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Partners & Partnerships - Recent Developments

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Recent Developments

EXECUTIVE SUMMARY

From a tax perspective, 1995 was an intriguing year for partnerships and partners. The use of limited liability companies became more common, leading many partnerships and corporations to convert. Further, the IRS announced the implementation of a partnership Industry Specialization Program. Numerous rulings were issued on classification as a partnership for Federal tax purposes, the tax effects of conversion from one entity to another, special allocations of income and deductions and allocations of liabilities. In addition, regulations under Secs. 701, 704(c) and 737 were issued. This update is presented in six major categories: definition and formation; LLCs; operations; allocations; distributions and dispositions; and other developments.

Definition and Formation

Definition

Secs. 761(a) and 7701(a)(2) define a partnership as any unincorporated organization (not a trust, estate or corporation) through which any business, financial operation or venture is carried on. Regs. Secs. 301.7701-2 and -3 set forth rules distinguishing between a partnership and a corporation. Included in these rules are four corporate characteristics: limited liability, centralized management, free transferability of interests and continuity of life. If an organization has a preponderance (i.e., more than two) of these characteristics, it is deemed to be a corporation; otherwise, it is a partnership. Today's entities are so sophisticated that they can make difficult the determination of the existence of a specific characteristic. To help simplify the classification process, the IRS issued Notice 95-14¹ and Rev. Proc. 95-10² (discussed below).

Check-the-Box Proposal

Notice 95-14 proposed to simplify the classification of domestic unincorporated organizations by allowing them to make an affirmative, binding election to be treated as a partnership or as an association for Federal tax purposes. This "check-the-box" election would apply to all entities that have two or more associates and an objective to carry on business and divide the gains therefrom. Organizations not making the election would be treated as partnerships; existing organizations would retain their current classification. Any change in

classification would be treated as a complete liquidation of the current entity and the formation of a new one. This proposal, if formally adopted, should greatly reduce or eliminate future questions as to proper classification of such entities.

Formation

Under Sec. 721(a), the contribution of property to a partnership in exchange for a partnership interest is tax-free; according to Regs. Sec. 1.721-1(b), services generally do not qualify as property. The tax treatment of a contribution of services has differed in the past depending on whether the partner received a capital interest (taxable) or a profits interest (nontaxable).³ Recent rulings follow this reasoning.

In *Johnston*,⁴ the taxpayer became a general partner in and received a 1% interest for services performed in organizing a limited partnership. The partnership agreement stated that the general partner would provide organizational services, make no contribution to capital, and receive a 1% capital and profits interest as compensation for such services. The Tax Court held that the taxpayer realized income on the receipt of his interest because it was a shift in capital from the limited partners to the taxpayer as compensation for services. The court agreed with the IRS that the valuation date of the services was the date the limited partners transferred the interest to the taxpayer, not the date the partnership was formed.

Sec. 721(a) provides that no gain or loss is recognized on partnership formation; however, Sec. 721(b) states that that rule does not apply to a partnership that would be treated as

¹Notice 95-14, 1995-1 CB 297.

²Rev. Proc. 95-10, 1995-1 CB 501.

³See, e.g., Rev. Proc. 93-27, 1993-2 CB 343.

⁴*Robert Johnston*, TC Memo 1995-140.

an investment company if it were incorporated. In Letter Ruling 9538023,⁵ taxpayers contributed marketable investment assets and cash to a new partnership. All the partners transferred the same assets, but in different proportions to their personal portfolios. The transferors represented that the transferred assets would meet the diversification test of Sec. 368(a)(2)(F)(ii). The IRS ruled that the partnership would not have been an investment company if incorporated; thus, no gain or loss had to be recognized on the contribution of securities.

Limited Liability Companies

Classification

Limited liability companies (LLCs) are recognized as such for state law purposes, but are often treated as partnerships for Federal tax purposes. By definition, all LLCs meet the corporate characteristic of limited liability; thus, to avoid corporate classification, the entity cannot have any two of the other corporate characteristics. The IRS issued numerous rulings on LLCs in 1995.

