Tax Aspects of Getting into a Partnership-taxed Organization

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Tax Aspects of Getting into a Partnership-taxed Organization

This outline discusses tax aspects involved in the starting up of partnerships, including both general and limited partnerships, but it is equally relevant to limited liability companies if, as in the usual case, they are taxed as partnerships. Organizations taxable as partnerships (for simplicity of reference, sometimes referred to as "partnerships" in this outline) are not themselves taxpayers (IRC § 701) but are conduits to their partners of the income, loss, credits, or other tax results of the operation of the business. Partnerships file information tax returns (form 1065) regardless of the amount of their income or loss, and send K-1 forms to each partner showing that partner's share of various tax reporting items which the partner then reports on its own return in a manner consistent with the way the items were treated on the partnership's return. The tax rules set forth in Subchapter K of the Internal Revenue Code, the portion of the Code dealing with partnerships, are deceptively simple. However, a reading of the regulations will soon correct any misconceptions about their simplicity. Rather complex and subtle analysis is required with respect to partnership taxation.

What, then, are the major tax issues involved in deciding to do business in a form taxable as a partnership?

A. **Why Use an Organization Taxable as a Partnership?.** Partnerships come in two varieties, general and limited. Limited partnerships are partnerships which, pursuant to statute, offer limited liability to its partners who qualify. Limited partnerships always have at least one general partner who has general rather than limited liability (although in some states there are limited liability limited partnerships where the general partner can have limited liability, too) but who controls the business operations, and at least one limited partner with limited liability but without significant control over the business. In a general partnership, all partners are subject to the liabilities of the partnership but also have cross agency and equal rights to control the business. (Except in the case of the limited liability general partnerships now available in all states, where a partner's liability for an act of another partner may be limited, or the partner may have full limited liability.) Limited liability companies taxable as partnerships can have management structures very like a limited partnership (except that all members, including the managing member, may have limited liability) or like a general partnership (where all members have equal management rights), or like a corporation (where there is a governing board). Partnerships, limited partnerships, and limited liability companies, in all their variety, all are derived from early forms of partnerships and all share the feature of being mostly matters of contract; this contrasts with corporations which are strongly based on statutory authority. The tax law in many ways reflects this feature of the partnership derived organizations.

(1) Tax Pass Through. Organizations taxable as partnerships are often used because of their flexibility and tax pass-through treatment. The partnership statutes allow the parties to make just about any business arrangement among themselves that they desire. Although corporations, which are subject to detailed statutory provisions dealing with the governance of the organization, might with proper planning be made to accomplish all or most of the parties' goals, in certain transactions, especially those involving changes over time or as specified events occur, this often requires very complex corporate structures, if it can be done at all.

(2) Flexibility. Partnerships allow the parties to achieve their goals by agreement with a relatively minimal statutory backdrop. The agreement can be as simple or as complex as the goals of the parties dictate. Capital, income, cash flow, and other rights may be allocated among the parties and may change over time or upon the occurrence of events specified in the agreement. There may be different categories of partners (managing general partners, nonmanaging general partners, limited partnership interests with preferences and those without, etc.). There may be different series of interests in limited liability companies with separate assets, liabilities, and owners. The possibilities are quite broad, particularly for limited liability companies.

(3) Ability to Reflect Complex Economic Agreement. It is not unusual for parties to agree to take different shares at different stages of a project. For example a general partner might take a small percentage until such time as the limited partners have received out of income the amount of their initial investment, at which times the shares would "flip" so the general partner then begins to take a larger share. This is hard to do with a corporation, but relatively easy with a partnership. Partnership tax rules allow for special allocations of tax benefits, if such allocations have substantial economic effect; this ability can be very useful in structuring a transaction.

(4) Convenience. In a business which generates considerable income and is owned by a small group, it is sometimes convenient to use a partnership in order to be able to withdraw a large portion of the income yearly and to have a means of sharing credit risks and allocating income. General partnership joint ventures between corporations, LLCs, or similar organizations, are typical examples of the use of this feature.

B. **Tax Uses**. Let's look at some things that allow partnership-taxed organizations to be very useful in tax planning.

(1) Lack of Limitations. One key advantage of a partnership over an S-corporation, which also has substantial tax pass-through treatment, is that the S-corporation is limited to one class of stock while the partnership is not similarly limited, allowing a greater range of allocation options. The benefits of tax pass-through treatment may be achieved by a partnership without the other limitations (*e.g.,* 100 shareholders limit, only certain kinds of persons as shareholders), which burden S-corporations. Limited liability companies which (if planned properly) are taxed like partnerships, are a relatively new entrant in this area and can be an excellent choice because they can be as flexible as partnerships.

(2) Tax-free Liquidation. The legislative repeal of the *General Utilities* case (*General Utilities and Operating Co. v. Helvering*, 296 US 200 (1935)) now keeps corporations from being liquidated without a corporate level tax. The liquidation of a partnership can often be accomplished tax free. Thus, putting appreciating assets into a corporation has become much less attractive. Limited liability companies and partnerships are the entities of choice for real estate, for example.

(3) Pass-through of Losses. Although limited by the passive loss rules (IRC § 469) and by the at-risk rules (IRC § 465), losses still can be passed through to investors and, in some circumstances, used by them. The losses which might possibly be usable are limited by the basis of the partner's partnership interest. IRC § 704. This basis derives from the partner's cash investment and the partner's share of partnership debt. S-corporations, although also treated as a form of pass-through conduit, are not so favorable in this respect as partnerships since the S-corporation shareholder's basis, which will limit the losses the shareholder can use, derives from the shareholder's cash investment and money the shareholder loaned the corporation, but not from a share of the corporation's debts even if the shareholder guarantees those debts. The difficulty of having the shareholders of S-corporations incur the debt to obtain funds to loan the corporation in order to build basis so as to be able to use losses, often makes partnerships the preferred vehicle if there are losses which are expected to be generated either by the nature of the investment or because the business is in a startup phase. In a startup situation, for example with venture capital, the ability to maximize tax benefits acts as something of a hedge to reduce the overall loss should the business fail. If it is later decided to incorporate, this usually can be done without tax cost.

(4) Other Advantages over Other Forms of Business Organization. There are various issues to be considered in the selection of a form of business organization. The choice has become considerably more complex after 2017 with the passage of the Tax Cuts and Jobs Act (H.R. 1, P.L. 115-97).

(a) Advantages over C-corporation. The advantages of partnership-taxed organizations over corporations taxed under Subchapter C of the Code (*i.e.*, with no S-election) include:

(i) Easier transfer into organization of appreciated property, since for partnership there is no 80% control requirement, unlike IRC § 351(a) (which refers to IRC ' 368(c)) for corporations. (Both types of organization are subject to the no-increase-in-diversity rules which could trigger gain on contributions for organizations holding financial assets.)

(ii) Pass-through tax treatment avoids double taxation of the corporate tax and then the taxation of dividends to the share owner. Losses are often available sooner with pass through treatment. However, corporations may have IRC ' 1244 apply to worthless stock to avoid capital loss treatment (up to $100,000 on joint return per year) and thus obtain ordinary loss treatment. A 5 year holder of C-corporation stock in a qualifying small business (gross assets not exceeding $50 Million; active business) may benefit from a partial (or for stock

acquired in years 2010-2014, 100%) exclusion of gain from the disposition of such stock, with a high limit of $10 Million or 10 times the basis in all qualifying corporation stock disposed of. IRC ' 1202.

(iii) The corporate reorganization provisions will not apply to a partnership-taxed entity, but unless the liabilities of the partnership or limited liability company exceed their basis, the partnership or company can be incorporated tax free and possibly later participate in a reorganization. See, however, Rev. Rul. 1970-140, 1970-1 C.B. 73 and Rev. Rul. 2003-51, 2003-1 C.B. 938. Or the company could incorporate and go public. See Rev. Rul. 1984-111, 1984-2 C.B. 88.

(iv) Corporation distributions are taxable and generate a double layer of taxation, while partnership assets (other than cash and cash-like "hot assets") may often be distributed tax free. However, after 2017, the lower corporate tax rate of 21% needs to be taken into account, particularly for businesses that do not intend to pay dividends but to retain earnings for reinvestment in the business.

(v) The assets of a partnership-taxed entity may be stepped up on an owner's death; this is not possible with stock.

(vi) The 20% deduction, applicable after 2017, for qualified business income (IRC § 199A) needs to be taken into account; it applies to partnerships (and S-corporations) but not to C-corporations.

(b) Advantages over S-corporation. The advantages of partnership-taxed organizations over corporations with the S-corporation election include:

(i) There is no need to meet the limits on number of members, the one class of stock rule, etc., applicable to S-corporations in order for a partnership-taxed organization to obtain pass-through tax treatment.

(ii) State law creates special tax problems for S-corporations. As of a few years ago, for example, it would be fair to say that: Some jurisdictions do not recognize the S-election, have special taxes on S-corps, or require additional elections or other conditions on S-corp treatment. However, all states now have limited liability company laws and have long had partnership laws, and there are only a few jurisdictions which tax limited liability companies as corporations or apply substantial franchise or excise taxes, but some other states apply potentially substantial taxes or fees (determined in a variety of ways) particularly on larger (by members, capital, receipts, etc.) limited liability companies, while others apply only minor taxes or fees.

(iii) A number of states apply withholding or similar requirements on S-Corps or on partnership taxed organizations to assure that income from that state is taxed in that state (this is on top of non-resident return requirements for S-corp shareholders and for partners). Such rules create similar problems for both S-corps and partnership taxed organizations.

(iv) Distributions of property by an S-corporation is a taxable sale for market value which may accelerate gain while a partnership can often distribute property tax free and postpone gain recognition.

