

# **PARTNERSHIP TAXATION**

**September 2009 Update  
to  
SECOND EDITION**

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<b>Additions and Insertions .....</b>	<b>1</b>
<b>Errata .....</b>	<b>21</b>

# PARTNERSHIP TAXATION

## ADDITIONS AND INSERTIONS

### CHAPTER 1 DEFINING PARTNERSHIPS AND PARTNERS FOR TAX PURPOSES

#### § 1.03 Classifying Partnerships for Tax Purposes

##### B. The Classification of Domestic Business Entities

#### Page 14. Insert at the end of the page:

One exception to the general rule that domestic business entities with more than one owner may not be treated as disregarded entities is a spousal partnership. I.R.C. § 761(f) provides that a husband and wife who operate a joint venture may elect not to treat the joint venture as a partnership; in other words, they may treat it as a disregarded entity. In order to qualify, both spouses must materially participate in the business of the entity, and they must file a joint return. Rev. Proc. 2002-69<sup>1</sup> also allows spousal partnerships to be disregarded in community property states without regard to the material participation standard.

Some states have enacted legislation that provides for series limited liability companies. A series LLC is generally a limited liability company that has internal series or divisions that may have separate members, managers, assets, liabilities, business purpose, etc. In PLR 200803004 (Jan. 18, 2008), the IRS issued its first private letter ruling on the classification of a series LLC. In that Private Ruling, certain series LLCs that had only a single owner would not elect to be taxed as a corporation. Other series, which had more than one member, would not elect to be treated as other than a partnership, whereas a third group of series LLCs would be treated as corporations. The Private Ruling contained a number of representations by the taxpayer, including that each member's share of the profit and loss of a series would be based solely upon the items of income and loss of that series, that each series would consist of a separate pool of assets, liabilities and earnings, but upon a redemption, liquidation or termination of the series, the members of that series would only share in the assets of that series and that the creditors of each series would be limited to the assets of that series. The Private Ruling held that those series which had a single member would be treated as a disregarded entity (in the same manner as a single member limited liability company), that those series with multiple owners which did not elect to be taxed as other than a partnership would be taxed as a partnership, and that those series which elected to be classified as a corporation would be so classified. In effect, the Private Ruling stands for the proposition that each series would be treated as a separate entity for Federal income tax purposes, and that each series need not have the same tax classification.

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<sup>1</sup> 2002-2 C.B. 831.

## **CHAPTER 2 FORMATION OF THE PARTNERSHIP**

### **§ 2.02 Transfer of Property to Partnership**

#### **B. What Constitutes Property**

##### **2. Contract Rights**

##### **A. Promissory Notes**

##### **iv. Partnership's Indebtedness to the Partner**

#### **Page 34. Insert following the second paragraph:**

Proposed Regulations<sup>2</sup> have been issued which provide a safe harbor for determining the fair market value of the partnership interest issued by the partnership to a creditor in exchange for debt. Under the safe harbor, the fair market value of the partnership interest would be equal to the liquidation value of the partnership interest issued. Liquidation value means the amount of cash that would be received with respect to the partnership interest issued if, immediately after the issuance of the partnership interest, the partnership sold all of its assets for cash equal to the fair market value of those assets and then liquidated, but only if (i) the partnership determines and maintains capital accounts in accordance with the provisions of Treas. Reg. § 1.704-1(b)(2)(iv), (ii) the creditor, the partnership and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the partnership interest issued for purposes of determining the tax consequences of the debt-for-equity exchange, (iii) the debt-for-equity exchange is an arm's-length transaction, and (iv) subsequent to the debt-for-equity exchange, the partnership does not redeem, nor does any person related to the partnership purchase, the partnership interest issued as part of a plan which has as its principal purpose the avoidance of the cancellation of indebtedness income by the partnership. If the safe harbor requirements set forth above are not met, then all the facts and circumstances are considered in determining the value of the partnership interest issued.

#### **Page 34. Insert at the end of the page:**

Proposed Regulations would deny the contributing partner a loss on the contribution of a partnership's debt to the partnership when the contributing partner receives a partnership interest in exchange for the contribution.<sup>3</sup>

### **§ 2.03 Transfers to Investment Companies**

#### **Page 41. Add to footnote 40:**

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<sup>2</sup> Prop. Treas. Reg. § 1.108-8(b)(2).

<sup>3</sup> REG-164370-05, 73 Fed. Reg. 212 (Oct. 31, 2008).

The list of assets that are considered held for investment has been expanded by I.R.C. § 351(e) subsequent to the promulgation of Treas. Reg. § 1.351-1(c)(2).

## **§ 2.05 Effect of Liabilities**

**Page 43. Add at the end of the third paragraph:**

(unless the transaction is a disguised sale; see § 8.06).

## **§ 2.07 Holding Period of Partnership Interest**

**Page 44. Add at the end of the third line from the bottom of the first paragraph:**

(which are capital assets and section 1231 assets)

## **§ 2.11 Organization And Selling Expenses**

### **A. Selling Expenses**

**Page 47. Add at the end:**

Temp. Treas. Reg. § 1.709-1T(a)(3) makes clear that no deduction of capitalized selling expenses is allowable in the year in which the partnership liquidates.