In Rev. Proc. 95-10,⁶ the IRS specified the conditions under which it would consider a ruling request on the classification of an LLC as a partnership for Federal tax purposes. Generally, to obtain a ruling, an LLC must have at least two members and must lack any two of continuity of life, free transferability of interests and centralized management. Minimum ownership requirements must be met if the entity requests a ruling that it lacks continuity of life, free transferability of interests or limited liability; in general, member-managers must own at least a 1% interest in each material item of the LLC's income, gain, loss, deduction or credit during the LLC's existence, unless the LLC has total contributions exceeding \$50 million. In addition, the member-managers must maintain a minimum capital account balance; other requirements also apply.

In addition, Rev. Rul. 95-37⁷ provides that the conversion of a partnership interest to an LLC interest is a partnership-to-partnership conversion subject to the principles of Rev. Rul. 84-52.⁸ Thus, the conversion would not cause the partners or the partnership to recognize gain or loss, the part-

nership would not terminate under Sec. 708, and the partners' bases would not change unless their share of liabilities changed.⁹ The results would be the same even if the partnership and the LLC were formed in different states; further, the LLC can use the partnership's taxpayer identification number.

In Rev. Rul. 95-55,¹⁰ the IRS held that a general partnership registered as a New York registered limited liability partnership (RLLP) was a partnership for Federal tax purposes. Because the New York RLLP law does not correspond to the Uniform Partnership Act, the status of the RLLP in question had to be determined under Regs. Sec. 301.7701-2. The New York RLLP law provides that an RLLP is dissolved by the express will of any partner if no definite term is specified in the agreement, or by the express will of any partner when a dissolution would not otherwise be permitted; further, every partner is an agent of the partnership for purposes of its business whose acts bind the partnership. Thus, the RLLP in question lacked continuity of life and centralized management. Finally, under New York RLLP law, no one can become a partner in an RLLP without the consent of all partners, so that the RLLP lacked free transferability of interests. The IRS concluded the RLLP was properly classified as a partnership for Federal tax purposes because its only corporate characteristic was limited liability.

The IRS similarly concluded in two letter rulings. In Letter Ruling 9525058,¹¹ a partnership wanted to convert to an LLC to limit the partners' liability. The LLC's articles of organization and operating agreement provided that the LLC would be managed by its members and would dissolve on the death, bankruptcy or incompetency of a member unless members owning both a majority of capital and profits interests voted to continue. The agreement also provided that no member could sell or transfer his interest without unanimous consent of the capital members. The IRS found that the LLC lacked continuity of life and free transferability of interests and so would be taxed as a partnership. Further, the IRS ruled that the conversion would not result in the termination of the partnership, no gain or loss would be recognized on the

⁵IRS Letter Ruling 9538023 (6/26/95); letter rulings are not precedent for anyone but the requesting taxpayer, but they do signal the IRS's thinking and are substantial authority under Sec. 6662.

⁶Rev. Proc. 95-10, note 2, modifying Rev. Proc. 89-12, 1989-1 CB 798, so that the latter does not apply to ruling requests submitted by LLCs described in Rev. Proc. 95-10.

⁷Rev. Rul. 95-37, 1995-1 CB 130.

⁸Rev. Rul. 84-52, 1984-1 CB 157.

⁹See generally Cochran, Blazek and Elliott, "The Costs of Converting a Partnership to an LLC," 26 *The Tax Adviser* 455 (Aug. 1995).

¹⁰Rev. Rul. 95-55, IRB 1995-35, 13.

¹¹IRS Letter Ruling 9525058 (3/28/95).

