permit allocations of nonrecourse deductions),[228] but Regulations under I.R.C. § 168(h) do not explicitly include allocations that are deemed to be in accordance with the partners' interests in the partnership within the meaning of allocations that have "substantial economic effect."[229]

225. I.R.C. § 168(h)(6)(B).

226. I.R.C. § 168(h)(6)(C).

227. Treas. Reg. § 1.704-2(b)(1).

228. Treas. Reg. § 1.514(c)-2(b)(1)(ii).

229. Temp. Reg. § 1.168(j)-1T, A-22. The Regulations do allow allocations required under I.R.C. § 704(c) to be disregarded for these purposes.

C. Exceptions

"Tax-exempt use property" does not include property that would otherwise be tax-exempt use property solely by reason of the application of I.R.C. § 168(h)(6) (discussed above) if a low-income housing credit or a rehabilitation credit is allowable with respect to such property.[230]

There is also an exception in I.R.C. § 470(d) for certain leases that meet very narrow requirements:

> (1) The tax-exempt lessee may not have more than an "allowable amount" of funds subject to either (i) any arrangement described in I.R.C. § 470(d)(1)(B) or (ii) any arrangement under which a reasonable person would conclude, based on the facts and circumstances, that funds were set aside or expected to be set aside. I.R.C. § 470(d)(1)(B) refers to a defeasance arrangement, a loan by the lessee to the lessor or any lender, a deposit arrangement, a letter of credit collateralized with cash or cash equivalents, a payment undertaking agreement, prepaid rent, a sinking fund arrangement, a guaranteed investment contract, financial guaranty insurance, and any similar arrangement. An "allowable amount" of funds is generally equal to 20 percent of the lessor's adjusted basis in the property at the time the lease is entered into, although a higher percentage could be allowed by regulation.[231] If the lessee has the option to purchase property for a fixed price or for other than the fair market value of the property (determined at the time of exercise), the allowable amount at the time such option may be exercised may not exceed 50 percent of the price at which such option may be exercised;[232]
>
> (2) The taxpayer must make and maintain a substantial equity investment in the leased property. For this purpose, the taxpayer generally does not make or maintain a substantial equity investment unless (x) at the time the lease is entered into, the taxpayer initially makes an unconditional at-risk equity investment in the property of at least 20 percent of the taxpayer's adjusted basis in the leased property at that time, and (y) the taxpayer maintains such equity investment throughout the lease term;[233]

230. I.R.C. § 470(c).

231. I.R.C. § 470(d)(1)(C)(i). This amount is reduced to zero with respect to any arrangement that involves (i) a loan from the lessee to the lessor or a lender, (ii) any deposit received, letter of credit issued, or payment undertaking entered into by a lender otherwise involved in the transaction, or (iii) in the case of a transaction that involves a lender, any credit support made available to the lessor in which any such lender does not have a claim that is senior to the lessor.

232. I.R.C. § 470(d)(1)(C)(iii).

233. This requirement does not apply to leases with a term of five years or less.

(3) At all times during the lease term, the fair market value of the property at the end of the lease term is reasonably expected to equal at least 20 percent of its initial value;[234]

(4) There is no arrangement under which the lessee bears (i) any portion of the loss that would occur if the fair market value of the leased property were 25 percent less than its reasonably expected fair market value at the time the lease is terminated, or (ii) more than 50 percent of the loss that would occur if the fair market value of the leased property at the time the lease is terminated were zero;[235] and

(5) If the property has a class life of more than seven years (other than fixed-wing aircraft) and if the lessee has the option to purchase the property, the purchase price must be equal to the fair market value of the property at the time of exercise of the purchase option.