(v) Insolvent S-corporations take into account the insolvency exception to cancellation of debt income at the corporate level (under IRC § 108) and nontaxable cancellation of debt income does not increase the shareholder's basis in stock, thus the shareholders ultimately lose the benefit of the exclusion by at some point recognizing a smaller loss or additional income (*e.g.*, on liquidation). The insolvency exception applies at the partner and member level for partnership taxed organizations (this may not always be helpful to partners, however).

(vi) As to worthless stock, IRC ' 1244 can apply to S corporations, as with C-corporations, to avoid capital loss treatment, but generally is not needed as often by an S corp which has pass through tax treatment for most losses.

(vii) There is no step up in basis in the underlying assets of the business on the death of an S-corp shareholder. The best that can be achieved in the corporate context would be for an S corporation, after the death of a shareholder, to sell everything to a third party and liquidate in one year so that gain from the sale creates a basis increase resulting from that gain, which can be added to the step-up basis in the stock at death, producing a loss on liquidation, which offsets the gain on sale. This is often impractical and to the extent depreciable assets are held, recapture (see IRC § 1239) will reduce its effectiveness as a tax strategy.

(viii) Both S-corporations and partnership may be eligible after 2017 for the 20% qualified business income deduction. However, the compensation component used in determining the qualified business income might be more favorable for partnerships which are not subject to express requirements to pay reasonable compensation to owners, thus potentially leaving more business income for calculating the deduction.

(5) Estate Planning. Family limited partnerships and limited liability companies are often quite useful in estate planning. They may allow the retention of significant control, while enabling a donor to give away interests in property, particularly in property, such as real estate, that would otherwise be difficult to divide appropriately. They also provide certain protections from creditors to the underlying property and to the family members with interests in the partnership, if the creditor is restricted to obtaining a charging order, an assignee's interest, or similar relief against the distributions (if any) the debtor partner may sometime receive. The basis inside the partnership of a decedent's share of the assets can be stepped up on death, with the appropriate election. Trusts of all kinds can be partners or members of partnership-taxed organizations; with an S-corporation, only certain very restricted trusts can be shareholders, creating problems at death.

(6) Changes to Tax Environment Less Favorable to Partnership Use. Some changes in the tax laws over the last several years have made a significant difference in the tax environment for partnerships.

(a) Rate Differential. There were times when the lower rates for individuals compared to those for corporations, was an added incentive to use an organization with pass-through tax treatment. The tax rate after 2017 for corporations is 21%; individual high income earners are subject to a 37% rate. Although the rate differential alone will not be much of an incentive for pass-through treatment, the pass-through nature of partnerships (and S-corporations and limited liability companies) means that income will be taxed only one time, at the partner or shareholder or member level, while C-corporation income may be taxed twice, once to the corporation, which is a separate taxpayer, not a pass-through conduit, and once again as dividend income to the shareholder receiving it. Dividends are not deductible by the paying C-corporation. The combined federal rate for C-corporations which pay dividends would be 21% (corporate) + 20% (dividend) + 3.8 (net investment income), or 44.8%. State taxes would be on top of this. For a partnership or S-corporation with high earning partners or shareholders, the effective federal rate would be 29.6 (37% x 1-.20) + 3.8% (net investment income, depending on level of personal participation) or 33.4%, again with state taxes on top of this.

(b) Capital Gains. Capital gains for most individuals (not corporations) are generally taxed at a maximum rate of 15% or 20%, plus, for individuals subject to a Medicare surtax on net investment income, an additional 3.8%, for a total of 18.8% or 23.8%, which is still considerably lower than the highest rates applicable to ordinary income, 37%. As a result, there is some opportunity for the transfer of highly taxed ordinary income into lower taxed capital gains by means of the sale of stock of a corporation the stock value of which has been increased by retained earnings or unrealized appreciation. Corporate dividends are also generally taxed at the lower 15% or 20% rate, plus any 3.8% Medicare surtax.

(c) Corporate Gain Exclusion Rule. Although the 100% exclusion for gain from qualified small business stock (IRC ' 1202; applicable differently in different tax years 2009-2014) is limited to C-corporations and does not apply to partnerships, nevertheless partnerships may be part of the over-all structure of a transaction, because pass-through entities may own qualified small business stock and, with some limits, be able to take advantage of the exclusion for the benefit of the pass-through entity’s partners (or shareholders, if an S-corporation is involved). However, a partnership owning an interest in qualified small business stock may be better than an S-corporation holding the interest because S-corporations are restricted from being part of an affiliated group. IRC §§ 1361(b)(2)(A), 1504.

(7) Some Disadvantages.

(a) Generally. Some disadvantages to using a partnership or limited liability company include the complexity of the applicable tax rules, particularly where the business arrangement is itself complex, the inability to participate in corporate tax-deferred reorganizations, self employment tax on some portions of distributive shares, even where not truly compensatory, the uncertainty inherent in certain equity compensation arrangements in the partnership-taxed entities, and the uncertainty about whether a limited liability company will be treated as a corporation for bankruptcy filing purposes, and the applicability of the discharge of indebtedness income rule exceptions at the partner level.

(b) Like Kind Exchanges. Also, in some circumstances partnership treatment needs to be affirmatively avoided. For example, if a person desires like-kind exchange treatment and tax deferral on the disposition of real estate, the escrowed funds may not be put into a real estate holding organization, such as a partnership. Rather, if an exchange is to be recognized, it must be for a true real estate interest, which, if there is more than one owner, would generally be by means of a tenancy-in-common. If the tenants-in-common are over-organized, they may be treated as being a partnership. See Rev. Proc. 2002-22, 2002-14 I.R.B. 733 (April 8, 2002) setting forth the conditions to obtain a ruling by the Service as to the nonexistence of a partnership.

(c) Audit Complexity. The rules for auditing partnerships and partners are complex and in some circumstances can require that the partnership (and thus the current partners) pay tax allocable to former partners in the prior audited year. Bipartisan Budget Act of 2015 (P.L. No. 114-74, § 1101, 129 stat. 584 (Nov. 5, 2015)); see e.g. IRC §§ 6221 *et seq.*

C. **Certain Exempt Funds or Groups**. Qualified pensions, profit sharing and stock bonus plans, individual retirement accounts, charities, foundations, and charitable trusts, and other tax-exempt entities (for convenience, "Plans or Exempt Groups") create special issues for the partnerships in which they hold interests, and for themselves. Also, as noted below, for certain purposes, particularly limiting losses and credits and taxing deferred compensation, foreign persons also may be treated as tax exempt. On the other hand, there may be a positive side: for some charities, the use of a single member LLC may be quite useful to isolate certain risks yet, because it is a disregarded entity, avoid the necessity of obtaining a separate tax exemption determination for the organization as would be necessary if the subsidiary organization were a corporation. However, let's focus on the complexities created by Plans or Exempt Groups.

(1) Unrelated Business Income. Plans or Exempt Groups are generally exempt from federal taxation, except to the extent of unrelated business taxable income (determined in accordance with IRC §§ 511-514) in excess of $1,000 during any taxable year. Such income includes active trade or business income and debt-financed income. Plans or Exempt Groups with unrelated business taxable income also are subject to the alternative minimum tax with respect to tax preference items that enter into the computation of unrelated business taxable income. (There is an exception for ESOPS, which could help S corps but will not be of use to partnership taxed organizations. See IRC ' 512(e)(3).)

(2) Debt Financed Income. In general, even where an active trade or business is not involved, unrelated business taxable income includes income derived from "debt-financed property." The "debt-financed property" rules provide that, in the case of income or gain from the disposition of property, that gain will be treated as unrelated business taxable income if there is "acquisition indebtedness" on the property. "Acquisition indebtedness" includes indebtedness incurred in acquiring or improving property.

(a) Exception. IRC § 514(c)(9) provides an exception to the treatment of the debt-financed property rules. The exception, however, applies only to certain qualified pension,

profit-sharing or stock bonus plans (but not IRAs) and certain education charities, which acquire or improve real property through debt financing.

(b) Qualification. To qualify for relief from the debt-financed property rules, several conditions must be met, including the condition that all allocations to tax-exempt partners must be made in accordance with the strict pro rata allocation provisions of IRC § 168(h)(6), and that the allocations must meet the tests (or alternate tests) for substantial economic effect. There is also a complicated "fractions rule" (pursuant to which certain reasonable guaranteed payments or preferred returns may be allowable) to be met relating to various allocations. IRC § 514(c)(9)(E). Complexity is added by the special rules which take some items into account but exclude others, in determining overall partnership income or loss for these purposes. See IRC § 514(c)-2(c)(1)(i). There must also be no tax avoidance purpose in a tiered partnership structure.

(3) Other Consequences of Business Income. Although the receipt of unrelated taxable business income by a tax exempt investor generally has no effect on that entity's tax-exempt status or on the exemption from tax of its other income, for certain types of tax exempt entities (including charitable remainder trusts) the receipt of unrelated business taxable income may have adverse tax consequences in addition to the requirement to pay tax on such income.

(4) Plan Fiduciary Requirements. Persons investing on behalf of employee benefit plans subject to the Employment Retirement Income Security Act of 1974 ("ERISA") or the Code are required to determine whether such investments will satisfy the prudence, diversification, and other standards set forth in ERISA and the Code. Such persons must also evaluate the risks that unintended ERISA or Code prohibited transaction questions or fiduciary duty delegation questions may arise if the underlying assets of the investment are treated under ERISA or the Code as assets of the employer benefit plans which own partnership interests. A transaction involving the partnership and "parties in interest" or "disqualified persons" could constitute "prohibited transactions" under § 406 of ERISA and IRC § 4975 (a punitive excise tax provision). See, *e.g.*, *Eaves v. Penn*, 587 F.2d 453 (10th Cir. 1978) regarding general fiduciary duties of plan fiduciaries.