**The "check-the-box" classification election would apply
to all entities that have two or more
associates and an objective to carry on a business
and divide the gains therefrom.**

conversion and, except for Sec. 752 purposes, the basis of each member's interest would equal his basis in the former partnership. In addition, the holding periods would not change, the LLC could continue to use the cash accounting method used by the partnership and the same taxpayer identification number. On slightly different facts, the conclusions were generally the same in Letter Ruling 9525065,¹² even though the LLC in that ruling had both general and special members.

However, the results differed in Letter Ruling 9543017,¹³ in which an S corporation proposed to merge into an LLC. The LLC's operating agreement provided for dissolution on the death, incompetency, withdrawal, removal or bankruptcy of any member unless at least two members remained and a majority of the members voted to continue. Members could not assign an interest without the consent of a majority of the remaining members. Thus, the LLC lacked continuity of life and free transferability of interests and was properly classified as a partnership.

The merger would be treated as a transfer by the S corporation of its assets to the LLC in exchange for the LLC's assumption of the corporation's liabilities and an LLC interest that would be distributed in complete liquidation to the corporation's sole shareholder. Under Sec. 721, no gain or loss would result on the contribution of assets to the LLC; however, the corporation would recognize gain on the liquidating distribution.

Sec. 708

In the past few years, Sec. 708 has frequently been cited in the context of a partnership converting into an LLC. Letter Ruling 9538022¹⁴ dealt with the conversion of a general partnership engaged in the practice of law (*P*) into a professional limited liability company (PLLC). In the conversion, the partners contributed their interests in *P* to the PLLC in exchange for identical interests in that entity and received capital accounts in the PLLC identical to their *P* capital accounts. *P* dissolved and transferred its assets and liabilities to the PLLC.

The ruling concluded that because the PLLC lacked centralized management and free transferability of interests, it was a partnership for Federal tax purposes. The ruling next addressed whether *P* or its partners were required to recognize gain or loss on the conversion. Based on Rev. Ruls. 84-52 and 95-37, the IRS concluded that the conversion of *P*

into the PLLC was not a termination under Sec. 708.¹⁵ Further, under Secs. 722 and 723, and because the partners' shares of partnership liabilities did not change, the PLLC carried over *P*'s basis in assets; likewise, the partners' bases in their PLLC interests were the same as their bases in *P* interests. In addition, under Sec. 1223(1) and Rev. Rul. 84-52, the holding periods would not change. Finally, the IRS concluded that the PLLC had to continue to use *P*'s accounting method, because it was a continuation of *P*; IRS consent would be needed to change the method.¹⁶

Self-Employment Tax

Proposed regulations¹⁷ issued in late 1994 address when an LLC member is subject to self-employment (SE) tax. Generally, a member's net LLC earnings are subject to SE tax unless the member is treated as a limited partner under Sec. 1402(a)(13). A member is a limited partner if he is not a manager and the LLC could have been formed as a limited partnership rather than as an LLC in the same jurisdiction. The proposed regulations are effective for the member's first tax year beginning on or after the date final regulations are published. Because limited partnership rules can differ from state to state, the effect of the proposed regulations can be unequal treatment of LLCs formed in different states. Prior to the finalization of these regulations, practitioners should consider Letter Rulings 9432018¹⁸ and 9452024,¹⁹ in which the IRS stated that LLC members were not limited partners and thus could not use Sec. 1402(a)(13) to avoid SE tax.

LLC members who want to avoid SE tax should avoid being classified as "member-managers." Prop. Regs. Sec. 1.1402(a)-18(c)(3) defines a manager as any member of the LLC who, alone or together with others, is vested with continuing exclusive authority to make management decisions necessary to conduct the business for which the LLC was formed. It appears that the distinction between a limited partner and a general partner in an LLC rests on the member's managerial duties. Therefore, any member who wants to avoid SE tax should relinquish all managerial duties in the LLC. Of course, this results in a loss of control in running the company, and does not apply if all the members are subject to SE tax. Finally, SE tax can be avoided if the member would have been classified as a limited partner had the entity been formed as a limited partnership.

¹²IRS Letter Ruling 9525065 (3/29/95).