D. Application to Like-Kind Exchanges and Condemnations

There are several special rules under I.R.C. § 470 that further broaden its potential impact on taxpayers in general, and partnerships in particular. First, I.R.C. §§ 1031(a) and 1033(a) will not apply if the exchanged or converted property is tax-exempt use property subject to a lease that was entered into before March 13, 2004, and that would not have met the requirements for an exempt lease under I.R.C. § 470(d) had such requirements been in effect.[236] Furthermore, I.R.C. §§ 1031(a) and 1033(a) will not apply to an exchange if the replacement property is tax-exempt use property subject to a lease that is not an exempt lease under I.R.C. § 470(d).[237] Thus, every acquirer of leased replacement property will need to determine whether there is any tax-exempt or foreign user of the property. In addition, an acquirer of leased replacement property will generally need to determine if the seller is a partnership or other pass-through entity that has an exempt or foreign person as an owner. If the seller has an exempt or foreign user or an exempt or foreign owner, the seller will generally also need to verify that the lease satisfies the requirements of I.R.C. § 470(d).

234. I.R.C. § 470(d)(2)(A)(ii).

235. I.R.C. § 470(d)(3). The IRS is granted authority to issue Regulations under which this requirement is not met if the lessee bears more than a minimal risk of loss.

236. I.R.C. § 470(e)(4)(A)(i).

237. I.R.C. § 470(e)(4)(A)(ii).

§ 12.07 Comparison with S Corporations

Foreign corporations and nonresident foreign individuals are not eligible to be S corporation shareholders.[238] Organizations that are exempt from U.S. tax under I.R.C. § 501(a) may be S corporation shareholders, but, for the majority of them, all items of income, loss, or deduction from the S corporation and any gain or loss on the disposition of the stock of the S corporation must be taken into account as unrelated business taxable income of the exempt organization.[239] Thus, for both foreign taxpayers and exempt organizations, an entity treated as a partnership is generally a preferable investment vehicle to an S corporation.

§ 12.08 Reading, Questions, and Problems

A. Reading

Code:

I.R.C. §§ 470, 512, 514, 861, 871, 881, 897, 951, 954, 1441, 1445, 1446, 901, 909, 1471, 1473, 1474.

Treasury Regulations:

Treas. Reg. §§ 1.513-1, 1.514(c)-2, 1.884-1, 1.952-1(g), 1.954-1(g), 1.954-3(a)(6), 1.956-2(a)(3), 1.1441-5, 1.1446-2, -3, -5, 301.7701-2, -3, -5, 1.901-2(f).

Temp. Reg. § 1.897-7T.

B. Questions and Problems

1. NSULC is a Nova Scotia unlimited liability company.

   a. If NSULC has more than one member, what is NSULC's initial classification for U.S. tax purposes?

   b. If NSULC has only one member, what is NSULC's initial classification for U.S. tax purposes?

   c. May NSULC elect to change its classification for U.S. tax purposes?

2. Investment Trust is an Ontario investment trust. Assume that under Ontario law, investors in registered investment trusts have limited liability. Investment Trust explicitly has the power to vary the investment of the certificate holders.

   a. If Investment Trust has more than one member, what is Investment Trust's initial classification for U.S. tax purposes?

238. I.R.C. § 1361. There is a narrow exception to this in the case of a foreign corporation that is exempt from U.S. taxation under I.R.C. § 501(a).

239. I.R.C. § 512(e).

b. If Investment Trust has only one member, what is Investment Trust's initial classification for U.S. tax purposes?

c. May Investment Trust elect to change its classification for U.S. tax purposes?

3. A, a country X corporation, and B, a country Y corporation, form KG, a Kommanditgesellschaft in Germany to sell personal property manufactured by A. Assume, for purposes of answering the question, that at least one partner in a Kommanditgesellschaft must have unlimited liability. A and B are both owned 100% by C, a U.S. corporation.

a. What is KG's initial classification for U.S. tax purposes?

b. May KG elect to change its classification for U.S. tax purposes?

c. In determining C's U.S. foreign tax credits, may C take the taxes imposed upon the operations of KG into consideration?

d. Assuming KG is a transparent entity in Germany, will a payment to KG from a U.S. person be eligible to claim benefits of the U.S.-German tax treaty?

e. Assuming KG does not elect to change its classification for U.S. tax purposes, will the income on the sales of personal property by KG be foreign base company sales income?

f. Assuming KG elects to change its classification for U.S. tax purposes, will the income on the sales of personal property by KG be foreign base company sales income?

