A Short Journey Into Some Needed Reforms in the Partnership World

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In this article, Jackel provides a brief survey of some needed statutory and regulatory reforms in the taxation of partnerships and partners.

All views herein are solely the author's.

Introduction

It is no secret that subchapter K, which deals with the taxation of partnerships and partners, needs to be reformed.[1] This article provides a short survey of the key areas of the statute and regulations that badly need to be reformed. The article does not suggest solutions to the areas needing reform (a much more voluminous task[2]) and is not a complete survey and analysis of the areas highlighted. Rather, its purpose is to shine light on those issues in the hope that debate on the suggested reforms will take place.

Partnership Antiabuse Rule

The reg. section 1.701-2 partnership antiabuse rule was introduced into the law well over a decade ago amid much fanfare and controversy.[3] Although courts sometimes have applied the rule,[4] they have not yet applied it to a fact pattern in which the economic substance doctrine, or the doctrines of substance versus form or sham transaction, would not have otherwise applied.

The rule has created a lot of controversy and confusion in the application of the subchapter K rules and has added little, if anything, to the tax administrator's arsenal in applying the law. That is proven by the lack of a single litigated case in which use of the regulation was the only, or even the primary, reason the government won the case. The usual remedy for that would be repeal or revocation, and it is time for such action on reg. section 1.701-2.

The rule is full of inconsistencies, with the text of the regulation at odds with the examples illustrating its application. One key instance of this is Example 4 of reg. section 1.701-2(d), regarding umbrella real estate investment partnerships. The example concludes that under the facts presented, there is not an "in substance" transfer to the REIT. And yet the purpose of that regulation was to prevent abuses of subchapter K by invalidating transactions that were inconsistent with subchapter K's stated intent.

Suffice it to say that if the intent of subchapter K is not being violated in Example 4, then the partnership antiabuse rule serves no meaningful purpose and should be revoked. It's as simple as that.

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[1]*See, e.g.*, Ernst & Young LLP, "Analysis of the Administration's Partnership Proposals," *Tax Notes*, July 5, 1999, p. 103, *Doc 1999-22932*, or *1999 TNT 128-72*; Karen C. Burke, "Reassessing the Administration's Proposals for Reform of Subchapter K," *Tax Notes*, Mar. 6, 2000, p. 1423, *Doc 2000-6574*, or *2000 TNT 44-122*; Philip Postlewaite and John S. Pennell, "JCT's Partnership Tax Proposals: 'Houston, We Have a Problem,'" *Tax Notes*, July 28, 1997, p. 527, *Doc 97-21690*, or *97 TNT 144-66*; Joint Committee on Taxation, "Review of Selected Entity Classification and Partnership Tax Issues," JCS-6-97 (Apr. 8, 1997), *Doc 97-9833*, *97 TNT 68-8*; William B. Brannan, "The Subchapter K Reform Act of 1997," *Tax Notes*, Apr. 7, 1997, p. 121, *Doc 97-9547*, or *97 TNT 66-66*. The suggested reforms highlighted in this article are not the only provisions of the statute and regulations that are in need of reform. The section 752 regulations, the disguised sale regulations under section 707(a)(2)(B), and the guaranteed payment rules of section 707(c) are all in need of reform. Carried interests also has been a frequently discussed topic of reform over the past couple of years. These issues are not highlighted here because the government is currently looking at them as areas of possible reform, or because the issue has already been thoroughly discussed elsewhere. I am sure that readers will think of other statutory and regulatory provisions of subchapter K in need of reform. My purpose here is not to be **(Footnote continued in next column.)** comprehensive but rather to help further along debate on the topic of subchapter K reform generally.

[2]I will take on that task at a later date.

[3]*See, e.g.*, Sheldon I. Banoff, "Anatomy of an Antiabuse Rule: What's Really Wrong With Reg. Section 1.701-2," *Tax Notes*, Mar. 20, 1995, p. 1859.

[4]*See, e.g.*, *Pritired 1 LLC v. United States*, 816 F. Supp.2d 693 (S.D. Iowa 2011), *Doc 2011-20916*, *2011 TNT 193-9*.