¹³IRS Letter Ruling 9543017 (7/26/95).

¹⁴IRS Letter Ruling 9538022 (6/23/95).

¹⁵A similar conclusion was reached in Rev. Rul. 95-55, note 10.

¹⁶The ruling does not discuss Sec. 448.

¹⁷EE-45-94 (12/29/94); see Cleveland, "Minimizing Self-Employment Tax," 26 *The Tax Adviser* 163 (March 1995).

¹⁸IRS Letter Ruling 9432018 (5/16/94).

¹⁹IRS Letter Ruling 9452024 (9/29/94).

Tax Matters Partner

Prop. Regs. Sec. 301.6231(a)(7)²⁰ provides guidance on who can be the tax matters partner (TMP) of an LLC taxed as a partnership. Generally, the LLC's member-manager is treated as a general partner for purposes of determining the TMP.

Operations

Sec. 701

A partnership is not taxed; instead, the income is passed through to partners, who include the income on their tax returns. Because partnerships avoid double taxation, they are sometimes formed specifically to avoid the second level of tax. In early 1995, the IRS issued Regs. Sec. 1.701-2,²¹ an anti-abuse rule that allows it to disregard any partnership formed with a principal purpose of substantially reducing the present value of a partner's aggregate Federal tax liability in a manner inconsistent with the intent of subchapter K. The regulation is designed to prevent taxpayers from using partnerships to obtain tax results inconsistent with the substance of the transaction or to avoid tax. The purpose of structuring the transaction as a partnership will be determined by the facts and circumstances. The IRS later clarified, via Regs. Sec. 1.701-2(h),²² that the rule only applies to taxes under Subtitle A of the Code. The final regulation is effective for transactions entered into after May 11, 1994.

Sec. 708(b)

Letter Ruling 9529037²³ involved sales of interests in two partnerships by a wholly owned subsidiary to its parent corporation. The two transfers occurred 13 months apart. The IRS ruled that neither of the partnerships terminated under Sec. 708 because there had been no sale or exchange of 50% or more of the capital and profits interest in either partnership within a 12-month period.

Allocations

Sec. 704(a)

A partner's distributive share of income or loss should be determined by the partnership agreement, according to Sec. 704(a). A question can arise as to the proper amount of income each partner must report if there is no partnership agreement or the agreement is modified.

In *Brooks*,²⁴ there was no partnership agreement; however, tax returns were filed for 1988 and 1989 showing that the taxpayer and her brothers were members of a partnership. The taxpayer did not report her share of the partnership's

income because she had not received distributions during those years. On audit, the IRS increased the taxpayer's income by her share of the partnership's profits, as determined by her percentage interest in the partnership. The Tax Court agreed with the IRS that the taxpayer was liable for her share of the profits, even though there was no partnership agreement and she had not received distributions.

In *Curtis*,²⁵ the taxpayer was a 50% partner in a partnership with Green and reported his share of the partnership's profits. The partnership was audited and a substantial adjustment was made to increase income. After the adjustment, the partners modified the partnership agreement for the year in question to allocate 100% of the increase in income to Green. The Tax Court ruled that income had to be reported based on the partnership agreement in existence when the partnership return was originally filed; thus, the taxpayer had to report 50% of the adjustment on his return.

Sec. 704(b)

A partnership agreement can make special allocations of income, loss, gain or deductions, but the allocations must have substantial economic effect. Regs. Sec. 1.704-1(b)(2)(ii)(b) provides that an allocation will have economic effect if the partnership maintains capital accounts, makes liquidating distributions in accordance with positive capital accounts and requires partners to restore deficit capital balances. Under Regs. Sec. 1.704-1(b)(2)(iii), economic effect is "substantial" if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership. In Letter Ruling 9540034,²⁶ the contract for an oil and gas venture called for special allocations of income, drilling costs, depreciation, depletion and the gain or loss on the disposition of depreciable assets. The IRS determined that the allocations had substantial economic effect because the three requirements for economic effect under Regs. Sec. 1.704-1(b)(2) were met and, due to the speculative nature of the entity, there was a reasonable possibility the special allocations would affect substantially the dollar amounts received by the partners.