(a) Labor Rules. Under Department of Labor ("DOL") regulations, the assets of an investment partnership in which employee benefit plans make equity investments will be treated as plan assets, unless the investments are within one of the regulation's exemptions. See DOL Regs. § 2510.3-101. In general, assets of an investment partnership are exempt from the DOL regulations if (i) the interest acquired by employee benefit plans qualify as "publicly offered securities", (ii) less than 25% of the value of the interest outstanding is held by ERISA plans, individual retirement accounts, and other employee benefit plans not subject to ERISA (*e.g.*, governmental plans), (iii) the interests acquired by the employee benefit plans are not "equity interest," or (iv) the investment vehicle is an "operating company," such as a "real estate operating company," which meets certain requirements. In general, under the DOL regulations, an investment vehicle is a "real estate operating company" if at least 50% of its assets are invested in real estate which is managed or developed and with respect to which the investment entity has the right to substantially participate directly in the management or development

activities. Further, in the ordinary course of its business, the investment entity must actually engage in real estate management or development activities. DOL Regs. § 2510.3-101(c), (d), and (e). See also DOL Regs. § 2509.75-2 regarding plan investments in entities not subject to these plan asset regulations.

(b) Party In Interest and Related Matters. If an undivided portion of the underlying assets of a partnership were treated as an asset of an employee benefit plan that purchases a partnership interest, each person who is a fiduciary or "party in interest" under ERISA or a "disqualified person" under the Code with respect to such plan would be subject to the prohibited transaction and other fiduciary rules under ERISA § 405(a) and the Code in dealing with the assets of the partnership. In addition, such persons might be subject to cofiduciary liability under ERISA for any breach of fiduciary duty by the general partner of the partnership (or LLC manager), its affiliates and other persons directly or indirectly controlling the assets of the partnership, each of whom might become a fiduciary with respect to the plan if the underlying assets of the partnership are treated as the assets of the plan.

(5) Charitable Fiduciary Requirements. In addition, for charities, foundations, charitable trusts, and certain other tax-exempt organizations there are prohibited transaction rules, self-dealing and other punitive excise tax rules (*e.g.*, IRC §§ 4941 and 4958) and other adverse rules which may apply under certain circumstances to investments in partnerships (especially where related parties are involved), in addition to the unrelated business income tax rules. For example, among other excise taxes, there is an excise tax on participation in a prohibited "tax shelter" transaction as specially defined (generally listed or reportable transactions, described in IRC § 6707A(c)). See IRC § 4965. These rules are in addition to generally applicable fiduciary requirements.

(6) Depreciation and Other Deduction and Credit Limits. The ACRS cost recovery benefits are lost to a partnership which includes a Plan or Exempt Group along with nonexempt partners, if there is any disproportionate allocation involving an exempt partner. IRC § 168(h)(6). Also, if a lessor leases to such a partnership, the ACRS benefits are lost to the lessor in proportion to the exempt partner's interest. IRC § 168(h)(5). An alternative depreciation system must be used as to the proportion of cost recovery covered under IRC § 168(h), and this alternate will generally be a straight-line method for most types of property. See *e.g.*, IRC §§ 168(g)(2)(C)(iii) and 168(g)(3)(A). Certain foreign persons are treated as exempt for this purpose of denying ACRS benefits, as well. See IRC § 168(h)(2)(B). However, some planning is possible under IRC §168(h)(6)(F)(ii), because an irrevocable election may be made by a tax-exempt controlled entity not to be treated as a tax-exempt entity. A "tax-exempt controlled entity" is any corporation in which 50% or more in value of its stock is held by one or more tax-exempt entities (but not foreign persons). IRC § 168(h)(6)(F)(iii)(I). If such an election is made, the share of the tax exempt controlled entity in the depreciable property owned by the partnership in which it is a partner is not tax-exempt-use property. IRC § 168(h)(6)(F)(ii)(I). However, with the election, gain recognized by the tax-exempt entity on disposition of shares in the tax-exempt controlled entity and any dividends or interest received or accrued from the tax-exempt controlled entity allocable to income of the tax-exempt controlled

entity which was not subject to federal income tax, becomes unrelated business taxable income under IRC § 511. IRC § 168(h)(6)(E).

(7) Tax Exempt Use Losses. Also, under IRC § 470, deductions attributable to tax-exempt use property in excess of income attributable to the property are denied, but carry forward to periods when there is sufficient income or until disposition of the entire interest. These rules are intended to disrupt abusive sale-leaseback transactions. See Notice 2005-13, 2005-9 IRB 630 (relating to so-called Sale in-Lease out "SILO" transactions and Lease in-Lease out "LILO" transactions).

(a) Deemed Leases. Where being leased is part of being tax-exempt use property under the definitions contained in IRC § 160(h) (other than IRC § 168(h)(6) which has special rules) used for applying the tax-exempt use loss rules, a partnership taxed organization which is in essence a lease will cause those loss limiting rules to apply. IRC §§ 470(c)(2) and 7701(e). For determining if the partnership taxed organization in which the tax exempt entity is a partner or member should be treated as a lease of the property held by the partnership, all relevant factors will be used, including factors similar to those used under IRC § 7701(e)(1) with respect to service agreements treated as leases. IRC § 7701(e)(2). Those factors are whether or not—

A. The exempt entity (the service recipient) is in physical possession of the property,

B. the exempt entity controls the property,

C. the exempt entity has a significant economic or possessory interest in the property,

D. the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

E. the service provider does not use the property concurrently to provide significant services to entities unrelated to the exempt entity, and

F. the total contract price does not substantially exceed the rental value of the property for the contract period.

Also, the legislative history (Joint Comm. Staff, Description of the Tax Technical Corrections Act of 2007, as passed by the House of Representatives (JCX-119-07) 12/18/2007, p. 9) provides as factors, whether:

I. a tax-exempt partner maintains physical possession or control or holds the benefits and burdens of ownership with respect to the property;

II. there is insignificant equity investment by any taxable partner;

III. the transfer of the property to the partnership doesn't result in a change in use of the property;

IV. the property is necessary for the provision of government services;

V. a disproportionately large portion of the deductions for depreciation with respect to the property are allocated to one or more taxable partners relative to the partner's risk of loss with respect to the property or to the partner's allocation of other partnership items; and

VI. amounts payable on behalf of the tax-exempt partner relating to the property are defeased or funded by set-asides or expected set-asides.

(b) Investment Tax Credit. No investment tax credit is allowable for property used by tax-exempt organizations (including foreign persons) as defined by IRC § 168(h)(2). An exempt partner's share of property is treated as tax-exempt use property unless allocations to the partner are qualified (proportionate) allocations under IRC § 168(h)(6)(B) and (C). See IRC § 50(b)(3) and (4).

(8) Deferred Compensation. Certain partnerships and foreign corporations ("nonqualified entities") are subject to some strong tax limitations regarding the use of deferred compensation. IRC § 457A, effective for services rendered after 2008. A partnership taxed organization subject to these rules is any partnership unless substantially all of its income is allocated to persons other than foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and organizations which are exempt from income tax under the Code. See Notice 2009-8, 2009-4 IRB. Deferred compensation is as defined in the onerous IRC § 409A (which may also apply separately to certain deferred compensation arrangements). Any compensation which is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income of the service provider when there is no substantial risk of forfeiture of the rights to such compensation, and such a risk of forfeiture will only exist where compensation is conditioned on the future performance of substantial services, or in some cases (investment funds, *e.g.*) on disposition of an investment asset where the compensation is determined solely by gain on its disposition. In addition to early inclusion in income, the tax will be increased by a stiff interest factor (underpayment rate under IRC § 6621 plus 1 percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred, or, if later, the first taxable year in which such deferred compensation is not subject to a substantial risk of forfeiture), and also by an additional 20% of the compensation.

D. **Applicability of Partnership Tax Rules**. If an entity is treated as a partnership, it has numerous options open to it under the flexible partnership tax rules, but it or its participants also may be able to elect corporate tax treatment or individual tax treatment. Thus, there is a fair amount of flexibility available to taxpayers as to whether the partnership tax rules will apply at all. Further, the Service has some ability to deny partnership treatment in abusive situations.

(1) Partnership Entity Treatment. There is a step-by-step analysis to determine whether partnership treatment is appropriate.

(a) First Step: Business Entity?. The first step in determining whether partnership tax rules apply to an organization is to see whether the arrangement at issue is a business entity for tax purposes at all. For an unincorporated organization, this requires an arrangement where participants carry on a trade, business, financial operation, or venture and divide the profits. An undertaking to share expenses is not alone sufficient to create an entity. Tenancy-in-common ownership does not necessarily create an entity. Regs. § 301.7701-1(a)(2). The rules for determining whether an entity exists are very similar to those in effect prior to the check-the-box rules for determining whether a partnership existed. See, *e.g.*, *Johnson v. U.S.*, 632 F. Supp. 172 (DC NC 1986).

(b) Second Step: Corporation?. The second step is to confirm that the entity is not properly treated as a corporation (including associations treated as corporations), trust, or estate. See Regs. § 301.7701-2(b) on organizations mandatorily classified as corporations, and § 301.7701-3 on associations treated as corporations.

(i) If the organization is incorporated under state law, it is a corporation for tax purposes, but so are insurance companies, federally-insured banks, and certain other organizations.

