[JOINT COMMITTEE PRINT]

REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

APRIL 8, 1997

U.S. GOVERNMENT PRINTING OFFICE

39-609 WASHINGTON : 1997 JCS-6-97

For sale by the U.S. Government Printing Office
Superintendent of Documents, Mail Stop: SSOP, Washington, DC 20402-9328
ISBN 0-16-054335-5

JOINT COMMITTEE ON TAXATION

105TH CONGRESS, 1ST SESSION

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INTRODUCTION

Over the past few years, the tax rules governing the form in which business income is taxed have been affected by developments other than Federal tax legislation. Both State law developments, particularly the burgeoning of limited liability company statutes, and changes in Treasury regulations and rulings have had a significant impact.

In particular, the "check-the-box" regulations, issued in final form by the Treasury Department on December 17, 1996, simplify and liberalize the current entity classification rules, and enhance the ability of a business entity to choose to be treated as a partnership for tax purposes. This trend places increased pressure on the rules governing the taxation of partnership income, making it more important to identify and, if possible, correct provisions in the partnership tax rules that give anomalous results, create problems in application, or are anachronistic.

During the latter part of 1996, the Joint Committee on Taxation staff undertook a review of the recent developments in the tax rules governing entity classification and taxation of the income of partnerships.[1] This review was undertaken pursuant to the Joint Committee's statutorily imposed duties to investigate the operation and effects of the Federal tax system, to investigate the administration of the Federal tax system by the Internal Revenue Service and other Federal agencies, and to make such other investigations of the Federal tax system as are necessary.[2] As part of this ongoing review, this pamphlet[3] sets forth issues relating to the tax treatment of partnerships and the classification of entities as corporations or partnerships.[4] Specifically, Part I of the pamphlet is an executive summary. Part II contains a discussion and analysis of the issues relating to entity classification, and Part III describes possible proposals relating to the tax treatment of partnerships.

[1] Joint Committee on Taxation Chief of Staff Kenneth J. Kies announced this review in a press release (November 25, 1996).

[2] Internal Revenue Code section 8022.

[3] This pamphlet may be cited as follows: Joint Committee on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS–6–97), April 8, 1997.

[4] The Joint Committee staff review also covered issues relating to corporate spinoffs. Those issues will be addressed separately.

I. EXECUTIVE SUMMARY

In general

Under present law, a corporation generally is treated as an entity separate from its shareholders for Federal tax purposes. The corporation is taxed separately on its income, and shareholders are taxed separately on distributions by the corporation. Corporate income is thus subject to a two-tier Federal income tax regime. Partnerships, by contrast, are not treated as separate taxpayers for Federal income tax purposes. The income of the partnership is taxed to the partners and items of income, gain, loss, deduction and credit generally are allocated to the partners in accordance with the partnership agreement. Partnership income is thus subject to one level of Federal income tax at the partner level.

Historically, owners of business enterprises have chosen to incorporate a business for various non-tax reasons. A primary reason for incorporating in many cases has been the fact that corporate form shields the shareholders of the corporation from liabilities of the business. Passthrough treatment is often preferred for Federal income tax purposes, however, to avoid the two levels of tax generally applicable to distributed corporate income. In recent years, the growth of limited liability companies ("LLCs"), which can provide owners with protection from liability and at the same time can be treated as partnerships for Federal tax purposes, has reduced the importance of some non-tax reasons that business owners may choose to operate in corporate form.

The Treasury check-the-box regulations finalized in late 1996 simplify and liberalize the entity classification rules, thereby enhancing the ability of the owners of a business entity to choose to be treated as a partnership for tax purposes. As a result of the issuance of the proposed check-the-box regulations, the staff of the Joint Committee on Taxation undertook a review of the recent developments in the tax rules governing entity classification and the taxation of the income of partnerships. The Joint Committee staff met with and talked to partnership tax experts as part of the review. Part II of this pamphlet discusses issues presented by recent trends in the classification of entities as corporations or partnerships.

Entity classification

Prior entity classification regulations applied a four-factor test for determining whether an entity was classified as a corporation or a partnership for Federal tax purposes. The new check-the-box entity classification regulations achieve across the board what the Internal Revenue Service (the "Service") had been moving toward in a series of revenue rulings holding that LLCs established under various States' laws can be classified as partnerships for Federal income tax purposes. In general, under the check-the-box regula-

tions, pass-through entity status is elective for most domestic unincorporated entities other than those whose interests are publicly traded. Single-member entities may be disregarded, so that sole proprietors pay no entity-level tax and corporate sole owners can use the tax attributes of the entity as if it were a division or branch, while remaining insulated from the entity's liabilities. Thus, these entity classification rules tend to make it easier for business activities to fall within the "one-level-of-tax" partnership regime rather than the two-tier regime applicable to corporations.