Sec. 704(c) and Remedial Allocations

Final regulations²⁷ were issued under Sec. 704(c) to implement changes made by the Tax Reform Act of 1984 and the Revenue Reconciliation Act of 1989. They provide a mechanism (the remedial allocation method) for a partnership to eliminate distortions caused by the ceiling rule.²⁸ This method allows allocations of income, gain, loss

²⁰PS-34-92 (10/27/95).

²¹TD 8588 (12/29/94).

²²TD 8592 (4/12/95).

²³IRS Letter Ruling 9529037 (4/27/95).

²⁴*Roxanne Brooks*, TC Memo 1995-400.

²⁵*Danny Curtis*, TC Memo 1995-344.

²⁶IRS Letter Ruling 9540034 (7/5/95).

²⁷TD 8585 (12/27/94); see Walsh, "Accounting for Book-Tax Differences of Property Contributed to a Partnership (Parts I and II)," 26 *The Tax Adviser* 195 and 288 (April and May 1995).

²⁸The ceiling rule, Regs. Sec. 1.704-3(b)(1), is invoked when the amount of built-in gain or loss exceeds the gain or loss realized by the partnership. Under this rule, the contributing partner cannot be allocated more than the total gain or loss realized by the partnership. For example, property with a built-in gain of \$200 was contributed to a partnership. The partnership realized a \$150 gain on the subsequent sale of the property. Instead of allocating the \$200 built-in gain to the contributing partner and a \$50 loss to the other partners, the ceiling rule would allocate the entire \$150 to the contributing partner and nothing to the other partners.

or deductions to a noncontributing partner equal to the limitation caused by the ceiling rule. The remedial items do not affect a partnership's taxable income and are merely notional tax items that do not affect the partners' book capital accounts. Generally, the remedial allocation method is the only reasonable Sec. 704(c) method to allow for the creation of notional tax items. Regs. Sec. 1.704-3(e) (3) provides special definitions and aggregation rules for securities partnerships.

Final regulations²⁹ issued in late 1995 provide rules on when Secs. 704(c) and 737 apply. Generally under Regs. Sec. 1.704-4(a) (1), the contributing partner must recognize gain or loss on a distribution of the contributed property to another partner within five years after its contribution. The gain or loss is the amount that would have been allocated to the contributing partner if the property had been sold to the distributee partner at its fair market value (FMV); the character of the gain or loss is the same as if the property had been sold. Under Regs. Sec. 1.737-1, a partner who contributes built-in gain property and receives a distribution of property other than money within five years after the contribution must recognize as gain the lesser of (1) the excess of the FMV of the distributed property over the adjusted basis of the partner's partnership interest or (2) the partner's net pre-contribution gain. The character of the gain is determined by reference to the character of the partner's net pre-contribution gain. The regulations are proposed to be effective for distributions after Jan. 8, 1995.

Sec. 752

Rev. Rul. 95-41³⁰ provides guidance on how Sec. 704(c) affects the allocation of nonrecourse liabilities under Regs. Sec. 1.752-3(a). Nonrecourse liabilities are allocated first based on a partner's share of minimum gain, then based on gain allocated to the partner under Sec. 704(c); any excess may be allocated based on the partner's share of partnership profits. According to the ruling, remedial allocations made under Sec. 704(c) are taken into consideration when allocating liabilities, but curative allocations are not. In addition, Sec. 704(c) allocations must be considered if the partnership allocates excess nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to the nonrecourse liabilities will be allocated.

In other developments, the IRS held in Rev. Rul. 95-26³¹ that the short sale of securities by a partnership creates partnership liabilities for Sec. 752 purposes. According to the IRS, liabilities include any obligation that creates or increases the partnership's basis in an asset. A short sale creates an obligation to return borrowed securities, while the cash

received in the sale increases the basis of an asset. Thus, short sales create liabilities that increase a partner's basis.