(ii) Publicly-traded partnerships are taxed as corporations under IRC § 7704 unless their income is primarily passive (generally, 90% or more passive-type income), in which event they are treated as partnerships but are subject to adverse treatment under the passive loss rules of IRC § 469.

(A) Publicly traded partnerships are those with partnership interests traded on an established securities market, or the substantial equivalent of such a market. Among other things, a partnership would need to participate in the market for the interests to be treated as "publicly traded" other than on an established securities market; thus, a partnership should not become publicly traded without its knowledge. It will not so participate unless it participates in the establishment of a market or in the recognition of transfers made on the market. Regs. § 1.7704-1(d). The following are safe harbors from treatment as a publicly traded partnership. A partnership will not be considered "readily tradeable" if: (i) all interests in the partnership were privately placed in an unregistered transaction and either the partnership has no more than 100 partners; (ii) the interests traded during the partnership's tax year represent five percent or less of partnership capital or profits; or (iii) the interests traded during the partnership's tax year represent two percent or less of partnership capital or profits if transfers executed through a qualified matching service or pursuant to qualified redemption and repurchase agreements or certain private transactions are excluded from the calculation. Regs. §§ 1.7704-1(h)(1) and (2); 1.7704-1(j)(1). Certain private transfers are excluded in determining whether partnerships are readily tradable on a secondary market or its substantial equivalent. Regs. §§ 1.7704-1(c)(1) through (3); 1.77094-1(e).

(B) For purposes of defining a publicly traded partnership, the term "established securities market" includes any national securities exchange and any local exchange registered under the Securities Exchange Act of 1934 or exempt from registration because of the limited volume of transactions. The term also includes certain foreign markets and any U.S. over-the-counter-market. Regs. § 1.7704-1(h). A secondary market is generally indicated by the existence of a person standing ready to make a market in the interest. An interest is treated as readily tradeable if the interest is regularly quoted by persons, such as brokers or dealers who are making a market in the interest. The substantial equivalent of at secondary market exists where there is not an identifiable market maker, but the holder of an interest has a readily available, regular, and ongoing opportunity to sell or exchange his interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests. Similarly, the substantial equivalent of a secondary market exists when the prospective buyers and sellers have the opportunity to buy, sell, or exchange interests in a time frame and with the regularity and continuity that the existence of a market maker would provide. Regs. § 1.7704-1(c)(1). Certain qualified matching services meeting a number of specific requirements may be allowed, however, without creating a market. Regs. § 1.7704-1(g).

(C) If a partnership were recharacterized as a corporation by virtue of these publicly traded partnership provisions, it would be deemed to have contributed all of its assets (subject to all of its liabilities) to a newly formed corporation in exchange for all of the corporation's stock. The stock would then be treated as having been distributed to the Partners in complete liquidation of the Partnership. Generally speaking, the income from a partnership that is reclassified as a corporation would be treated as dividend income and, for purposes of the passive loss rules, would be treated as portfolio income.

(D) Some otherwise publicly traded partnerships are not subject to corporate tax treatment if at least 90% of its gross income for the tax year is specified passive-type income ("qualifying income"), and certain other requirements are met. IRC § 7704(c). Such qualifying income includes interest, dividends, real estate rents, gain from real estate, natural resource income of various kinds and certain trading in commodities of regulated investment companies. IRC § 7704(d)(1) (A) through (G).

(iii) See Regs. § 301.7701-4(a) on what is a proper trust (see also, *A.A. Lewis & Co v. Com'r*, 301 US 385 (1937)), and see Regs. § 301.7701-2 on what is a business entity (possibly taxed as a partnership or as a corporation), even if cast in trust form (see also, *Hecht v. Malley*, 265 US 144 (1924)).

(c) Third Step: Partnership?. The third step is to see whether the entity has elected into or defaulted into partnership classification under the check-the-box rules of entity classification where the entity is not a corporation (or association properly treated as a corporation), trust, or estate. IRC §§ 761, 7701(a)(2); Regs. 1.761-1(a) and §§ 301.7701-1,-2, and -3. The default rule is partnership treatment. An entity may be a partnership even if none of the participants believe they are partners or hold themselves out as such. See *Haley v. Com'r*, 203 F.2d 815 (5th Cir. 1953); *Holdner v. Com'r*, TC Memo. 2010-175 (father-son farm

operation). See also *Luna v. Com'r*, (1964), 42 TC 1067 (listing eight factors for partnership treatment) and Chief Counsel Advice 201323015 (collaboration between corporations treated as partnership based on *Luna* factors).

(d) Single-member Organization. An entity which would otherwise be taxed as a partnership which has only one member will be treated as a disregarded entity for tax purposes. Disregarded entities have uses. For example, an LLC may not be a shareholder of an S-corporation unless the LLC is a single member LLC disregarded for tax purposes with a member otherwise eligible to be an S-corp stockholder (PLR 200303032); also, LLCs which are disregarded entities are helpful in isolating risks in organizations without creating complex corporate affiliated groups. However, disregarded entities probably cannot be used to divide up interests by use of special allocations and sales of classes of the disregarded entity. See AM 2012-001.

A disregarded entity is treated as a corporation (which is a separate entity) for purposes of employment tax reporting and liability as to wages paid on or after January 1, 2009. Regs. § 301.7701-2(c)(2)(iv) which is the finalization of proposed regulations from 2005. (Before 2009, a single member LLC was just ignored for employment tax purposes and its actions were treated as those of its owner. See Regs. § 301.7701-3(b)(1)(ii); see also, *Medical Practice Solutions, LLC v. Com'r*, T.C. Memo. 2010-98); *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007); *McNamee v. Dept. of the Treas*., 488 F.3d 100 (2d Cir. 2007) (cases in which prior check the box regulations were upheld).)

Although the disregarded entity is treated as a corporation for employment tax purposes, for FICA (i.e., Social Security) and FUTA (Federal unemployment tax) purposes, the use of a disregarded entity will not prevent the application of the exceptions to these taxes for family members or religious organization members under IRC §§ 3121(b)(3) (individuals who work for certain family members, such as, for FICA purposes, a child under 18 working for a parent, domestic service by individual under age 21 for spouse or parent), Code Sec. 3127 (members of religious faiths), and Code Sec. 3306(c)(5) (for FUTA purposes, persons employed by children and spouses, and children under 21 employed by their parents). Regs. § 31.3121(b)(3)-1T; Regs. § 31.3127-1T; Regs. § 31.3306(c)(5)-1.

Similarly, for certain excise taxes a single member disregarded entity is treated as a corporation for administering those excise taxes, such as for determining the location for filing a notice of federal tax lien or the place for hand-carrying a return. Regs. § 301.7701-2.

(e) Spousal Election. If a husband and wife in a community property state own an entity not treated as a corporation, it will be treated as a partnership or disregarded as the husband and wife choose. Rev. Proc. 2002-69, 2002-2 C.B. 831.

This choice, however, is not available for a common law jurisdiction husband and wife; although beginning in 2007 a qualified joint venture between husband and wife is subject to an election under IRC § 761(f) for treatment as not being a partnership, according to the Service, this election does not apply for a business conducted by a state law entity, such as a

general partnership, limited partnership, or limited liability company. http://www.irs.gov (search "qualified joint venture"; then follow hyperlink entitled "Election for Husband and Wife Unincorporated Businesses"). If the benefits of a state law entity are not desired, this election may be an option. Income and expenses must be allocated between spouses based on ownership interest and each must take them as if a sole proprietor. If the election to disregard the spousal partnership is made, each spouse's share of income (or loss) is taken into account for self employment tax. IRC § 1402(a)(16). The election under IRC § 761(f) is not revocable without Service consent. Material participation by each spouse is required.

(i) However, the exclusion for rental income normally used in calculating self employment income will not apply. Thus rental income will be subject to the tax if the election is made; also, if there is a loss, the loss will offset other self employment income if the election is made.

(ii) If one deemed sole proprietor spouse substantially controls the business management decisions and the other spouse is under the direction and control of the that spouse, the other spouse will be an employee subject to income tax withholding, FICA taxes, Medicare taxes, but not FUTA taxes. "Benefits of Qualified Joint Ventures for Family Businesses," SSA/IRS Reporter, Summer 2010.

(iii) Either of the deemed sole proprietor spouses may report and pay the employment taxes due on wages paid to other employees, using the employer identification number of that spouse's sole proprietorship. "Benefits of Qualified Joint Ventures for Family Businesses," SSA/IRS Reporter, Summer 2010.

(f) Series LLC. Some states (including Utah), allow series LLCs. See UCA § 48-3a-1201 to 1209. These allow one entity to have separate series of divisions which are separately treated with potentially different members, managers, businesses, etc. PLR 200803004 ruled that each series of a Delaware series LLC is a separate entity, and seems to imply that a separate tax election may be made for each. See also Rev. Rul. 2008-8, 2008-1 C.B. 340, dealing with a foreign (likely Bermuda) "protected cell company" in the business of insuring affiliates. Separate assets and liabilities are significant in deciding whether separate entity treatment is appropriate but it may be even more significant if there are important differences among members of the different series. See Stephen B. Land, *Entity Identity: The Taxation of Quasi-Separate Enterprises*, 63 Tax Lawyer 99 (Fall 2009) (general discussion of issues across a variety of contexts, corporations, trusts, limited liability companies, debt interest, etc.).