Besides, the codified economic substance doctrine in section 7701(o) has a strict liability penalty, which should go a long way in policing overaggressive interpretations of the law.

Aggregate or Entity Rules of Application

Various authorities over the years have inconsistently and incoherently addressed the treatment of a partnership as either an entity separate from its partners or as a nonentity that is an aggregate of its partners.[5] That aggregate or entity treatment is not confined to subchapter K and permeates the code and regulations.[6] Complicating that are various rules, both statutory and regulatory, that treat a partnership and its partners in one manner or another.[7]

The ad hoc treatment of the partnership as sometimes an entity and sometimes a nonentity has gone on long enough. Clear rules should be provided in the regulations setting forth governing principles applying to both taxpayers and the government.[8]

Check-the-Box and Disregarded Entities

A key culprit of tax avoidance or, if you wish, aggressive tax planning, has been the advent of the wholly owned limited liability company state law entity, which may be treated as a nonentity when applying most of the other rules of the code and regulations.[9] That tax treatment surprised the tax bar when it happened almost two decades ago without any real policy justification other than — as some might say — as a political bargaining chip for the promulgation of the partnership antiabuse rule issued around the time the check-the-box project was getting off the ground inside the government.

I was involved in drafting both the partnership antiabuse rule and the check-the-box regulations while at the IRS and the Treasury Office of Tax Policy and was surprised by the decision to treat a single-member LLC as a disregarded entity for federal tax purposes. It could just as easily have been decided to treat that kind of entity as an association taxable as a corporation.

Various difficult issues have arisen as a result of that disregarded treatment of a single-member limited liability entity.[10] Now is the time to revisit that poor policy decision.

Substance vs. Form

Subchapter K is full of form-driven provisions.[11] A key example is the treatment of a sale of a partnership interest as compared with a redemption of a partnership interest. The economics of the two choices are identical, or close to it, for the seller when less than the entire partnership interest is sold or redeemed. However, the tax consequences to the seller or redeemed partner can be very different.[12]

Various attempts have been made to address that anomaly. Several years ago, regulations were proposed to address so-called disguised sales of partnership interests,[13] but they were withdrawn.[14] Another time, the administration proposed imposing mandatory basis adjustments on sales of partnership interests and partnership redemptions in lieu of the elective rule of section 754, and along with those proposals, imposing a partial liquidation approach to the less complete redemption of a partner's interest in the partnership.[15] That reform effort never made it off the drawing board.

There should be concrete rules of application regarding when a sale of a partnership interest is to be respected as such and when a redemption, in whole or in part, of a partner's interest in a partnership is to be respected as such. Too much electivity in the current law is undesirable as a policy matter, given the relative ease of distributing property out of a partnership without either a partnership- or

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[5]*See* Monte A. Jackel, "Aggregate and Entity in the Partnership World," *Tax Notes*, July 30, 2012, p. 559, *Doc 2012-14715*, or *2012 TNT 146-7*.

[6]*See, e.g.*, reg. section 1.956-2(a)(3).

[7]*Compare* reg. section 1.701-2(f), examples 1 and 2 (aggregate treatment) *with* Example 3 (entity treatment).

[8]Reg. section 1.701-2(e), called the "abuse of entity" rule, is a one-sided rule whereby the government can apply aggregate principles in lieu of entity principles in some cases. No rules are provided for cases when taxpayers seek to apply either the aggregate or entity view of partnerships.

[9]*See, e.g.*, Douglas Holland, "Check-the-Box Rules in the Cross-Border Context," *Tax Notes*, Sept. 5, 2005, p. 1151, *Doc 2005-12668*, or *2005 TNT 172-18*; Stephanie R. Hoffer, "Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities," *Tax Notes*, Apr. 18, 2005, p. 327, *Doc 2005-5259*, or *2005 TNT 74-50*; David L. Click, "Treasury Withdraws Extraordinary Check-the-Box Regulations," *Tax Notes*, Oct. 6, 2003, p. 95, *Doc 2003-21863*, or *2003 TNT 194-35*; David S. Miller, "The Strange Materialization of the Tax Nothing," *Tax Notes*, May 1, 2000, p. 685, *Doc 2000-12186*, or *2000 TNT 84-87*; Miller, "The Tax Nothing," *Tax Notes*, Feb. 3, 1997, p. 619, *Doc 97-3208*, or *97 TNT 22-69*.