These changes raise a number of issues. An initial issue involves the legal authority for the regulations under the statutory language defining partnerships and corporations, which does not explicitly describe an elective regime. A closely related issue is whether it would be appropriate or necessary for the Congress to legislate specifically to authorize the check-the-box regulations. Other issues relate to whether, on the one hand, the check-the-box regulations have the effect of simplifying but not significantly expanding the availability of pass-through tax treatment under present law, or whether, on the other hand, they have the effect of making significant changes to the business tax base, giving taxpayers many more choices of when or whether to be subject to tax. Another set of issues involves the continued utility of other statutory pass-through regimes, such as subchapter S of the Code (governing S corporations), in light of the ability of taxpayers to elect partnership status or (in the case of single-member entities) to disregard an entity altogether.

Partnerships

Business transactions and tax planning in the partnership area have become more sophisticated since the bulk of the present-law partnership rules were enacted in 1954. Some provisions may be out of date, may give anomalous results, or may have unforeseen problems in application. The tax rules applicable to partners and partnerships merit scrutiny in light of the possibility that they will be more widely used, given the simple electivity of partnership status under the check-the-box regulations. Possible changes to the Federal income tax treatment of partnerships that could be considered are described in Part III of this pamphlet. These issues generally have been discussed in the tax literature, in articles, bar group submissions, and other publications. These possible proposals include the following:

(1) Provide legislative authorization of the check-the-box regulations or codify elective entity classification;

(2) Modify basis rules to minimize basis shifting among assets (and basis creation or disappearance) in the event of a distribution of partnership assets;

(3) Require basis adjustments to assets when a partnership distributes certain stock to a corporate partner;

(4) Limit partnership terminations;

(5) Modify the rules taxing pre-contribution gain (including repeal of the 5-year time limit);

(6) Eliminate the substantial appreciation requirement for inventory of a partnership in certain transfers and distributions;

(7) Require closing of the partnership taxable year with respect to a deceased partner to avoid the bunching of income or deductions upon a partner's death;

(8) Limit partnership allocations made after the end of a taxable year to allocations of service income of a service partnership;

(9) Modify the treatment of guaranteed payments made by a partnership;

(10) Modify the employment and self-employment tax and income tax withholding treatment of partners of a partnership;

(11) Require partial recognition of gain on the transfer of marketable securities to a partnership or corporation;

(12) Deny installment sale treatment for all readily tradable debt;

(13) Realize cancellation of indebtedness income on satisfaction of debt with partnership interest; and

(14) Apply earnings-stripping rules to partnerships and S corporations.

II. ENTITY CLASSIFICATION

A. Prior and Present Law

1. Tax treatment of corporations, partnerships, and publicly traded partnerships

Corporations

For Federal income tax purposes, a corporation generally is treated as a separate entity apart from its shareholders. Corporations and shareholders generally are each separately subject to tax on distributed corporate income. The shareholders do not calculate their tax liability by reference to the corporation's income; instead, the corporation pays tax on its income. In addition, the shareholders generally include in their income amounts that the corporation distributes to them. The rules governing the relationship of a taxable corporation and its shareholders generally are found in subchapter C of the Internal Revenue Code of 1986 ("Code"), and corporations subject to tax as such are known as "C corporations."

Partnerships

A partnership, on the other hand, generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners, and distributions from the partnership generally are tax-free. The items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement (or in accordance with the partners' interests in the partnership if the agreement does not provide for an allocation), so long as the allocation has substantial economic effect. The rules governing the treatment of a partnership and its partners generally are found in subchapter K of the Code.