### **B. Organization Expenses**

**Page 48. Add after the first paragraph:**

Temp. Treas. Reg. § 1.709-1T(a)(2) provides that the partnership is deemed to have made the election to amortize organizational expenses under I.R.C. § 709(b) for the taxable year in which the partnership begins business. If the partnership does not wish to make this election, it may do so by clearly electing to capitalize its organizational expenditures on a timely filed return for the taxable year in which the partnership begins business.

**Page 48. Add at the end of §2.11:**

### **C. Expenses of Starting a Business**

I.R.C. § 195(a) denies a deduction for start-up costs. However, I.R.C. § 195(b) specifically allows the taxpayer to elect to treat these costs as deferred expenses and amortize them over a period of not less than 180 months.

I.R.C. § 195(c) provides the definitions of the terms “start-up costs” and “beginning of trade or business.” Start-up costs are costs for creating an active trade or business or investigating the creation or acquisition of an active trade or business. Start-up costs include any amounts paid or incurred in connection with any activity engaged in for profit or for the production of income before the trade or business begins, in anticipation of the activity becoming

an active trade or business. The expenditures must be of such a nature that they would be deductible if they had been incurred in the operation of an existing business.

When an active trade or business is purchased, start-up costs include only costs incurred in the course of the general search for or preliminary investigation of the business. Costs incurred in the attempt to actually purchase a specific business are capital expenses and are not amortizable under I.R.C. § 195. Investigatory expenses are those incurred in the review of a prospective business before a decision to acquire the business has been made.

As in the case of organizational expenditures, Temp. Treas. Reg. § 1.195-1T(b) provides that a taxpayer is deemed to have made the election under I.R.C. § 195(b) to amortize start-up expenditures for the taxable year in which the active trade or business to which the expenditures relates begins. If the taxpayer does not wish to have the election apply, the taxpayer may do so by clearly electing to capitalize its start-up expenditures.

A partnership using the cash basis cannot take an amortization deduction until the start-up cost has been paid. If such costs are paid in a year after the business has begun, a partnership can deduct an amount equal to the number of months beginning with the effective date of the I.R.C. § 195(b) election. This will allow the amount of amortization on items paid in subsequent years to catch up to the amortization on costs paid in the initial election year.

## **CHAPTER 3 OUTSIDE BASIS AND ALLOCATION OF LIABILITIES**

### **§ 3.03 General Rules For Computing Basis** **A. Starting Point**

#### **3. Gifts**

**Page 53. Replace with the following:**

If a partnership interest is received by gift, the normal rules with respect to the receipt of gifts apply. Under I.R.C. § 1015(a), the basis of the partnership interest in the hands of the recipient is generally the same as the basis of the partnership interest in the hands of the donor, subject to the loss limitation rules of I.R.C. § 1015(a). If the donor pays any gift tax with respect to such gift, the donee's basis is increased by an amount which bears the same ratio to the gift tax as the net appreciation in value of the gift (if any) bears to the amount of the gift (but not in excess of the gift tax paid).<sup>4</sup> The net appreciation is the amount by which the fair market value of the gift exceeds the donor's basis immediately before the gift.<sup>5</sup>

#### **4. Inherited Partnership Interest**

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<sup>4</sup> I.R.C. § 1015(d)(6)(A); see Treas. Reg. § 1.1015-5(c).

<sup>5</sup> I.R.C. § 1015(d)(6)(B).

**Page 53. Add at the end:**

(excluding any value attributable to income in respect of a decedent, which includes depreciation recapture).

**§ 3.04 Effect of Partnership Liabilities**

**B. Definition of Recourse and Nonrecourse Liabilities**

**2. Definition of Recourse Liability**

**Page 59. Add to footnote 18:**

This general rule is subject to one exception for partners for state law purposes that are disregarded entities for tax purposes. In such a situation, a partner is treated as capable of performing its obligations only to the extent of the net value of the assets of the disregarded entity.<sup>6</sup>

**§ 3.05 Reading, Questions And Problems**

**B. Questions and Problems**

**Page 71, Question 2. Add at the end of the first paragraph:**

Assume that there is a state law assumption of the mortgage by the partnership.

**CHAPTER 4 OPERATION OF THE PARTNERSHIP:  
CALCULATION OF PARTNERSHIP  
TAXABLE INCOME**

**§ 4.03 Computing Income, Gain, Loss, Deductions and Credits  
of Partnership**

**A. Generally**

**Page 74. Add after the carryover sentence at the top of the page:**

A partner is required to include his distributive share of the partnership's income even in situations in which there are disputes among the partners and the income of the partnership are being held in escrow.<sup>7</sup>

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<sup>6</sup> Treas. Reg. § 1.752-2(k).

<sup>7</sup> *Burke v. Commissioner*, T.C. Memo 2005-297, *aff'd* 485 F.3d (1<sup>st</sup> Cir. 2007).

## **§ 4.07 Loss Limitation Rules**

### **B. At Risk Rules**

#### **2. Calculation of Amount at Risk**

#### **Page 86. Add after the second full paragraph:**

*In Hubert Enterprises, Inc. v. Commissioner*<sup>8</sup>, the Tax Court held that a deficit restoration obligation contained in an operating agreement of a limited liability company taxed as a partnership did not result in the members being at risk with respect to the recourse liabilities of the limited liability company because (i) the deficit restoration obligation would only be effective if the limited liability company liquidated, and even then there was no assurance that the amount of the deficit restoration obligation would be equal to the amount of the unpaid recourse debt, (ii) under the terms of the operating agreement, the amount paid under the deficit restoration obligation could be paid to members with positive capital account balances, rather than to creditors, and (iii) the creditors had no enforceable right to collect any unpaid debt directly from the member by reason of the deficit restoration obligation.