Under proposed regulations, each domestic series is treated as an entity formed under local law, and whether it will be treated as a separate entity is determined under Regs. ' 301.7701-1 and general tax principles, whether or not so treated as separate under local law. Prop. Regs. ' 301.7701-1(a)(5)(i). If treated as separate for tax purposes, the series' treatment as a partnership, corporation, etc. is based on the general "check the box" rules of Regs. '' 301.7701-2 through -4. Who owns interests in a series is determined under general tax

principles; thus, mere title of assets in the series organization (*i.e.*, the overall structural organization) is not determinative, rather the economic benefits and burdens of ownership will determine ownership. As to a series for which capital is a material income producing factor, IRC ' 704(e)(1) and Regs. ' 1.704-1(e)(1) recognize owners of capital interests as partners (where not a sham), and Regs. ' 1.704-1(e)(2) provides a list of factors for determining if a purported partner is the real owner of a capital interest. Basically, retained controls, whether direct or indirect, over the key assets may indicate no such partnership interest ownership, while participation in management, income distributions, and conduct of a partnership business tend to indicate ownership in such a partnership interest. The collection of tax from another series in the group of series will depend on local creditor law, so that if a creditor may collect against some other series, that other series may be assessed the tax and subjected to direct collection. Each series and each series organization would be required under the proposed regulations to annually file an information statement identifying each series or the series organization.

It may be risky to use series LLCs across state lines. In some states, state tax authorities may not view each series as a truly separate unit, so one series could create nexus for the entire LLC and the entire LLC could be liable for the taxes of any other series.

(2) Possible Corporate Tax Treatment. If the organization would be treated as a partnership, it may, under the check-the-box rules, elect to be treated as a corporation, and may, if qualified, even elect to be treated as an S-corporation.

(3) Classification Elections. Entity-classification elections are made by filing Form 8832, Entity Classification Election. The effective date specified on Form 8832 for the election may not be more than 75 days before nor more than 12 months after the date on which the election is filed.

(a) Late Election Relief. Under certain conditions, where the election form is not timely filed, Rev. Proc. 2009-41, 2009-39 IRB, effective Sept. 28, 2009, allows late classification relief to both initial classification elections and changes in classification elections and extends the time for filing late classification elections to within 3 years and 75 days of the requested effective date of the classification. If its requirements are met, Rev. Proc. 2009-41, Sec. 3.01, is the exclusive means for obtaining relief for a late entity classification election and is in lieu of the letter ruling procedure that is used to obtain relief for a late entity classification election under Regs. § 301.9100-1 and Regs. § 301.9100-3. If its requirements are not met, a ruling must be applied for as the means to possibly obtain relief.

(b) Relief Requirements. Among other things, to qualify for relief under Rev. Proc. 2009-41, either the due date for the tax return of the entity's default classification (excluding extensions) for the tax year beginning with the date of the entity's formation must not have passed or the organization timely filed all required federal tax and information returns consistent with its requested classification for all years it intended the requested election to be effective and no inconsistent tax or information returns were filed, and the organization must have reasonable cause for its failure to have timely made the initial entity classification election

by filing Form 8832 which failure to timely file is the sole reason for not receiving the desired classification.

(c) Other Relief. An organization that doesn't satisfy the requirements for relief under Rev. Proc. 2009-41 may request relief by applying for a letter ruling. To obtain such a ruling, the organization must represent that all U.S. tax and information returns required of it or, if it wasn't required to file any returns under the desired classification, then all required U.S. tax and information returns of each affected person (as defined in Rev. Proc. 2009-39, Sec. 4.02), were filed timely or within 6 months of the due date of the respective return (excluding extensions) as if the entity classification election had been in effect on the requested date. It must further represent that no inconsistent U.S. tax or information returns were filed.

(4) Election out of Partnership Rules. Also, in some circumstances, the participants in an entity which would otherwise be classed as a partnership may elect out of some (with some exceptions and only with the consent of the Commissioner) or all of the partnership tax rules in order to be taxed as individual co-owners. (This election is not available to unincorporated associations properly taxable as corporations.)

(a) Qualification. To qualify for the election, the organization must be either (i) an investing partnership not involved in the active conduct of a business, (ii) an operating agreement group for the joint extraction, production, or use of property but not for selling services or property produced or extracted (the participants generally take their shares of production in kind), or (iii) a securities syndicate organized for a short period of time to underwrite, sell, or distribute a particular issue of securities. The election can only be made where the participant’s income may be adequately ascertained without the partnership tax rules of Subchapter K or, as to a partial election out, without the specific rules from which the organization seeks exemption. IRC § 761(a). The election does not apply to any unincorporated organization, one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization. Regs. § 1.761-2(a)(3).

(b) Joinder. Participants must all join in the election. The procedures to make the election are set forth in Regs. § 1.761-2(b)(2)(i) (as to total election-out) and in Regs. § 1.761-2(c) (as to partial election-out).

(c) Other Rules Apply. Also, only the special partnership tax rules are affected by the election-out and the entity remains, for example, a partnership for self-employment tax purposes (*Cokes v. Com’r*, 91 TC 222 (1988); *Methvin v. Commissioner*, 653 Fed. Appx. 616, 117 AFTR 2d 2016-2231 (10th Cir. 2016) (passive oil and gas working interest amounts subject to self employment tax), a new organization for capitalizing start-up expenses (*Madison Gas & Electric v. Com’r*, 72 TC 521 (1979) *aff’d* 633 F.2d 512 (7th Cir. 1980)), and a closely-held business for estate tax installment payment purposes (PLR 8042011). See *Bryant v. Com’r*, 399 F.2d 800 (5th Cir. 1968) *aff’g* 46 TC 848 (1966) (election-out still leaves the organization as a partnership for other purposes). See also TAM 9214011 (Dec. 26, 1991) as to effect of election-out on other tax provisions.

(d) Reasons to Elect. The reasons participants might elect out might include to make separate elections at the individual level that would otherwise be made at the partnership level (*e.g.*, what method of depreciation to use, whether to expense or capitalize intangible drilling costs, etc.), or to avoid having to use the same accounting method as the partnership. The election-out of partnership tax treatment may also be useful in planning a tax-free exchange, which cannot apply to partnership interests. See IRC § 1031(a)(2)(D). Reasons not to make the election might include the desire to use the special allocations available to partnerships. If the election-out comes after the organization has already been treated as a partnership, the election could be treated as the liquidation of the partnership, which in turn could create tax problems under IRC §§ 731 through 735 and under IRC §§ 704(c)(1)(B) and 737.

(e) Deemed Election. Even if the election is not made in accordance with the prescribed procedure, a total (not partial) election-out may be deemed to have been made under all the facts and circumstances. For example, if (i) the participants at the time of formation agreed that the organization would be excluded from the partnership tax rules beginning with its first tax year or (ii) the participants owning substantially all the capital interests in the organization report their taxes consistent with such an exclusion beginning with the first taxable year. Regs. § 1.761-2(b)(ii)(a) and (b). The deemed election is a factual determination to be made by the Service on audit. PLR 7951080.

(5) Disregarding Partnership. As we will see in the discussion of antiabuse rules, the Service may in an abusive situation disregard a partnership altogether, treat a partner as not being a partner or otherwise recast an arrangement involving an entity taxable as a partnership in order to eliminate perceived abuses.

E. **Antiabuse Rules**. Antiabuse regulations have been issued which can adversely affect partnerships. Regs. § 1.701-2. The Service is authorized to recharacterize partnership transactions if a principal purpose of the transaction or arrangement is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intentions of Subchapter K.

(1) Recharacterization. The Service may challenge a transaction or arrangement from a number of directions, even if the transaction or arrangement is within the "literal words of a particular statutory or regulatory provision." Regs. § 1.701-2(b). The Service may challenge:

A. Whether the partnership should be treated as a partnership;

B. Whether a partner should be treated as a partner;

C. Whether the method of accounting clearly reflects income;

D. Whether allocations of income, gain, loss, deduction, or credit are proper;

E. Whether any other claimed tax treatment should be adjusted.

(2) Intention of Subchapter K. The new rules rely heavily on finding a taxpayer principal purpose that is inconsistent with the intent of Subchapter K "to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax." The regulations (Regs. § 1.701-2(a)) find three parts to this intent:

A. a bona fide partnership with each transaction or series of transactions having a substantial business purpose (this is a variation on an old theme);

B. a transaction the form of which does not violate substance over form principles (again, nothing new);

C. tax consequences accurately reflect the partner's economic agreement and clearly reflect the partner's income. This provision is the new concept. The rules recognize that there are compromises under a number of specific code provisions that, for administrative convenience or simplicity, allow some departure from what would otherwise be the proper reflection of income. In such cases this test is met if the prior two tests are met and if the tax result is "clearly contemplated" by the specific provisions.

(3) Factors Indicating Proscribed Purpose. The regulations look to a number of factors as relevant in establishing a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intention of Subchapter K (Regs. § 1.701-2(c)):

A. such present value is substantially less than if the partners had owned the assets and conducted the activity directly;

B. such present value is substantially less than if the separate steps were treated as a single transaction;

C. necessary partners have only a nominal interest, are protected from liabilities and risk, have little profit participation other than preferred return for use of capital;

D. substantially all partners are related;

E. allocations are made to partners legally or effectively tax exempt;

F. benefits or burdens of property ownership are in substantial part retained by contributing partner or related person;

G. benefits or burdens of partnership property ownership are in substantial part shifted to the distributee before or after actual distribution.

(4) Comment. These regulations appear to impede planning through the use of vague standards. The meaning of the "intention of Subchapter K" although somewhat elaborated on by the regulation, is particularly troublesome.

There are also antiabuse rules in other parts of the Treasury Regulations dealing with particular aspects of partnership taxation. See, *e.g.*, Regs. § 1.704-3(a)(10) dealing with IRC § 704(c) allocation methods relating to contributions of appreciated assets.