Publicly traded partnerships

A publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704). An exception to the rule treating the partnership as a corporation applies if 90 percent of the partnership's gross income consists of "passive-type income," which includes (1) interest (other than interest derived in a financial or insurance business, or certain amounts determined on the basis of income or profits), (2) dividends, (3) real property rents (as defined for purposes of the provision), (4) gain from the sale or other disposition of real property, (5) income and gains relating to minerals and natural resources (as defined for purposes of the provision), and (6) gain from the sale or disposition of a capital asset (or certain trade or business property) held for the production of in-

come of the foregoing types (subject to an exception for certain commodities income). [5]

The exception for publicly traded partnerships with "passive-type income" does not apply to any partnership that would be described in section 851(a) of the Code (relating to regulated investment companies, or "RICs"), if that partnership were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision. Nevertheless, if a principal activity of the partnership consists of buying and selling of commodities (other than inventory or property held primarily for sale to customers) or futures, forwards and options with respect to commodities, and 90 percent of the partnership's income is such income, then the partnership is not treated as a corporation.[6]

A publicly traded partnership is a partnership whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

Treasury regulations provide detailed guidance as to when an interest is treated as readily tradable on a secondary market or the substantial equivalent. Generally, an interest is so treated "if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market" (Treas. Reg. sec. 1.7704-1(c)(1)).[7]

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[5] When the publicly traded partnership rules were enacted in 1987, a 10-year grandfather rule provided that the provisions apply to certain existing partnerships only for taxable years beginning after December 31, 1997. Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), sec. 10211(c).

[6] Also, present law treats a taxable mortgage pool as a separate corporation for Federal tax purposes (sec. 7701). For this purpose, a taxable mortgage pool is any entity (other than a real estate mortgage investment conduit, or "REMIC"), which generally is treated as a conduit for Federal tax purposes) that meets a definition based in part on the portion of its assets consisting of debt that constitutes real estate mortgages. Generally, an entity that is a mortgage pool and does not qualify as a REMIC is treated as a corporation. See Report of the House Committee on the Budget to accompany H.R. 3435, H. Rept. 100-391, 100th Cong., 1st Sess. 1068 (1987), stating, "it is not intended that the provisions of present law applicable to real estate mortgage investment conduits be made non-exclusive by this provision once the rules of present law relating to taxable mortgage pools become effective (for taxable years beginning after December 31, 1991)."

[7] The regulations further provide that interests are readily tradable on an established securities market if: (1) interests are regularly quoted by any person making a market in the interests; (2) any person regularly makes available to the public bid or offer quotes, and stands ready to effect buy or sell transactions; (3) the holder has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests; or (4) prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange interests in a time frame and with the regularity and continuity that is comparable to that described by the foregoing (Treas. Reg. sec. 1.7704-1(c)(2)). The regulations also provide rules for when an interest is not so treated. An interest is not treated as traded on an established securities market and not readily tradable on a secondary market or the substantial equivalent thereof without (1) the participation of the partnership in the establishment of the market or inclusion of interests on the market, or (2) recognition by the partnership of transfers made on the market. Transfers not involving trading, such as transfers at death, between family members, block transfers, and other specified types of transfers, are disregarded in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent. Further, a transfer pursuant to a redemption or repurchase agreement, or through a matching service, generally is disregarded in determining whether partnership interests are readily tradable on a secondary market or the substantial equivalent. Further, an interest is not so treated if there is a lack of actual trading, which is defined to occur if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership does not exceed 2 percent of the total interests in partnership capital or profits. For this purpose, transfers described in the foregoing exceptions are not taken into account.

Choosing pass-through tax treatment

Owners of business enterprises may wish to incorporate for non-tax reasons (easier access to capital markets, or to meet regulatory requirements), but may prefer not to have corporate tax treatment. Limited liability for all the owners of the business generally has been provided by operating in corporate form; but now, because limited liability companies generally may be treated as partnerships for Federal tax purposes, and LLCs generally provide limited liability for LLC owners, limited liability is not as compelling a rationale for choosing corporate tax status. With the passage of time, the increased acceptance of LLCs and the resolution of questions of interstate comity may further reduce the importance of some non-tax reasons that taxpayers may have chosen corporate form.[8]

Pass-through tax treatment often is preferred over corporate tax treatment because owners may not wish business earnings to be subject to two levels of tax (once when earned and again when distributed). Other reasons for preferring pass-through tax treatment to corporate tax treatment are that: (1) the average or marginal tax rates for individual shareholders may be lower than that of the corporation;[9] (2) owners may wish to use losses generated by the business to offset income from other sources; (3) the corporate tax base may include items not applicable to individuals (e.g., items included under the corporate alternative minimum tax); and (4) favorable tax accounting methods available to individuals may not be available to corporations (e.g., the cash receipts and disbursements method).