#### **3. Material Participation**

#### **Page 90. Add to footnote 81:**

This is subject to exceptions for real estate professionals, I.R.C. §469(c)(7), and certain individuals subject to a \$250,000 limitation. I.R.C. § 469(i).

#### **Page 91. Add before the last paragraph:**

In *Garnett v. Commissioner*,<sup>9</sup> the Tax Court concluded that interests in limited liability partnerships and limited liability companies were not limited partnership interests for the purposes of the passive activity loss rules. In reaching this determination, the Tax Court relied largely on the fact that members in limited liability companies and partners in limited liability partnerships are not precluded from participating in the management of the entity for state law purposes, as are limited partners.

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<sup>8</sup> TC Memo 2008-46.

<sup>9</sup> 132 T.C. No. 19 (June 30, 2009).

**CHAPTER 5 OPERATION OF THE PARTNERSHIP:  
ALLOCATION OF PARTNERSHIP  
INCOME AND LOSSES**

**§ 5.03 Substantial Economic Effect Rules**

**C. Substantiality**

**1. General Rules**

**Page 110. Add at the end of the carryover paragraph at the top of the page:**

In determining the effect of the after-tax consequences that result from an allocation, comparison is made to the allocations that would be made in accordance with the partners' interests in the partnership.<sup>10</sup> 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.<sup>11</sup> A *de minimis* rule is provided that will allow partnerships to ignore partners holding less than 10% of the partnership for the purposes of testing the substantiality rules.<sup>12</sup>

**§ 5.05 Book-Tax Disparities--I.R.C. § 704(c) Allocations**

**A. Introduction**

**Page 116. Add after the fourth sentence of the first paragraph:**

The Regulations achieve this result by allowing a partnership to apply the rules of I.R.C. § 704(c) with reference to the partners' distributive shares of the corresponding book items as determined under I.R.C. § 704(b).<sup>13</sup>

**B. I.R.C. § 704(c) Methods of Allocation**

**1. The Traditional Method**

**Page 117. Add before the first paragraph:**

In general, the traditional method requires that when the partnership has income, gain, loss or deduction attributable to I.R.C. § 704(c) property, it must make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss. Under this rule, if the partnership sells I.R.C. § 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner.

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<sup>10</sup> Treas. Reg. § 1.704-1(b)(2)(iii)(a).

<sup>11</sup> Treas. Reg. § 1.704-1(b)(2)(iii)(d).

<sup>12</sup> Treas. Reg. § 1.704-1(b)(2)(iii)(e).

<sup>13</sup> Treas. Reg. § 1.704-1(b)(1)(vi).

## § 5.07 Allocations of Nonrecourse Deductions

**Page 132. Add after the carryover paragraph:**

### **D. Partner Nonrecourse Deductions**

As we learned in Chapter 3, when a partner or a related person has the economic risk of loss for a liability of the partnership, the liability is allocated to the partner in proportion to the extent to which the partner or the related partner bears the economic risk of loss.<sup>14</sup> Just as the liability is allocated among the partners that bear the economic risk of loss for the purposes of determining the partners' bases in their partnership interests under I.R.C. § 752, the deductions associated with such liabilities must be allocated to the partners that bear the economic risk of loss.

Although for purposes of I.R.C. § 752 such debt is treated as "recourse debt," for purposes of I.R.C. § 704 such debt is treated as "partner nonrecourse debt." Rules similar to the rules for allocating deductions attributable to partnership nonrecourse debt are required to be applied to partner nonrecourse debt.<sup>15</sup> Partner nonrecourse debt minimum gain is separately calculated from partnership minimum gain, and partner nonrecourse debt deductions are allocated to the partners according to their shares of increases in partner nonrecourse debt minimum gain. Also similar to the general rules for nonrecourse debt, if there is a reduction in a partner's share of partner nonrecourse minimum gain during a taxable year, the partnership is required to allocate to the partner that had the decrease items of income and gain equal to the amount of the decrease.

## § 5.09 Changes in Partnership Interests During the Tax Year

**Page 135. Add at the end:**

Treas. Reg. § 1.706-1(c)(2)(ii) provides that, under the proration method, the partnership's income and losses may be prorated based on the portion of the taxable year that has elapsed prior to the date upon which the partners' interests varied, or "under any other method that is reasonable." These other reasonable methods have become known as conventions.

The IRS issued a news release<sup>16</sup> announcing that partnerships using the interim closing method were permitted to use a semi-monthly convention. Under a semi-monthly convention, partners entering during the first 15 days of the month are treated as entering on the first day of the month, and partners entering after the 15th day of the month (but before the end of the

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<sup>14</sup> Treas. Reg. § 1.752-2(a).

<sup>15</sup> Treas. Reg. § 1.704-2(i).

<sup>16</sup> IR-84-129 (<http://www.irs.gov/pub/irs-drop/ir-84-129.pdf>) (Dec. 13, 1984).

month) are treated as entering on the 16th day of the month (except to the extent that I.R.C. § 706(c)(2)(A) applied). The news release provided that, until regulations were issued, partnerships that use the proration method were required to use a daily convention.