F. **Tax Aspects of Contributions**. The kinds of property contributed or whether services are contributed to a partnership may well be determined by the tax implications.

(1) Basic Rules. Generally, no gain or loss is recognized on the contribution of property to a partnership by a partner. IRC § 721. The partnership succeeds to the basis and holding period that the contributing partner had in the property. IRC § 723. The contributing partner's basis in the partnership interest he receives is the basis he had in the property contributed as adjusted, for example, for any gain recognized. IRC § 722. The contributing partner's holding period in the partnership interest includes his holding period in the contributed property if it is a capital asset or is property used in a trade or business as designated in IRC § 1231(b). If the contribution is cash or a noncapital asset, the holding period in the partnership interest starts when the interest is acquired and any prior holding time is not tacked on. It is quite possible for a partnership interest to have a fragmented holding period where a number of different sorts of assets or assets with different holding periods are contributed to the partnerships. Note that the partnership's basis in its property and the partner's basis in his partnership interest although generally the same at the time the initial contribution is made, could diverge over time. Unlike corporations, including S corps, there is no 80% control test to be met to avoid gain on contributions to the organization in exchange for an interest (see IRC ' 351(a)).

There are special rules with requirements to be met in order to defer realization of built in gain on contributed property if a contribution is made to a partnership (domestic or foreign) with foreign partners related to the contributor. Regs. §1.721(c)-1 through 6; Regs. §1.197-2; Regs. §1.704-1; Regs. §1.704-3; Regs. §1.6038B-2.

(2) Property Subject to Debt. If property subject to debt, for example, mortgaged real estate, is contributed, the debt is treated as having been assumed by the partnership to the full amount of the debt if the assumption is explicit, or up to the value of the contributed property if the property is only taken subject to the debt. IRC § 752. This results in the contributing partner being treated as if he had received a cash distribution of like amount from the partnership. The deemed distribution may or may not be taxable. Distributions are usually not taxable unless they exceed the basis of the partner in his partnership interest prior to the distribution or unless the distribution is made in connection with a shift in the potential tax liability of the "hot assets", accounts receivable and appreciated inventory, in which case the distribution may be taxable even if not in excess of the partner's basis in his partnership interest. If the basis of the property is low and the debt is high, part of the deemed distribution may be taxable. It may be possible for the partner to avoid tax on the deemed distribution by increasing his basis in his partnership interest if, for example, the partner could agree to be solely liable for

a debt if the partnership assets are insufficient to pay the debt. There are complex rules to take into account contingent obligations. Regs. § 1.752-6.

(3) Accounts Payable. Unsecured open account trade payables transferred to a partnership generally are not treated as liabilities assumed by the partnership so as to create a deemed cash distribution to the partner. Regs. § 1.752-7 (also, basis will be affected only as set forth in this regulation). Such liabilities will be taken into account (Regs. § 1.752-1(a)(4)(i)) for purposes of the deemed cash distribution rule only to the extent that holding or incurring the obligation gives rise to

A. the creation of, or increase in, the basis of any property owned by the obligor,

B. a deduction that is taken into account in computing the taxable income of the obligor (*e.g.*, where the obligor is on the accrual basis),

C. an expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital (*e.g.,* personal expenses).

(4) Appreciated or Depreciated Property. The difference between value and basis at the time of contribution will have some effects in the future of the organization.

(a) Mandatory Special Allocation. If property with a value over or below its tax basis is contributed to a partnership, a special allocation of the built-in gain or loss must be made to the contributing partner. IRC § 704(c). This is generally a fair economic result for the other partners. Depreciation of the contributed property needs to be shared so that the other partners receive the same depreciation they would otherwise have received if the basis of the property equaled the value of the property.

(i) Let's look at an example showing why such a required allocation makes sense. Let's assume partner A contributes $1,000 cash to partnership AB while partner B contributes undeveloped real property, Blackacre, with a fair market value of $1,000 but with a basis of $800 (*i.e.*, with built-in gain of $200). The AB partnership, which receives a basis of $800 in Blackacre, later sells it for $2,000, resulting in a gain of $1,200. Some of this $1,200 of gain is the $200 built-in gain from B's contribution, and the rest ($1,000) is gain which was earned during the period the property was held by the AB partnership. Under the rules of IRC § 704(c), the $200 is allocated to B and the $1,000 is split between A and B. Thus, B recognizes $700 of gain and A recognizes $500 of gain. Without the special allocation of built-in gain, the $1,200 of gain would be split $600 to A and $600 to B; A would not likely be happy to be taxed on $100 of the built-in gain actually earned by B before the property was contributed to the AB partnership.

(ii) There are three methods of allocation recognized under the Treasury Regulations. They are known as the traditional method, the traditional method with curative allocations, and the remedial method. Even where such a recognized method is used, if the allocation is 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, it will not be treated as valid. This is consistent with the general antiabuse rules of Regs. § 1.701-2(c). However, there are more specific antiabuse rules in this context as well. The anti-abuse rule of Regs. § 1.704-3(a)(10) was amended in 2010 to provide that the tax effect of an allocation method (or combination of methods) used under 704(c) on both direct and indirect partners will be considered. Regs. § 1.704-3(a)(10)(i). An indirect partner is any direct or indirect owner of a partner in the partnership, including through a partnership, S corporation, controlled foreign corporation, trust or estate, and any consolidated group of which the partner in the partnership is a member.

(b) Seven-year Taint. Also, under what are sometimes called the mixing bowl rules, if appreciated or depreciated property is contributed and then is distributed to another partner within 7 years, the contributing partner will as of the distribution recognize gain (or loss) in the amount of the built-in gain (or loss) which existed at the time of contribution determined as if the property had been sold at the date of distribution. IRC § 704(c)(1)(B). Further, in the case of a distribution of property to a partner who contributed appreciated property in the previous seven years, the contributing partner will recognize gain (but not loss) equal to (i) the net built-in gain at the time of contribution, or (ii) if less, the excess of the value of the distributed property over the basis of the partner's partnership interest, reduced, but not below zero, by money received in the distribution. IRC § 737(a). There is, however, an exception allowing the return of assets originally contributed. IRC § 737(d).

(i) Let's assume that in the example above the AB partnership expands to allow C to join it and C contributes to the ABC partnership an undeveloped parcel of property Whiteacre with a value of $1,000 and a basis of $200 (*i.e.*, with built-in gain of $800). If ABC distributes Whiteacre to A in total liquidation in the sixth year when it has a fair market value of $2,000, then C will recognize the $800 of built-in gain. (IRC § 704(c)(1)(B).) (Further gain may or may not be recognized, depending on other factors.)

(ii) If in our example, Blackacre were distributed to C in total liquidation in the 6th year when Blackacre has a fair market value of $2,000, C would recognize the built-in gain in the Whiteacre property. (IRC § 737.) If Blackacre has not been held more than seven years, B may also recognize the built-in gain in Blackacre. (IRC § 704(c)(1)(B).) (Further gain may or may not be recognized, depending on other factors.)

(5) Disguised Sale. A contribution to a partnership followed sufficiently closely in time by a distribution to the contributing partner or to another partner may constitute a disguised sale so as to cause the realization of gain or loss to the deemed seller. IRC § 707; Regs. §§ 1.721-1(a), 1.731-1(c)(3), §§ 1.707-3 to 1.707-9; see, *Virginia Historic Tax Credit Fund 2001 LP v. Com'r*, 639 F.3d 129 (4th Cir. 2011) (overruling Tax Court and finding an allocation of state tax credits, a form of property, for contributions is a disguised sale of the credits) and *Route 231, LLC v. Com'r*, 2016 WL 97598 (4th Cir. 2016) (allocation of state credits for contributions was disguised sale). Remember, an assumption of debt will be a deemed distribution for application of this rule. The deemed disguised sale can be treated as being either

between the partnership and a third person, or between partners in capacities outside their capacities as partners. IRC § 707(a)(2)(b).

(a) Examples. Examples of the kinds of transactions which may be subject to this treatment are:

(i) Cash for Property.

- X transfers property to partnership
- Partnership distributes to X cash derived from other Partners or from borrowing
- (Possible sale by X)

(ii) Debt Assumption for Property.

- X borrows against property
- X transfers property to partnership
- Partnership assumes debt
- (Possible sale by X)

(iii) Cash for Partnership Interests.

- X transfers cash to partnership
- Partnership transfers cash to other partners
- Partner's partnership interests change
- (Possible sale of partnership interests)

(iv) Property for Property.

- X transfers property R to partnership
- Y transfers property S to partnership
- Partnership distributes property R to Y
- Partnership distributes property S to X
- (Possible taxable exchange treatment unless special tax deferral provisions apply)

Much depends on the timing of the component parts to the transaction. If a long enough period elapses, the transaction will not be restructured. Three years before or after a contribution has been suggested as a reasonable measuring period (see Sen. Fin. Comm. Rep., 5 Prt. No. 169, 98th Cong., 2d Sess. 231 (1984)); the regulations presume transfers within two years of a contribution are disguised sales unless the facts and circumstances clearly establish otherwise (Regs. § 1.707-3(c)), and, conversely, transfers more than two years apart are presumed not to give rise to a disguised sale unless the facts and circumstances clearly establish otherwise. (For an example of a complex transaction treated as a disguised sale and also applying the substantial understatement penalty, see *Canal Corporation and Subsidiaries v. Com'r*, 135 TC No. 9 (2010) (overly restricted indemnity regarding the distribution of cash from loan proceeds was ignored, so the cash distribution after a contribution of property by the partner was a disguised sale). A

more standard indemnity not designed to prevent actual liability could be effective to allocate the debt under IRC ' 752 to the contributing partner, thus allowing leveraged partnerships continuing viability; the taxpayer in *Canal Corp*. went too far.).