2. Prior entity classification regulations

Classification as a corporation or partnership

Prior to the check-the-box regulations, the Treasury regulations governing the classification of entities as partnerships or, alternatively, associations taxable as corporations for Federal income tax purposes were adopted in 1960. These regulations were known as the "Kintner" regulations because they were a response to the decision in *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954). The classification issue arose in that case because of favorable pension plan rules applicable, at that time, to corporate employees but not to partners. The Kintner regulations generally made it more likely than did the previous entity classification rules that a business entity would be classified as a partnership rather than a corporation.

The Kintner regulations provided that whether a business entity was taxed as a corporation depended on which form of enterprise the entity "more nearly" resembled (former Treas. Reg. sec. 301.7701-2(a)). The regulations listed six corporate characteristics, two of which are common to corporations and partnerships: the presence of associates and an objective to carry on business and di-

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[8] The classification of LLCs as partnerships is described in more detail in Part II. A. 2., below. The increased use of LLCs may be reflected in the future by a decline in the use of S corporations (passthrough corporations), and some have questioned the continuing need for S corporation status for new businesses, discussed below in Part II. B. 2.

[9] The top marginal rate applicable to individuals under present law (39.6 percent) is higher than the top marginal rate applicable to corporations (35 percent). However, the graduation of the corporate and individual rate schedules and the division of entity income among owners may have the effect that the average and marginal tax rates for the individual owners under present law may be lower than the rates applicable to the entity as a corporation.

vide the gains therefrom. Whether an unincorporated organization was classified as a partnership or a corporation depended on whether the entity had more than two of the remaining four corporate characteristics.

The four corporate characteristics identified in the Kintner regulations were (1) continuity of life, (2) centralization of management, (3) liability for entity debts limited to entity property, and (4) free transferability of interests (former Treas. Reg. sec. 301.7701-2). The effect of the regulations generally was to classify an unincorporated entity as a partnership if it lacked any two or more of the four corporate characteristics, without further inquiry as to how strong or weak a particular characteristic was or how the evaluation of the factors might affect overall resemblance to a partnership or a corporation (former Treas. Reg. secs. 301.7701-2 and -3; *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1).[10]

An organization was treated as having continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member did not cause a dissolution of the organization. In the case of a limited partnership, if the death, insanity, bankruptcy, retirement, resignation, expulsion, or other event of withdrawal of a general partner caused a dissolution unless the remaining general partners, or at least a majority in interest of all the remaining partners, agreed to continue the partnership, continuity of life did not exist. The regulations provided that a general or limited partnership subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act lacked continuity of life. Under these rules, continuity of life generally did not exist even if the remaining partners had agreed to continue the partnership.

An organization generally had centralized management under the regulations if any person (or any group of persons which did not include all the members) had continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed. A general partnership subject to a statute corresponding to the Uniform Partnership Act could not achieve centralization of management because of the mutual agency relationship between the partners. A limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act generally did not have centralized management unless substantially all the interests in the partnership were owned by the limited partners. However, if all or a specified group of the limited partners could remove a general partner (even with a substantially restricted right of removal), the test for whether there was centralized management was to be based on all the facts and circumstances.

An organization was treated under the regulations as having limited liability if, under local law, there was no member who was per-

[10] In 1976, the Tax Court suggested that the regulations might not effectively identify those entities that had an overall corporate resemblance; however, the court concluded it was required to follow the regulations and held that the particular entity at issue was classified as a partnership. *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1. A proposed revision of the regulations was issued in January, 1977 (42 Fed. Reg. 1038, January 5, 1977), but was withdrawn almost immediately (42 Fed. Reg. 1489, January 7, 1977). The revised and withdrawn regulations would have made it less likely that an entity would be classified as a partnership than under the Kintner regulations.

sonally liable for the debts of, or claims against, the organization. In the case of an organization subject to a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act, personal liability generally existed with respect to each general partner. In the case of a limited partnership, however, personal liability did not exist with respect to a general partner when he had no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he was merely a "dummy" acting as the agent of the limited partners.