4. LP is an investment partnership formed in Delaware with its principal office in Nevada. LP's only activity is to trade in stocks and securities for its own account. LP is not a dealer in stocks or securities. Among the partners in LP are F, a U.K. resident, and EXP, an organization generally exempt from tax under I.R.C. § 501(c)(3).

a. Solely taking the activities of LP into consideration, is F engaged in a U.S. trade or business?

b. Would LP be obligated to withhold on F's distributive share of income?

c. Does EXP have unrelated trade or business income?

d. If LP normally maintains a 1:1 debt-equity ratio in all of its investments, does your answer to c. change?

5. LP is a real estate investment partnership formed in Delaware with its principal office in Nevada. LP's only activity is to triple net lease an office building in Las Vegas to a master tenant who subleases portions of the building to the operating tenants. LP provides no services related to the lease. LP's rights under the lease are not dependent upon the income or receipts of any person. Among the partners in LP are F, a U.K. resident, and EXP, an organization generally exempt from tax under I.R.C. § 501(c)(3).

a. If F does not make the election under I.R.C. § 871(d), is F engaged in a U.S. trade or business? What are LP's withholding obligations?

b. If F makes the election under I.R.C. § 871(d), is F engaged in a U.S. trade or business? What are L.P.'s withholding obligations?

c. Does EXP have unrelated trade or business income?

d. If LP normally maintains a 1:1 debt-equity ratio in all of its investments, does your answer to c. change?

e. What provisions would EXP require to be added to the partnership agreement to change the answer to d.?

6. Partnership ABC operates a widget export business. In general, all income and expenses are allocated one-third, one-third, one-third, but foreign tax credits are allocated 5% to A, 5% to B, and 90% to C. Will the allocation of foreign tax credits have substantial economic effect? How are the credits likely to be reallocated?

7. Partnership ABC operates a widget export business. It runs its distribution business through a Luxembourg holding company that is treated as a disregarded entity for U.S. tax purposes. The Luxembourg holding company has several subsidiaries (one for each jurisdiction in which operations are maintained) with which it consolidates for Luxembourg tax purposes. The subsidiaries are treated as corporations separate from the holding company for U.S. tax purposes. Foreign taxes are imposed upon the subsidiaries, but the holding company pays the taxes as parent of the consolidated group. The holding company has no income for Luxembourg tax purposes. May ABC allocate the foreign taxes paid by the holding company among its partners as the taxes are paid?

8. ABC operates a widget export business. In Year 1, ABC purchased the stock of WidgetKnockOff Co., one of its competitors in jurisdiction X. WidgetKnockOff Co. had elected to be a disregarded entity for U.S. tax purposes. The purchase price paid by ABC was in excess of the basis of the assets of WidgetKnockOff Co. In Year 2, ABC sold the assets of WidgetKnockOff Co. in a transaction subject to tax in jurisdiction X. What portion, if any, of the tax imposed by jurisdiction X will be creditable in the United States?

9. ABC manufactures and sells widgets in the Unites States. A and B are U.S. domestic individuals, but C is a non-U.S. entity that is primarily engaged in the business of manufacturing and selling widgets around the world. C's stock is not publicly traded. ABC makes annual allocations and distributions of the partner's allocable shares of income. C also loaned $100x to ABC on April 1, 2012, to support the capitalization of ABC. ABC pays C $5x of interest annually. What portions of the allocations, distributions, and payments to C will be subject to FATCA withholding? What must C do to avoid the withholding?