Proposed regulations (the “706 Proposed Regulations”)<sup>17</sup> have been issued that update and change the manner in which partnerships account for changes in interests of partners during the partnership taxable year. The 706 Proposed Regulations add a rule that for each partnership taxable year in which a partner’s interest varies, the partnership must use the same method to take into account all changes in partnership interests occurring within that year (the “Consistency Rule”). Although the Consistency Rule on its face would appear to apply to changes in partnership interests, informal comments by representatives of the Treasury have indicated that it is their intent and interpretation that if any partnership items require the partnership only to allocate the items among the partners in the partnership on that day,<sup>18</sup> the partnership may not use the proration method for the year in which the items occur.

Prop. Treas. Reg. 1.706-4(d) provides that by agreement among the partners a partnership may use a proration method, rather than the interim closing of the books method, to take into account any variation in a partner’s interest in the partnership during the taxable year. Under the proration method, except for extraordinary items,<sup>19</sup> the partnership allocates the distributive share of partnership items under I.R.C. § 702(a) among the partners in accordance with their pro rata shares of these same items for the entire taxable year. In determining a partner’s pro rata share of partnership items, the partnership is required to take into account that partner’s interest in such items during each segment of the taxable year.

In addition, Prop. Treas. Reg. § 1.706-4(d)(3) requires a partnership using the proration method to allocate extraordinary items among the partners in proportion to their interests at the beginning of the day on which they are taken into account. For this purpose, an extraordinary item is (i) any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset as defined in I.R.C. § 1221 (determined without the application of any other rules of law); (ii) any item from the disposition or abandonment of property used in a trade or business (other than in the ordinary course of business) as defined in I.R.C. § 1231(b) (determined without the application of any holding period requirement); (iii) any item from the disposition or abandonment of an asset described in I.R.C. §§ 1221(1), (3), (4), or (5), if substantially all the assets in the same category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions); (iv) any item from assets disposed of in an applicable asset acquisition under I.R.C. § 1060(c); (v) any I.R.C. § 481(a) adjustment; (vi) any item from the discharge or retirement of indebtedness (for example, if a debtor partnership transfers a capital or profits interest in such partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, any discharge of indebtedness income recognized under I.R.C. § 108(e)(8) must be allocated among the persons who were partners in

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<sup>17</sup> Prop. Treas. Reg. § 1.706-4.

<sup>18</sup> See I.R.C. § 706(d)(2).

<sup>19</sup> Defined in Prop. Treas. Reg. § 1.706-4(d)(3).

the partnership immediately before the discharge); (vii) any item from the settlement of a tort or similar third-party liability; (viii) any credit, to the extent it arises from activities or items that are not ratably allocated (for example, the rehabilitation credit under I.R.C. § 47, which is based on placement in service); and (ix) any item which, in the opinion of the IRS, would, if ratably allocated, result in a substantial distortion of income in any consolidated return or separate return in which the item is included.

## **CHAPTER 6 DISPOSITIONS OF PARTNERSHIP INTERESTS**

### **§ 6.06 Dispositions other than Sales or Exchanges**

#### **D. Abandonment and Worthlessness**

##### **Page 150. Add immediately after carryover paragraph:**

In Rev. Rul. 93-80,<sup>20</sup> the IRS concluded that a loss incurred as a result of the abandonment or worthlessness of a partnership interest where the partnership had debt at the time of the abandonment or worthlessness would be treated under I.R.C. § 751(b), rather than I.R.C. § 751(a). One of the results of such treatment, which is discussed in greater detail in Chapter 7, is that in order for a partner to have ordinary income treatment, the inventory would need to be substantially appreciated. “Substantially appreciated” in this context means having a fair market value in excess of 120 percent of the adjusted basis of the inventory.

Thus, in the situations in which a partner is most likely to abandon a partnership interest – when the value of partnership property is low – Rev. Rul. 93-80 may not permit ordinary loss treatment on an abandonment if the partnership has debt.

#### **E. Conversion to Corporation**

##### **Page 150. Add at the end of the page:**

Rev. Rul. 84-111<sup>21</sup> describes three methods pursuant to which a partnership may be converted to a corporation:

1. The assets of the partnership may be contributed to a newly formed corporation in exchange for stock of the corporation, and then the partnership is terminated by distributing all of the stock of the corporation (the “Assets-Over Form”);

2. The assets of the partnership may be distributed out to the partners in liquidation of the partnership, and the partners then contribute the assets to a newly formed corporation in exchange for stock in the corporation; and

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<sup>20</sup> 1993-2 C.B. 239.

<sup>21</sup> 1984-2 C.B. 88.

3. The partners of the partnership contribute all of their partnership interests to a newly formed corporation in exchange for stock in the corporation.

The ruling assumes that the steps chosen for the particular structure actually occur. As the ruling discusses, the alternatives must be analyzed based upon the general rules for contributions of assets under I.R.C. § 351 and partnership distributions.

With the introduction of the check-the-box Regulations and the state law development of between-entity mergers and formless conversion statutes, a method needed to be developed for dealing with partnership-to-corporate conversions that did not actually take some or all of the steps described in the alternatives in Rev. Rul. 84-111.