(b) Factors to Analyze. The regulations under IRC § 707(a)(2)(A) and (b) (Regs. §§ 1.707-3 to 1.707-9) are concerned with whether under all the facts and circumstances the contributor receives an entrepreneurial interest in the partnership capital, and to answer this question they give a number of factors to be analyzed (Regs. § 1.707-3(b)(2)(i) - (x)):

A. That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

B. That the transferor has a legally enforceable right to the subsequent transfer;

C. That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

D. That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

E. That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking in account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

F. That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking in account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

G. That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking in account the income that will be earned from those assets);

H. That the partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

I. That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

J. That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

(6) Swap Fund. Transfers to a partnership investment company to diversify investment holdings will cause recognition of gain, but losses will not be recognized. IRC § 721(b); see Regs. § 1.351-1(c)(1) for a definition of "investment company"; this definition is in the corporate provisions of the Code but is used not only for corporations but also partnerships and trusts (see IRC ' 683 regarding trusts). If after the exchange of assets for an interest in the company more than 80% of the value of the company's assets (other than cash and nonconvertible debt) is held for investment and consists of readily marketable securities (or interests in regulated investment companies or real estate investment trusts or any of a large number of other financial investment types, including money, precious metals, options, etc., (see IRC § 351(e)(1)), then the company is an investment company. However, if no direct or indirect diversification results from the contribution, no gain will be recognized. Regs. §1.351-1(c)(2). These rules can be extremely important in family limited partnerships or limited liability companies created for estate planning purposes (*e.g.*, valuation discounts, gift giving, asset protection, etc.).

(a) Alternatives. In order to avoid taxation on the contribution to a partnership or limited liability company of assets consisting of marketable securities, there are generally 4 alternatives.

(i) Contribute Diverse Portfolios. All members contribute diverse portfolios under the 25%/50% test of the diversification regulations. This requires at least 15 security positions (bearing in mind that certain related securities will be treated as one position) where there is a large (25%) holding:

A	25% (none over 25%)
B	10%
C	5%
D	5%
E	5%
	50% (five or fewer no more than 50%)

F through O (or beyond) at 5% or less each.

What if there are insufficient security positions available to meet the mathematical tests? There is a possibility of affecting the percentage calculation by an infusion of governmental securities into a contributed portfolio. This possibility is not foreclosed by IRC § 368(a)(2)(F)(iv), which otherwise removes these sorts of assets from the calculation of both the numerator and denominator. Rather, a regulation which in the context of IRC § 351 applies the

tests of IRC § 368(a)(2)(F)(iv) provides instead, "However, Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests." Regs. § 1.351-1(c)(6)(i). See also PLR 199909045. Thus, for example, if the prospective portfolio for contribution is close to the percentage tests, some governmental securities in the portfolio could reduce a holding below 25% or reduce holdings below the 50% test positions. However, it is forbidden that these governmental securities be acquired just to meet these tests.

Other securities may be acquired and contributed (counted in both numerator and denominator). The infusion of such assets just to meet the percentage tests will be highly suspect; the statute grants authority to prescribe regulations to combat this possibility, but other tax law principles (substance over form) may be used, as well, absent such regulations. Although such regulations have not been promulgated despite Congress' invitation to do so, Congressional policy on the point is clear enough and would appear to justify the use of substance over form principles.

To increase the diversity of the contributed portfolio, either with governmental securities or other securities, a partner may well need to liquidate, and pay tax on, or borrow against, some positions in order to acquire others. This should be done, if done at all, for good and sufficient business reasons where the newly acquired securities are held for some adequate time and are not part of a plan just to meet the diversity test. After a successful contribution of a portfolio, what later happens to particular components of it (sales, etc.) is mostly a matter of indifference; however, if a security is quickly disposed of after contribution, this can provide an argument for the Service that the security was just being used for stuffing to meet the percentage tests. Thus, partners should plan on some time of continued holding of the securities contributed. An appropriate time for holding a security, before or after contribution, would need to be at least enough time to expose the security to significant market risk (up or down).

(ii) Contribute Non-Financial Assets. Have members contribute in excess of 20% in real estate or business assets (*i.e.*, less than 80% are listed financial assets).

(iii) Use Later Gifts. Have one member contribute a concentrated portfolio, and give interests away to obtain additional family members as members of the company.

(iv) Contribute Identical Assets. Have each member contribute the identical asset. For Example:

Example (1)

Member	**Asset**	**Percentage Interest**
A	10,000 Shares of X	90.09%
B	1,000 Shares of X	9.01%

C	100 Shares of X	0.90%

This does not create diversity and is clearly authorized by the regulations. However, there may well be a problem if more than one asset is contributed even where all members contribute the same securities, unless the percentages of each security contributed are the same as the members' percentage interest.

Let's look at two more examples:

Example (2)

Member	**Assets by Shares**	**Percentage Interest**
A	10,000 X 1,000 Y 100 Z Value $33,333	33.3%
B	100 X 1,000 Y 10,000 Z Value $33,333	33.3%
C	1,000 X 10,000 Y 100 Z Value $33,333	33.3%

In this example the economic proportionate share in each security changes after the contribution. Although not clear, this may constitute a substantial increase in diversity triggering gain recognition. Alternatively, it may, under substance over form principles, be treated as a deemed taxable exchange between the members, again triggering gain recognition, although perhaps in differing proportions than under the diversity rules. If a deemed exchange could be involved, where the parties involved are spouses, then as between the two spouses the protection of IRC ' 1041(a)(1) could prevent taxation.

Example (3)

Member	Assets by Value	Percentage Interest
A	$10,000 X 10,000 Y 10,000 Z Total $30,000	90.09%
B	$1,000 X 1,000 Y 1,000 Z Total $3,000	09.01%

C	$ 100 X 100 Y 100 Z Total $300	00.90%

In this example, there does not appear to be any increase in diversity; although the regulations do not use this specific example, it appears to fit the rationale of example (1) above rather well.

(b) Pass-through Rules. For determining investment company status, pass-through rules apply. For example, if 90% or more of a partnership's assets are prohibited investment assets, the entire partnership interest is treated as an investment asset, and if 20% or more (but less than 90%) of the partnership's assets are such investment assets, a proportionate part of the partnership interest is treated as an investment asset. IRC § 351(e)(1); see Regs. ' 1.731-2(c)(3)(ii) (the rules follow the provisions of IRC § 731(c)(2); see S. Rep No. 33, 105th Cong., 1st Sess. 131, n. 69).

(c) De Minimis. There is a de minimis rule which allows some diversification. See PLR 9345047 (Aug. 17, 1993) (transfers of cash representing less than one percent of total value of assets transferred); PLR 200006008 (Sept. 30, 1999) (transfers of nonidentical assets in an amount less than 5 percent of the value of total assets- insignificant under Regs. § 1.351-1(c)(5)). The de minimis provision is no safe harbor and any planned future contributions are taken into account right away and will destroy the de minimis exception.

(d) Special Allocation. A special allocation to a class of interests may well qualify under a statement made in the Senate Report (S. Rep. No. 938, 94th Cong. 2d Sess. at 44 (1976)) to the effect that no increase in diversity occurs where the operating agreement provides an allocation to the contributor of income, gain, and loss from specific property and requires that a withdrawing partner receive the asset contributed. Thus, any contributions would, under this plan, need to be subject to an express special allocation provision for the class of interest affected (which may be a new class), or to a new series of LLC interest (more like a separate company inside the company). The special allocation approach does not require a separate series, but is not incompatible with a separate series. If too much of this type of allocation occurs, the antiabuse rules (discussed at E above) may be applied to deny partnership status or to otherwise recast the transaction.

(e) Later Contributions. The diversity rules could be a problem after the initial formation of the company, too. If a new investment position is contributed by a new or existing partner, there could be gain recognition. The new position, unless deminimis, should be part of a diversified portfolio being contributed as described in the example shown at (6)(a)(i) above. If only additional shares in positions already held by the company are contributed, unless the proportions among the members are maintained or, perhaps, unless a sufficient time has expired to eliminate issues of a prearranged plan to avoid the rules, the problems described with *example (2)* shown at (6)(a)(iv) above could trigger gain recognition.

(7) No General Utilities Avoidance. The General Utilities case was legislatively repealed by the Tax Reform Act of 1986 so that corporations now recognize gain on liquidating distributions. The IRS is seeking to prevent the avoidance of this result where a partnership acquires or owns the stock of a corporate partner and the corporate partner relinquishes to a partnership an interest in appreciated property in exchange, through its partnership interest, for an interest in its stock or the stock of a member of its affiliated group where the stock was contributed at the inception of the partnership or where the stock is purchased after inception by the partnership with cash contributed by another partner. Notice 89-37, 1989-1 C.B. 679. Such a transaction will be treated as a deemed redemption regardless of whether the stock is distributed to the corporate partner. Without this rule the built-in gains might never be realized by the corporate partner. Assume the corporation continues to survive, but the partnership liquidates sometime after the contribution of the property to it (long enough to avoid the disguised sale rules); if as part of the partnership liquidation the corporation obtains a distribution of the stock, the corporation, in effect, receives the property tax free under IRC § 731 and on a later sale of the stock would not be taxed since under IRC § 1032 the corporation does not recognize gain or loss on the receipt of money or property in exchange for its stock.