In *Marcaccio*,³² the Tax Court ruled that the discharge of a partner's share of partnership debt was includible in income. A bank had loaned money to the partnership under the personal guarantee of each partner for a portion of the note. After the partnership defaulted, the bank sold the property for less than the amount owed. The bank tried to collect the deficiency from the individual partners; after negotiations, the bank accepted from the taxpayer approximately one-half of the amount he had guaranteed and extinguished the remainder of his obligation. The IRS contended, and the Tax Court agreed, that the taxpayer received discharge of debt income in the amount forgiven by the bank.

Distributions and Dispositions

Distributions

Under Sec. 731(a) (1), a partner must recognize gain to the extent he receives cash in excess of the adjusted basis in his partnership interest. Under the General Agreement on Tariffs and Trade (GATT) Section 741, amending Sec. 731, the distribution of marketable securities is treated as a distribution of cash. Gain must be recognized to the extent the FMV of the securities exceeds the partner's adjusted basis, but is reduced by the partner's share of the appreciation. Generally, these rules do not apply to investment partnerships, to securities contributed by the distributee partner, to securities that were not marketable securities when acquired by the partnership, and to distributions made in complete liquidation of a publicly traded partnership. Proposed regulations³³ were issued in 1995.

The IRS ruled in Rev. Rul. 95-5³⁴ that, for Sec. 469 purposes, distributions in excess of adjusted basis are treated as gain on the sale of a partnership interest. The ruling stated that Temp. Regs. Sec. 1.469-2T(e) (3) applies, potentially allowing all or part of the gain to constitute passive activity income.

Interaction of Property Distribution and Bond Premium Rules

In Rev. Rul. 95-24,³⁵ the IRS held that if a bond is distributed in liquidation of a partner's interest, the transfer is treated as an exchange in applying Sec. 171(b) (4).

Example: Partner B's partnership interest is liquidated when it has an FMV of \$400 and a basis of \$1,000. B receives a taxable bond with an FMV of \$400 in the liquidation. Under Sec. 732, B's basis in the bond is \$1,000. However, to prevent the built-in capital loss in

Rev. Proc. 95-10 specified the conditions under which the IRS would consider a ruling request on the classification of an LLC as a partnership for tax purposes.

²⁹TD 8642 (12/22/95).

³⁰Rev. Rul. 95-41, 1995-1 CB 167.

³¹Rev. Rul. 95-26, 1995-1 CB 132.

³²A.C. *Marcaccio*, TC Memo 1995-174.

³³PS-2-95 (12/29/95).

³⁴Rev. Rul. 95-5, 1995-1 CB 100.

³⁵Rev. Rul. 95-24, 1995-1 CB 14.

the bond from being treated as amortizable bond premium under Sec. 171(b) and circumventing Sec. 171(b)(4), *B*'s basis in the bond is limited to \$400, its FMV for Sec. 171 purposes. This result is reached by treating the liquidation as an exchange for Sec. 171 purposes; however, for other purposes, *B*'s basis in the bond is determined under Sec. 732.

Other Developments

Sec. 174

In *Scoggins*,³⁶ the Ninth Circuit reversed the Tax Court to hold that a partnership formed to develop new technology was entitled to research and experimentation (R&E) deductions under Sec. 174. Many cases involving partnerships formed to develop technology have concluded that the partnership was a passive financier of an R&E project, rather than having incurred the expenditures in connection with a trade or business, disallowing R&E deductions.³⁷

In *Scoggins*, two individuals formed and owned 75% of a corporation (*C*) to provide R&E services on a contract basis; they also formed a partnership (*P*) to engage in semiconductor equipment R&E. *P* and *C* entered into a contract under which *C* would perform certain R&E work for *P*. *P* paid *C* \$500,000 and granted *C* a 15-month nonexclusive license for a 20% royalty and an option to acquire the rights to the technology for \$5 million. *P* deducted the \$500,000 as R&E under Sec. 174, which was passed through to the two individual partners. The IRS disallowed the deductions and assessed negligence and understatement of tax penalties on the basis that *P* did not incur the expenditures in connection with its own trade or business.