The check-the-box Regulations themselves contemplate that a partnership may file Form 8832 and elect to be treated as a corporation even though the entity continues as a partnership or limited liability company for state law purposes. If a partnership makes such an election, the partnership is deemed to use the Assets-Over Form described above.<sup>22</sup> The contribution is deemed to occur at the end of the day before the effective date of the election, and the first day of the taxable year of the corporation is the effective date of the election.<sup>23</sup>

Of course, a partnership may convert for state law purposes without filing an election under the check-the-box Regulations. Rev. Rul. 2004-59<sup>24</sup> provides that if a partnership converts to a corporation for state law purposes using a method that does not require an actual transfer of assets or interests, such as a cross-entity merger statute or an elective conversion statute, the partnership will also be deemed to use the Assets-Over Form. Unlike the check-the-box Regulations, Rev. Rul. 2004-59 does not specify the times at which the deemed transactions are deemed to occur. In regard to a conversion to an S corporation, the IRS has clarified the timing issue in Rev. Rul. 2009-15.<sup>25</sup> In Rev. Rul. 2009-15, the IRS ruled that a partnership that converts to a corporation under a formless conversion statute may elect to be treated as an S corporation effective as of the day the state law conversion became effective. Thus, the deemed contribution of assets by the partnership and the deemed liquidation of the partnership are deemed to occur immediately before the start of the day on which the state law conversion was effective.

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<sup>22</sup> Treas. Reg. § 301.7701-3(g)(1)(i).

<sup>23</sup> Treas. Reg. § 301.7701-3(g)(3)(i).

<sup>24</sup> 2004-1 C.B. 1050.

<sup>25</sup> 2009-21 I.R.B. 1035.

## CHAPTER 7 PARTNERSHIP DISTRIBUTIONS

### § 7.03 Nonliquidating Distributions of Property A. General Rules

#### **Page 173. Add following the first full paragraph:**

Not every time that a partnership conveys property to a partner will that conveyance necessarily be a distribution. In some circumstances, the conveyance may be a sale. I.R.C. § 707(a) provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, the transaction is treated as if occurring between the partnership and someone who is not a partner.

In Rev. Rul. 2007-40<sup>26</sup>, a partnership was obligated to make a guaranteed payment to a partner of the type described in I.R.C. § 707(c). In lieu of distributing cash in satisfaction of the guaranteed payment, the partnership distributed real property having a fair market value equal to the guaranteed payment. Generally, if a partnership makes a distribution of property to a partner, no gain or loss is recognized under I.R.C. § 731(b). On the other hand, if a taxpayer conveys property to another in satisfaction of an obligation, or in exchange for the performance of services, the taxpayer must recognize gain or loss measured by the difference between the basis of the property conveyed and the fair market value of the property. Rev. Rul. 2007-40 holds that the conveyance of the real property to the partner was not a distribution, but rather was a sale of the real property under the general rules.

In Chief Counsel Advice 20065014 (December 15, 2006), the taxpayer's interest in a partnership was to be liquidated. To accomplish the liquidation, the partnership formed a single member limited liability company (treated as a disregarded entity) that purchased a house which it then transferred to the partner in exchange for his partnership interest. The taxpayer treated the transaction as a liquidating distribution in which neither he nor the partnership had any gain or loss pursuant to I.R.C. § 731. The IRS concluded, however, that I.R.C. § 731 did not apply because the house was acquired solely for the purpose of the distribution, and was not related to the partnership's business. It also stated that the partnership was never the owner of the house for tax purposes. Lastly, the IRS stated that there was no economic substance to the transaction.

#### **C. Marketable Securities**

#### **Page 175. Add at the beginning of the sixth sentence of the first full paragraph:**

Ignoring (for the sake of simplicity) I.R.C. § 731(c)(3)(B),

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<sup>26</sup> 2007-1 C.B. 1426.

## CHAPTER 8 TRANSACTIONS BETWEEN PARTNER AND PARTNERSHIP; ISSUANCE OF A PARTNERSHIP INTEREST FOR SERVICES

### § 8.06 Disguised Sales

#### B. The Disguised Sales of Partnership Interests

**Pages 214-217. Delete all of §8.06.B, and substitute the following:**

One of the distinctions that hopefully is now apparent between the sale of a portion of a partnership interest and a distribution from a partnership to a partner reducing (but not liquidating) the partner's interest in the partnership is the manner in which gain is calculated. As discussed in Chapter 7, I.R.C. § 731 generally provides that a partner does not recognize gain on a distribution except to the extent that the money distributed exceeds the recipient partner's basis immediately before the distribution. As discussed in Chapter 6, if a partner disposes of a portion of the partner's partnership interest, the partner must allocate the partner's basis between the portion retained and the portion transferred. Thus, a partner is able to use the partner's entire basis to absorb distributions from a partnership, but only a portion of the partner's basis when a portion of a partner's interest is sold.

Other differences also may occur. For example, a transferee succeeds to a proportionate share of the transferor's capital account and I.R.C. § 704(c)(1)(A) built-in gain amount. A new partner by contribution would start with a clean slate.

Whenever economically similar transactions are treated differently by the Code, taxpayers will have a tendency to structure the transaction in a manner that produces the least tax.