(8) Depreciation Recapture. No gain is recognized even if the property contributed to the partnership is subject to depreciation recapture. IRC §§ 1245(b)(3), 1250(b)(3). If gain is otherwise recognized, the recapture provisions will operate to the extent of the gain. Regs. § 1.1245-4(c)(4) Ex. 3. Even if the contributing partner does not recognize gain, the partnership must take the appropriate depreciation adjustment into account at the time of sale and ordinary income may result. Regs. §§ 1.1245-2(c)(2), 1.1250-3(c)(3). It is possible for the partnership to recognize depreciation recapture on a property even though the contributing partner earlier recognized recapture, for example, because he recognized gain due to an assumption by the partnership of liability under the deemed distribution rule. Upon the sale of the property by the partnership, the gain will nevertheless also be treated as a recapture item.

(9) Investment Tax Credit. Ordinarily, investment tax credit recapture results when investment credit property (§ 38 property) is disposed of early, including upon a transfer to a partnership. However, if a "substantial" interest in the partnership is taken in return and if other conditions are met (the property remains §38 property in the partnership business, a carryover basis applies, substantially all assets necessary to conduct the business are contributed), then the recapture can be avoided by characterizing the transaction as a mere change in form. Regs. § 1.47-3(f)(1)(ii). A 48% partnership interest in exchange for all assets of a sole proprietor was held to be a sufficiently "substantial interest" in *Soares v. Com'r*, 50 T.C. 909 (1968). On the other hand, the taxpayer in that same case also exchanged his 48% partnership interest for a 7.22% stock interest and this caused him to suffer recapture recognition. Recapture may also be avoided by a sale-leaseback with the partnership. Regs. § 1.47-3(g).

(10) Installment Obligations. When an obligation the gain on which is being reported on the installment basis, is contributed to the partnership, the installment gain is not accelerated. Regs. §§ 1.453-9(c)(2), 1.721-1(a). When the installment obligation now held by the partnership is paid, the gain will have the same character as if it continued to be held by the

transferor. Regs. § 1.453-9(c)(3). This nonrecognition rule probably does not apply if it is the installment obligation of the partnership itself which is transferred to the partnership. See discussion of Rev. Rul. 73-423, 1973-2 C.B. 161 at A-47, Huntington, 161-3rd T.M., Partnerships-Statutory Outline and Definition (1990); IRC § 453B. Prop. Regs. § 1.721-18(d)(2).

(11) Contributing Partners Note. If the contributing partner contributes his own promissory note in exchange for a partnership interest it is treated as a property contribution without the recognition of gain or loss. The note will have no basis and will not add to the basis of the contributing partner's partnership interest. *VisionMonitor Software, LLC v. Com'r*, TC Memo 2014-182. See also Willis, Pennell, & Postlewaite, Partnership Taxation 4th Ed., § 42.07. However, if the partner assumed or guaranteed a preexisting debt of the partnership, this could create basis for the partner. *Gefen v. Com'r*, 87 TC 1471 (1986).

(12) Cancellation of Partnership Indebtedness. Normally the cancellation by a creditor of the indebtedness of a partnership will cause the partnership to recognize gain or loss. See generally IRC §§ 61, 108. However, if canceled in exchange for a partnership interest the result is not always clear. In the corporate context, (at least prior to the Revenue Reconciliation Act of 1993 which repealed the stock for debt exception (IRC § 108(e)(8)), the obligation needed to be evidenced by a security in order to be subject to nonrecognition treatment under IRC § 351(d). The IRS analogizes IRC § 721 to this treatment under IRC § 351(d). Private Letter Ruling ("PLR") 8117210. The strength of this analogy is questionable. See Willis, Pennell and Postlewaite, Partnership Taxation 4th Ed., at § 42.06. Nevertheless, one can expect that the cancellation of debts arising from loans or sales to the partnership should qualify under IRC § 721 for nonrecognition treatment where the contribution of the underlying cash or property without the intervening debt would have qualified, whether or not evidenced by a security, and this is basically true, as described below. On the other hand, the cancellation of debts arising from the rendering of services for the partnership would be treated differently and likely would not be given nonrecognition treatment. Also if a partner's share of liability is reduced by the transaction, the reduction would result in a deemed cash distribution to the partner under IRC § 752 with a consequent possibility of taxation to the partner. Thus, Partnerships issuing a profits or capital interest in satisfaction of its debt, whether recourse or nonrecourse, are treated in a manner similar to corporations issuing stock for debt satisfaction and recognize cancellation of debt income to the extent the debt exceeds the fair market value of the interest. IRC § 108(e)(8). This income is included in the distributive shares of those who were partners immediately before the discharge. (Effective on or after 10/22/04.) Regulations deal with some of the issues involved:

(a) Value. The fair market value of the interest given in exchange for the debt will be, under a safe harbor rule, its liquidation value, assuming a hypothetical sale of all assets (including good will and intangibles) for cash immediately after the contribution and a hypothetical liquidation. This safe harbor treatment applies if certain conditions are met; otherwise the value is determined under all the facts and circumstances. The conditions to such liquidation value treatment are:

(i) maintenance of proper capital accounts,

(ii) the creditor, debtor (partnership), and partners all treat the fair market value of the debt as being equal to such liquidation value of the interest received for other tax purposes,

(iii) the transaction is arms length, and

(iv) there is no later redemption or related party purchase of the interest which is part of a plan at the time of the original exchange with a principal purpose of avoiding partnership cancellation of debt income. Regs. § 1.108-8(b)(1) and (2).

(b) Income and Basis of Partner. IRC § 721 provides tax free treatment for contributions to partnerships, but not where the partnership interest is given for the transfer to the partnership of partnership debt for rent, royalties, or interest on debt (including original issue discount). IRC § 453B, which relates to the disposition of installment obligations would continue to apply, and would not be superceded (as could occur in other situations involving the contribution of installment obligations of other persons; Regs. §§ 1.453-9(c)(2), 1.721-1(a)); thus tax could be accelerated. However, no loss would be recognized if the principal of the debt is more than the liquidation value of the partnership interest received in return for it, rather the partners basis in the interest would be increased by the basis in the debt and the holding period of the debt would tack on to the holding period for the interest (see IRC § 1223(1)).

(13) Property Usage for Partnership Interest. The tax treatment of the transfer of the usage of property for a partnership interest (assuming such a transaction qualifies under the Utah Limited Partnership Act or other applicable state law) is not clear. There may be a distinction between short term loans of property and long term leases of property with the former being treated not as a contribution but as a transaction by a partner not acting in his capacity as a partner, and the later being treated as a contribution subject to IRC § 721 nonrecognition treatment. Compare Regs. §§ 1.721-1(a), 1.707-1(a) with PLR 8225069.

(14) Inventory, Unrealized Receivables, Capital Loss Property. The character of gain cannot be changed from ordinary to capital and the character of loss changed from capital to ordinary by merely transferring property to a partnership which would hold the gain asset (*e.g.*, real estate held as inventory) as a capital asset and the loss asset as an ordinary asset (*e.g.*, inventory).

(a) Receivables. The sale of unrealized receivables (IRC § 751(c)) contributed to a partnership produces ordinary gain or loss to the partnership regardless of when sold or for what purpose the partnership held them, and the gain or loss must be allocated to the contributing partner. IRC § 704(c).

(b) Inventory. The sale of inventory contributed to the partnership produces ordinary income or loss if sold within five years after the contribution, even if not appreciated at the time of contributions. IRC § 724(b)(2).

(c) Built-in Loss. The built-in loss in property which was a capital asset in the hands of the contributing partner is treated as a capital loss for the partnership. IRC § 724(c)(2). Any additional loss is controlled by the partnership's purpose. Any gain is also controlled by the partnership's purpose. The taint remains even if the property is disposed of in a nonrecognition transaction or series of such transactions. The taint also can apply at the same time to both the property and to a second partnership interest if for example the first partnership later contributed the property to a second partnership.

G. **Organizational and Syndication Expenses**. No current deduction is allowed for the costs of organizing a partnership or for the costs of promoting sales of interests in a partnership. IRC § 709(a).

(1) Organizational Expense. However, organizational expenses, as distinguished from selling or syndication expenses, may, at the election of a partnership, be amortized beginning in the month in which the partnership begins business, otherwise they are not deductible. IRC § 709(b). If amortization is elected, in the first year the deductible amount would be the lesser of (i) the organizational expenses or (ii) $5,000 reduced (not below zero) by the amount the expenses exceed $50,000; the remainder is amortized over 180 months beginning with the month the partnership begins business. Organizational expenses are defined as expenditures which (i) are incidental to the creation of the partnership, (ii) are chargeable to capital account, and (iii) are of a character which, if expended incidental to the creation of a partnership having an ascertainable life, would be amortized over such life.

(2) Syndication Expense. Syndication expenses are not amortizable or currently deductible. They are expenses connected with the issuing and marketing of interests in the partnership, such as commissions, registration fees, printing costs, legal fees for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes, and accounting fees for preparation of representations to be included in the offering materials. There are some uncertainties regarding the distinction between costs properly classified as organizational expenses subject to amortization and costs properly classified as syndication expenses not subject to amortization.

(3) Effect. Although organizational or syndication expenses are not deductible, they are also not covered by IRC § 705(a)(2)(B) and so will not reduce the basis of the partner's interest; this allows for a potential later capital loss or reduced capital gain on the sale or liquidation of a partner's interest.

H. **Foreign Withholding**. Where a foreign person (*e.g.*, a nonresident alien or foreign corporation) is a partner, the partnership may be subject to special tax withholding rules. See IRC §§ 1441 (where income not effectively connected), 1446 (where income is effectively connected to a U.S. trade or business), and 1445 (on dispositions of U.S. real property by foreign persons). This could require adjustments to allocations or to shares where the withholding has the effect of an early non-pro rata distribution for the foreign partner. It will also create administrative burden.