[10]*Id.*

[11]*See, e.g.*, *Foxman v. Commissioner*, 41 T.C. 535 (1964), for an explication of the basic principle of economic equivalence between sales under section 741 and redemptions under section 731.

[12]The key difference lies in the recovery of tax basis. When there is a sale of less than all of a partner's partnership interest, only a prorated portion of the seller's basis offsets the amount realized on the sale. However, for a less-than-complete redemption of a partner, the partner generally may use its entire tax basis before recognizing gain under section 731(a).

[13]*See, e.g.*, Peter Poulos, "Disguised Sales of Partnership Interests: Where Are We Now?" *Tax Notes*, Apr. 2, 2012, p. 91, *Doc 2012-4709*, or *2012 TNT 64-6*.

[14]*Id.*

[15]*See* E&Y, *supra* note 1; *see* Burke, *supra* note 1.

partner-level tax. The time to focus on that disparate treatment of partners and partnerships is long overdue.

Tiered Partnerships

Tiered partnerships present some of the most complex issues in all of subchapter K. The confusion stems from the basic question whether the tiers of partnerships will be respected as separate entities or as one single, aggregated partnership entity. Corporate tiers of entities are policed by various rules, such as the consolidated return regulations. There are no rules for policing tiers of partnerships.

Should a tier of partnerships be treated as one single aggregated entity for federal tax purposes? The concept sounds simple, and perhaps it is, when all the partnerships in the tiers are commonly controlled. Without common control, the ability to treat all the tiers of entities as a single partnership breaks down, mostly because of the lack of information flowing from the lower-tier entities to the upper-tier entity to allow the latter to properly report the income and losses allocated from the lower-tier entities. Still, some progress should be made to start cleaning up the mess.

Elective Basis Adjustments

Section 754 and its companion provisions, sections 734 and 743, generally allow for elective basis adjustments when there is a sale or exchange of a partnership interest or a distribution of money or other property by a partnership to a partner.[16] Outside basis step-ups of distributed partnership property are now allowed only if there is a corresponding downward adjustment to retained partnership property.[17] There is no similar rule for the inverse case when distributed partnership property takes a basis step-down in the hands of the distributee partner and there is a related basis step-up to retained partnership property.

That continued allowance of the so-called basis strips is policed only by the disguised sale of property rules under reg. section 1.707-6 regarding disguised sales of property by partnerships to partners. Now seems the time to reconsider that elective rule, along with the past proposal for the treatment of partial partnership redemptions.[18]

Partnership Special Allocations

Since the advent of subchapter K, partnerships have been allowed to allocate income or loss to their partners in a manner different from the partners' economic interests in that item of income or loss.[19] That ability to specially allocate items when the assignment of income common law doctrine would prevent similar attempts outside the partnership context to separate income from the ownership of the related capital is perhaps the key feature of subchapter K. Any tax abuse is policed by the rules of section 704(b) and its related regulations, principally the rules regarding substantial economic effect.[20]

The rules applying the substantial economic effect standard often are subjective and difficult to apply. The complexity is caused by the flexibility of the notion that income can be separated from the capital to which it relates.

Solving that complexity problem by relegating partnerships to the pro rata capital ownership rules of subchapter S are unnecessary and would lead to the dismantling of the essence of subchapter K. We need either clearer and more objective standards on how to apply the substantial economic effect rules of section 704(b)[21] or the promulgation of standards regarding how to apply section 482 to partnership allocations where there is common control.[22]

Tax-Free Transfers to Partnerships

Professor Calvin H. Johnson[23] has proposed that section 721(a) tax-free transfers to partnerships be made taxable. He does not discuss the policy justifications for generally allowing transfers to corporations to remain tax free if his suggested reform became law.