The Ninth Circuit relied on *Kantor*,³⁸ which held that to obtain an R&E deduction, a taxpayer must demonstrate a "realistic prospect" of subsequently entering its own business in connection with the fruits of the research, assuming that the research is successful. Such a prospect could be shown by manifesting both the objective intent to enter such a business and the capability of doing so. The Ninth Circuit held that *P*'s partners were the type of taxpayers whom Congress intended to encourage and reward by enacting Sec. 174. Factors inducing the court to rule for the taxpayers included the partners' technical expertise and experience, *P*'s right to market the product for 18 months before *C*'s option became effective, and *C*'s lack of commitment to market the product.

³⁶ *William V. Scoggins*, 46 F3d 950 (9th Cir. 1995) (75 AFTR2d 95-762, 95-1 USTC ¶50,061), rev'g TC Memo 1991-263.

³⁷ See, e.g., *United Fibertech, Ltd.*, 976 F2d 445 (8th Cir. 1992) (70 AFTR2d 92-5783, 92-2 USTC ¶50,487), aff'g TC Memo 1991-445, and cases cited therein.

³⁸ *Sharon D. Kantor*, 998 F2d 1514 (9th Cir. 1993) (72 AFTR2d 93-5476, 93-2 USTC ¶50,433).

³⁹ Rev. Rul. 95-69, IRB 1995-42, 4.

⁴⁰ *Brown Group, Inc.*, 104 TC 105 (1995), reconsidering 102 TC 616

Sec. 368

In Rev. Rul. 95-69,³⁹ limited partnership *PRS* had two individual partners, *GP* and *LP*. *PRS* was the sole shareholder of *X* corporation. *X* merged with *Y* corporation, which was wholly owned by individual *A*. In the merger, *PRS* received *Y* stock, which it then distributed to its two individual partners so that *Y* could make an S election. At issue was whether *PRS*'s distribution of the *Y* stock to its partners affected the continuity-of-proprietary-interest requirement of Regs. Sec. 1.368-1(b). The IRS held that the distribution did not affect it, because partners *GP* and *LP* indirectly owned *X* both before and after the merger.

Entity vs. Aggregate Theories

The issue of entity vs. aggregate theories was addressed in *Brown Group, Inc.*⁴⁰ *Brown Group, Inc.* (*BGI*) was the parent of an affiliated group that included a controlled foreign corporation (*CFC*); the *CFC*, in turn, owned an 88% partnership interest in a foreign partnership. The IRS assessed *BGI* on its pro rata share of the *CFC*'s income received from the foreign partnership, claiming that such income was foreign base company sales income (*FBCSI*) includible by *BGI* as subpart F income. The Tax Court initially held in favor of *BGI*, but later reconsidered and reversed, concluding that income from a foreign partnership is subpart F income includible in the *CFC*'s gross income under Sec. 951(a); thus, *BGI* was required to include its pro rata share of such subpart F income in its gross income.

One of *BGI*'s arguments was that the character of the income (as *FBCSI*) is determined at the partnership level, by treating the partnership as a separate entity of the partners (the "entity" approach).⁴¹ The IRS argued that the aggregate theory of partnerships should apply because that would further the purpose of subpart F. The court, agreeing with the IRS, noted that a conduit approach is used in taxing subpart F income, because such income is taxable to the shareholders even though it has not been distributed to them. Thus, shareholders are treated as if they directly earned the subpart F income, an approach that ignores the *CFC* as an entity. The court stated that it would be ironic if a taxpayer could defeat congressional intent as evidenced in the subpart F rules by engaging in its activities through a partnership and following an entity approach to characterizing income.