For example, A and B own partnership AB in which each partner owns a 50% interest. A and B each have a basis in their respective partnership interests of \$30. C wants to join the partnership and is willing to pay \$30 for a one-third interest in the partnership. If C buys one third of each of A and B's interests in the partnership, each of A and B will have gain of \$5 (\$15 paid to each less \$10 (one third of basis)). If A and B were successfully able to structure the transaction as a contribution by C to AB followed by a distribution to A and B, neither A nor B would have gain recognition (\$30 basis less \$15 distribution).

Although the proposed regulations dealing with the disguised sale of partnership interests had been promulgated, those proposed regulations have now been withdrawn. In the absence of regulations addressing the issues, the authority related to disguised sales of partnership interests is relatively sparse.

One case that has addressed the issue of a disguised sale of a partnership interest is *Jupiter Corp. v. United States*.<sup>27</sup> In *Jupiter Corp.*, a partnership that had been formed in 1962

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<sup>27</sup> 2 Cl. Ct. 58 (1983).

admitted new partners in 1966, with the new partners contributing capital to the partnership. The contribution to capital was distributed to the pre-existing partners in proportion to their prior percentage interests. The court looked to the intent of the parties and found that neither the old partners nor the new partners would have agreed to a purchase of a partnership interest from the old partners. In addition, the economic interest that the new partners held was different from that held by the old partners. The court held that the transaction was not a camouflaged sale of a partnership interest.

Similarly, in *Communications Satellite Corp. v. United States*,<sup>28</sup> the admission of new partners and the contemporaneous distribution of cash to the pre-existing partners was held not to be a disguised sale of partnership interests. In making its determination, the court looked particularly to the lack of financial negotiations between the pre-existing partners and the incoming partners and the lack of control of the pre-existing partners over the admission of the new partners.

On the other hand, in *Crenshaw v. United States*,<sup>29</sup> the court viewed (i) a distribution of a partnership asset, (ii) a like-kind exchange with a related party of the distributed asset, (iii) a sale of the distributed asset by the related party, and (iv) a contribution of the distributed property back to the partnership by the buyer, as a sale of a partnership interest under the step-transaction doctrine.

Relying largely on the legislative history to I.R.C. § 707, the IRS has issued two technical advice memoranda that conclude that transactions constitute disguised sales of partnership interests.<sup>30</sup> In TAM 200301004, the IRS acknowledged that the facts being considered were similar to those in *Communications Satellite Corp.*, but indicated that the legislative history allowed the IRS to reach a contrary conclusion.

## **§ 8.08A Issuance of a Partnership Interest in Exchange for Services**

**Page 219.**

### **A. Potential Gain to Partnership**

In general, a service recipient recognizes gain on the transfer of appreciated property to a service provider in payment for the performance of services to the extent that the amount the

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<sup>28</sup> 625 F.2d 997 (Cl. Ct. 1980).

<sup>29</sup> 450 F.2d 472 (5th Cir. 1971).

<sup>30</sup> TAM 200301004 (Dec. 26, 2002); TAM 200037005 (Sept. 18, 2000).

value of the services received exceeds the service recipient's basis in the property transferred.<sup>31</sup> The service recipient is treated as having sold the property transferred.<sup>32</sup>

When the service recipient is issuing equity in itself to the service provider, this general approach creates an issue because the service recipient will generally have a zero basis in its own equity.

In the case of a corporation transferring its own stock to a service provider, I.R.C. § 1032 prevents the corporation from recognizing any gain or loss on the issuance of the stock.<sup>33</sup> As discussed in Chapter 2, the Code section for partnerships that is similar to I.R.C. § 1032 is I.R.C. § 721. In contrast to the treatment under I.R.C. § 1032, the Regulations under I.R.C. § 721 provide:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.<sup>34</sup>

Thus, partnerships arguably are subject to income recognition on the issuance of their own interests in exchange for services under the current Regulations because the partnership is paying compensation with a partnership interest in which the partnership has a zero basis.

The general issue as to the potential of gain recognition by the partnership as a service recipient is further augmented because the Regulations treat the issuance of a partnership interest in exchange for services as a guaranteed payment.<sup>35</sup> In 2007, the IRS issued a public ruling that the transfer of property in satisfaction of a guaranteed payment results in an exchange under I.R.C. § 1001.<sup>36</sup>

Thus, whether the issue is approached from authorities focused on compensation or Subchapter K, absent the application of other authority, a partnership may be required to recognize gain equal to the value of the services received on the issuance of a partnership interest in exchange for services.

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<sup>31</sup> Treas. Reg. § 1.83-6(b).

<sup>32</sup> *U.S. v. General Shoe Corp.* 282 F.2d 9 (6<sup>th</sup> Cir. 1960).

<sup>33</sup> Treas. Reg. § 1.1032-1(a)

<sup>34</sup> Treas. Reg. § 1.721-1(b).

<sup>35</sup> Treas. Reg. § 1.721-1(b)(2).

<sup>36</sup> Rev. Rul. 2007-40, 2007-25 I.R.B. 1426.

## B. Income to the Service Partner

I.R.C. § 83 requires that, in general, if property is issued in connection with the performance of services, the excess of the value of the property over the amount paid for the property is included in the gross income of the service provider in the first year the rights of the recipient of the property are transferable or not subject to a substantial risk of forfeiture.<sup>37</sup> Special rules are provided for an election to recognize income in respect of property subject to a substantial risk of forfeiture in the year the property is transferred rather than the year of vesting.<sup>38</sup>

The question of how service providers should be taxed upon the receipt of partnership interests issued in payment for services was subject to substantial controversy. If a partnership interest issued for services was shown to have clear value through a sale of the partnership interest shortly after the issuance, the partnership interest was treated as taxable to the service provider in the amount of the interest's value.<sup>39</sup> On the other hand, a service partner was not taxable on the receipt of a profits interest where the interest had only speculative value at the time of its issuance.<sup>40</sup>

A variety of theories were addressed by both taxpayers and the IRS, with varying degrees of success.