I am not advocating the adoption of Johnson's proposal. On the contrary, the essence of subchapter K is the ability to enter into a partnership tax free, which would be destroyed if Johnson's suggested proposal were adopted. Change is often good, but

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[16]Sections 734(d) and 743(d) impose a mandatory step-down allocation when there is a substantial built-in loss.

[17]There is an exception for built-in losses less than $250,000.

[18]*See* E&Y, *supra* note 1; *see* Burke, *supra* note 1.

[19]Determined by treating the partnership as an aggregate of its partners.

[20]*See, e.g.*, William G. Cavanagh, "Targeted Allocations Hit the Spot," *Tax Notes*, Oct. 4, 2010, p. 89, *Doc 2010-19135*, or *2010 TNT 192-4*; Brian E. Ladin et al., "Hedge Fund Stuffing Allocations: A Path Through the Maze," *Tax Notes*, Nov. 24, 2008, p. 925, *Doc 2008-22965*, or *2008 TNT 228-34*.

[21]For example, some have suggested providing objective standards of what the baseline or comparative allocation standard is when evaluating whether a deviation from that standard changes the tax profiles of the partners without any meaningful risk of any economic change as a result of the allocation.

[22]*See, e.g.*, L. Andrew Immerman, "IRS Applies Section 482 to Partnership Contributions — Was It Necessary?" *Tax Notes*, Apr. 8, 2002, p. 249, *Doc 2002-8390*, or *2002 TNT 68-21*. Reg. section 1.704-1(b)(5), Example 28, states without analysis that section 482 can apply even if the rules of section 704(b) are complied with. No guidance or test is provided to perform the analysis. Thus, the example adds nothing to the analysis here.

[23]Johnson, "Recognizing Built-In Gain on Contribution to a Partnership," *Tax Notes*, Nov. 14, 2011, p. 905, *Doc 2011-19382*, or *2011 TNT 222-12*.

not solely for the basis of change or solely to raise revenue; tax policy should support the proposal. In this case, that threshold test is not met.[24]

Corporate Level Tax for Large Partnerships

It has been suggested that partnerships generating a set amount of gross receipts be taxed at the partnership level as if they were corporations.[25] The purpose here is not to debate that proposal, as it has been thoroughly discussed in other forums.[26] I do note that if enactment of that proposal were to disturb the equilibrium of current law, all of subchapter K would need to be reexamined.

Partnership Technical Terminations

Section 708(b)(1)(B) has long been recognized as obsolete and destined for the garbage dump.[27] I agree. The rule creates complexity in the tax system with no discernible rationale for its continued existence.[28]

Conclusion

This article has provided a brief survey into the areas of law where I believe reform is needed in the statutory provisions of subchapter K or its governing regulations. I hope that I have provided the foundation for a roadmap if and when fundamental tax reform becomes the focus of a tax policy debate by Congress and Treasury.

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[24]Johnson offers his take on the tax policy justifications for the change in the law. Although I do not agree with his positions as stated in his article, they are well written and worth reading as background if and when tax reform reaches subchapter K.

[25]*See* Philip F. Postlewaite, ''Raising Revenue Through Misguided Classification Reform,'' *Tax Notes*, Sept. 3, 2012, p. 1177, *Doc 2012-16730*, or *2012 TNT 172-5*; Bradley T. Borden, ''Three Cheers for Passthrough Taxation,'' *Tax Notes*, June 27, 2011, p. 1353, *Doc 2011-11596*, or *2011 TNT 124-5*.

[26]*See, e.g.*, George K. Yin, ''The Future Taxation of Private Business Firms,'' *Doc 1999-27170*, *1999 TNT 162-84*.

[27]*See, e.g.*, Thomas L. Evans, ''Terminating Partnership Terminations,'' *Tax Notes*, Mar. 5, 2001, p. 1397, *Doc 2001-6357*, or *2001 TNT 43-122*.

[28]It has been suggested that the rule serves as a ''section 382-type'' rule for partnerships. That rationale is not supported by the legislative history.