The Eighth Circuit recently reversed⁴² the Tax Court's

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a member's
net LLC earnings
are subject to
SE tax unless
the member is
treated as a
limited partner
under Sec.
1402(a)(13).**

(1994). See Tax Clinic, "Tax Court Holds Foreign Partnership Income is Subpart F Income: *Brown* Decision Reversed," 26 *The Tax Adviser* 404 (July 1995).

⁴¹ Under the "entity" theory, a partnership and its partners are treated as separate entities; under the "aggregate" or "conduit" theory, a partnership is viewed as a group of partners owning the partnership's assets and liabilities. See cites contained in *Brown*, id., at 104 TC 116.

⁴² *Brown Group, Inc.*, 8th Cir., 1995, rev'g 104 TC 105 (1995).

decision, finding that, under pre-Revenue Act of 1987 Sec. 954(d) (3), the partnership did not control the CFC (rather, it was controlled by it), and so it was not related to either the CFC or the U.S. parent; thus, the income was not FBCSI at the partnership level, and so could not be when distributed to the CFC. The court also discussed the anti-abuse regulations, noting that they had not been in effect for the year in issue.

Examinations

An informal IRS training manual⁴³ identifies 11 emerging issues to be addressed in examination of partnership returns. These issues include Sec. 704(b) allocations, the Regs. Sec. 1.701-2 anti-abuse rule previously discussed, and family limited partnership and estate and gift planning discounts. The IRS issued an Industry Specialization Program (ISP) paper⁴⁴ explaining the factors to be considered in determining whether an abusive partnership transaction exists that is to be recast by the IRS under the anti-abuse regulations.

Proposed Legislation

The Revenue Reconciliation Act of 1995⁴⁵ (RRA '95) had included two partnership simplification provisions. RRA '95 Section 11471 applied to "large partnerships," defined as those with at least 100 partners that elected to be so treated. The proposal required certain items to be computed at the partnership, rather than at the partner, level. The other proposal, RRA '95 Section 11472, required partnerships with

over 100 partners to file returns on magnetic media.

The AICPA's proposal to expand a partnership's choices for a fiscal year was included only in the House bill.⁴⁶ Under this proposal (which is part of the AICPA's workload compression initiative), partnerships and S corporations would have been able to elect any fiscal year by making quarterly estimated tax payments at a specified rate on behalf of the owners.

Conclusion

With the introduction of the IRS's ISP paper and the expansion of LLCs, it is more critical than ever to understand the partnership tax rules. The past year provided much-needed guidance and more can be expected in the future. It appears that the IRS plans to limit the use of partnerships to avoid taxation, as evidenced by the enactment of anti-abuse regulations.

The IRS is trying to provide sufficient guidance to taxpayers in the partnership area. During the past year, guidance was provided for partnerships in several areas, including pre-contribution gains and losses under Sec. 704(c) and classification and LLC issues. The current year will likely involve final guidance on whether entities can be classified merely by checking a box and on the proper treatment of distributions of marketable securities. In addition, other simplification proposals will likely arise. Based on these developments, it appears that the future will see an expansion of the types of entities classified as partnerships for Federal tax purposes. **TTA**

⁴³See Thumtack, "Partnerships," 26 *The Tax Adviser* 571 (Sept. 1995).

⁴⁴See Thumtack, "ISP paper on partnerships," 26 *The Tax Adviser* 512 (Aug. 1995); see also Ann. 94-87, IRB 1994-27, 124.

⁴⁵H.R. 2491, Revenue Reconciliation Act of 1995, Subtitle L, 104th Cong., 2d Sess. (1995), vetoed by Pres. Clinton.

⁴⁶See Joint Committee on Taxation, *Comparison of Tax Simplification Provisions of H.R. 2491 as Passed by the House and the Senate* (JCS-23-95, 10/31/95), p. V-25; Section 14554 would have modified Sec. 444 and added new Code Sec. 6654A.

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