In *Hale v. Commissioner*,<sup>41</sup> a pre-I.R.C. § 83 case, the court concluded that the gain recognized on the assignment of a profits interest should be given ordinary income treatment, although the partnership interest itself was a capital asset. The court also observed in a footnote that the mere receipt of a partnership interest in future profits of the partnership does not create a current tax liability.<sup>42</sup>

In *Diamond v. Commissioner*,<sup>43</sup> also a pre-I.R.C. § 83 case, the court, noting that in some cases a profits interest may have speculative value, found that the taxpayer had taxable ordinary

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<sup>37</sup> I.R.C. § 83(a).

<sup>38</sup> I.R.C. § 83(b). The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual. I.R.C. § 83(c)(1).

<sup>39</sup> *Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

<sup>40</sup> *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991). A general discussion of the issues surrounding the issuance of a capital interest for services may be found in Frost, "Receipt of Capital and Profits Interests Continues to Have Uncertain Tax Consequences," 75 JTAX 38 (1991).

<sup>41</sup> TC Memo 1965-274.

<sup>42</sup> *Hale*, at f.3.

<sup>43</sup> 492 F.2d 286 (7th Cir. 1974).

income treated as compensation for services on the receipt of a profits interest where the profits interest had clearly determinable fair market value because of a sale of the interest within a month after the interest was originally issued.

In other cases, the court has concluded or the IRS has conceded that receipt of a profits interest by a service partner creates no tax liability.<sup>44</sup> Similarly, in *Campbell v. Commissioner*,<sup>45</sup> the Eighth Circuit Court of Appeals found that a profits interest had only speculative, if any, value and was not taxable.

Much of the uncertainty and litigation over the treatment of profits interests was resolved by the IRS through the promulgation of Rev. Proc. 93-27.<sup>46</sup> Under Rev. Proc. 93-27, if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership.

Under Rev. Proc. 93-27, 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. Rev. Proc. 93-27 does not apply, however, if (i) the profits interest relates to a substantially certain and predicable stream of income from partnership assets; (ii) the partner disposes of the profits interest with two years of receipt; or (iii) the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of I.R.C. § 7704(b).

Rev. Proc. 93-27 was further clarified in Rev. Proc. 2001-43.<sup>47</sup> Rev. Proc. 2001-43 provided that if a partnership grants an interest to a service provider, the time for testing whether the interest qualifies as a profits interest is, under certain circumstances, tested at the time the interest is granted (rather than at the time of vesting). To qualify for such treatment, (i) the service provider must be treated as a partner from the time of grant; (ii) neither the partnership nor the other partners may deduct any amount in respect of the vesting of the interest; and (iii) the interest otherwise must qualify as a profits interest under Rev. Proc. 93-27.

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<sup>44</sup> See *National Oil Co. v. Commissioner*, 52 T.C.M. (CCH) 1223, 1228 (1986) (Commissioner conceded that if taxpayer received only profits interest, no taxable event had occurred); *Kenroy, Inc. v. Commissioner*, 47 T.C.M. (CCH) 1749, 1756-59 (1984) (profits interest had no fair market value, thus no tax liability upon receipt).

<sup>45</sup> 943 F.2d 815 (8th Cir. 1991).

<sup>46</sup> 1993-2 C.B. 343. See Paravano, "IRS Adopts 'Capacity' Approach for Treatment of Receipt of a Partnership Profits Interest," 94 TNT 4-57 (Jan. 3, 1994).

<sup>47</sup> 2001-2 C.B. 191. See Mincey, Sloan and Banoff, "Rev. Proc. 2001-43, Section 83(b), and Unvested Profits Interests -- the Final Facet of Diamond?" 95 JTAX 205 (Oct. 2001).

Thus, as to a profits interest under Rev. Proc. 93-27, neither the recipient partner nor the partnership will recognize income on the issuance of the interest in exchange for services if the requirements of Rev. Proc. 93-27 and Rev. Proc. 2001-43 are satisfied. As to a capital interest, which under Rev. Proc. 93-27 is any interest other than a profits interest, the general rules would appear to still apply.

## **§ 8.08 Issuance of a Capital Interest in Exchange for Services**

**Page 221. Add at the end of the page:**

### **C. Current Legislative Proposals**

Several recent legislative proposals would change the way in which the issuance of a partnership interest in exchange for services would be taxed.<sup>48</sup> One such bill, H.R. 1935, would amend I.R.C. § 83 to treat the fair market value of a partnership interest issued in connection with the performance of services as the liquidation value of the partnership interest unless the recipient partner elected not to have the provision apply. Such a provision would expand the treatment now provided by Rev. Proc. 93-27<sup>49</sup> to types of partnership interests excluded by Rev. Proc. 93-27.

H.R. 1935 would also add a new I.R.C. § 710 that would provide that, in the case of an investment services partnership interest, net income with respect to such interest will be treated as ordinary income for the performance of services, and net loss with respect to such interest (to the extent not disallowed) will be treated as ordinary loss.<sup>50</sup> In addition, any gain realized on the disposition of an investment services partnership interest would be treated as ordinary income for the performance of services.<sup>51</sup>

An “investment services partnership interest” means any interest in a partnership which is held by any person if such person provides (directly or indirectly) a substantial quantity of any of the following services to the partnership: (i) advising the partnership as to the value of any specified asset; (ii) advising the partnership as to the advisability of investing in, purchasing or selling any specified asset; (iii) arranging financing with respect to acquiring specified assets; or (iv) any activity in support of the forgoing services.<sup>52</sup> “Specified asset” means, in this context,

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<sup>48</sup>See, e.g., H.R. 1935, 11th Cong. 1st Sess. (April 2, 2009). Howard E. Abrams has predicted that the current form of the proposal will ultimately be abandoned by Congress because of the technical flaws in the proposal. Howard E. Abrams, “Carried Interests: The Past is Prologue” at 9 (Jan. 19, 2008), available at SSRN: <http://ssrn.com/abstract=1085582>.

<sup>49</sup> 1993-2 C.B. 343.

<sup>50</sup> Prop. I.R.C. § 710(a)(1). The designation “Prop.” has been used to indicate a portion of the bill that would change or add a current Code provision.

<sup>51</sup> Prop. I.R.C. § 710(b)(1).

<sup>52</sup> Prop. I.R.C. § 710(c)(1).

securities, real estate, interests in partnerships, commodities, or options or derivative contracts with respect to securities, real estate or commodities.

The bill provides an exception to the general recharacterization treatment for a portion of the investment services partnership interest that is acquired for invested capital.

As of the time of this writing, the adoption of the proposals remains unclear. However, the president has incorporated a similar proposal in his budget.

## **CHAPTER 9 BUSINESS COMBINATIONS: PARTNERSHIP MERGERS AND DIVISIONS**

### **§ 9.02 Partnership Mergers**

#### **C. Built-In Gain Resulting from the Merger**

**Page 233. Delete the last sentence and substitute the following:**

Proposed Regulations that implement the principles articulated in Rev. Rul. 2004-43 have now been issued. Prop. Treas. Reg. §§ 1.704-4(c)(4) and 1.737-2(b) provide that in an assets-over merger, I.R.C. §§ 704(c)(1)(B) and 737 do not apply to the transfer by a partnership (the transferor partnership) of all of its assets and liabilities to another partnership (the transferee partnership), followed by a distribution of the interests in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. The proposed Regulations, however, provide that I.R.C. § 704(c)(1)(B) applies to a subsequent distribution by the transferee partnership of I.R.C. § 704(c) property contributed in the assets-over merger by the transferor partnership to the transferee partnership. The proposed Regulations also provide that I.R.C. § 737 applies when a partner of the transferor partnership receives a subsequent distribution of property (other than money) from the transferee partnership.

## **CHAPTER 12 FOREIGN PARTNERSHIPS, FOREIGN PARTNERS AND PARTNERSHIPS WITH TAX-EXEMPT ENTITIES**

### **§ 12.03 U.S. Partnerships with Foreign**

#### **Partners**

#### **B. Withholding Obligations in Regard to FDAP Income**

**Page 289. Add at the end:**

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.<sup>53</sup> The IRS and

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<sup>53</sup> I.R.C. §§ 871(h); 881(c).

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.<sup>54</sup> 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.

## **CHAPTER 13 ANTI-ABUSE PROVISIONS**

### **§ 13.02 Judicial Doctrines**

#### **E. Failure to Form a Valid Partnership for Tax Purposes**

**Page 311. Delete the last paragraph and substitute the following:**

A result similar to that which occurred in *ASA Investorings Partnership* occurred in *TIFD III-E Inc. v. United States*,<sup>55</sup> also known as the Castle Harbour case. Although the District Court had found that the banks that invested in the venture had nearly unlimited upside potential and were, therefore, partners, the Second Circuit Court of Appeals found that as a practical reality the interest of the banks was limited and guaranteed and was, thus, “in the nature of” debt. The appellate court concluded that the banks did not hold a partnership interest in the venture.

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<sup>54</sup> Treas. Reg. § 1.871-14(g)(3).

<sup>55</sup> 459 F.3d 220 (2d Cir. 2006).

## ERRATA

Title Page: Paul Carman's firm is Chapman and Cutler LLP.

Acknowledgments: Paul Carman's last name is Carman.

Page 18, f. 42. The case was affirmed in 2000.

Page 21. Second line of the second full paragraph. The fourth word should be "co-ownerships."

Page 41. Fifth line of the second full paragraph. The words "readily marketable" should be deleted.

Page 59. Third sentence of the second full paragraph. The sentence should read: "In that case, the property subject to that debt is treated as sold for an amount equal to the liability and gain or loss is recognized depending upon the partnership's basis for the asset subject to the debt."

Page 61, f. 20. The cite should be to PLR 200120020 (May 21, 2001).

Page 71. The reference to PLR 200112002 (Feb. 13, 2001) should be to PLR 200120020 (May 21, 2001).

Page 232. Second full paragraph. The two references to I.R.C. § 704(b) in the paragraph should be references to I.R.C. § 704(c)(1)(B).