The Service's ruling position was that a corporate general partner in a limited partnership did not have a substantial assets unless its net worth (excluding the partnership interest) was greater than or equal to 10 percent of the total contributions to the partnership (Rev. Proc. 92-88, 1992-2 C.B. 496). For partnerships with more than one general partner, this test could be met on a collective basis. If this test was met, the corporate partner was considered to have substantial assets, and the entity was considered not to have limited liability, for advance ruling purposes. Some taxpayers successfully contended that a limited partnership lacked limited liability under the regulations if the corporate general partner was not a "dummy" acting as the agent of the limited partners (see *Larson, supra*).

An organization was treated as having free transferability of interests, under the regulations, if members owning substantially all the interests had the power, without the consent of other members, to substitute another person as a member and to confer upon the substitute all the attributes of the transferred interest. Although the regulations indicated, in examples, that free transferability did not exist where unanimous consent of the general partners was required for the assignee of a limited partner's interest to become a substitute limited partner, the court in *Larson* found free transferability where the consent of the general partner to substitute limited partners could not be unreasonably withheld.

If an unincorporated organization had no more than two of these four corporate characteristics (in addition to the two factors that corporations and partnerships have in common), then, under the regulations, it was classified as a partnership rather than a corporation for Federal income tax purposes. All foreign entities, whether or not considered corporations under local law, were treated as non-corporate entities for this purpose, with the result that they were classified as corporations only if they possessed more than two of the four corporate characteristics (Rev. Rul. 88-8, 1988-1 C.B. 403).

Classification as corporation or trust

The prior regulations also provided that, in general, the term "trust" refers to an arrangement created either by a will or by an *inter vivos* declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts (former Treas. Reg. sec. 301.7701-4(a)). The regulations further provided that, in general, an arrangement was treated as a trust for tax purposes if it could be shown that the purpose of the arrange-

ment was to vest in trustees responsibility for the protection and conservation of property for beneficiaries who could not share in the discharge of this responsibility and, therefore, were not associates in a joint enterprise for the conduct of business for profit. The income of a trust generally is subject to one level of tax. The income generally is subject to tax either at the beneficiary level (simple trusts), or at the trust level with a corresponding deduction for distributions to beneficiaries (complex trusts).

Because the four characteristics discussed above that distinguished partnerships from corporations under the regulations generally are common to trusts and corporations, the regulations used the other factors--namely the presence of associates and an objective to carry on business and divide the gains therefrom--in distinguishing a corporation from a trust (see Former Treas. Reg. sec. 301.7701-2(a)(2)). Thus, an entity was not treated as a trust for tax purposes if it was used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership. This type of organization is known as a business or commercial trust (e.g., a Massachusetts business trust) (Treas. Reg. sec. 301.7701-4(b)).

The prior regulations also provided rules for the classification of investment trusts (sometimes also called "management trusts"). An investment trust with a single class of ownership interests was treated as a trust, rather than an association taxable as a corporation, where there was no power under the trust agreement to vary the investment of the certificate holders (as in the case of so-called "fixed investment trusts" or "unit investment trusts").

Treasury regulations issued in March, 1985 (the so-called "Sears" regulations) provided rules for the classification of trusts with more than one class of ownership interest as trusts, or alternatively, as associations taxable as corporations. Treas. Reg. sec. 301.7701-4(c). Under the regulations, a trust having more than one class of ownership interest generally was classified as a corporation or partnership rather than a trust. Thus, if a trust held a portfolio of mortgages, and one class of interest in the trust was to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal on the mortgages, and another class of beneficiaries was to receive all remaining amounts collected by the trust, then such trust was treated as a corporation or partnership under the regulations. The regulations provided a limited exception for certain trusts with multiple classes of ownership interests, where the existence of multiple classes of interests was incidental to the purpose of facilitating direct investment in the assets of the trust.

3. Tax treatment of limited liability companies

In recent years a form of entity has emerged, the limited liability company (referred to as an LLC), that generally provides corporate treatment for State law purposes and partnership treatment for Federal tax purposes. LLCs are entities organized under State law. Although LLC statutes differ from State to State, common characteristics among most States include limited liability of owners,

management vested in owners or managers, lack of free transferability of interests, and often a lack of continuity of life.[11]

In 1988, the Service ruled that an LLC organized under the Wyoming LLC statute[12] could be treated as a partnership for Federal tax purposes, applying the four-factor test of the prior entity classification regulations then in effect.[13] All 50 States have enacted LLC statutes.[14] Over the years following the 1988 revenue ruling, the Service issued a series of revenue rulings on a State by State basis, eventually addressing the issue for many of the States, concluding that LLCs organized under each such State's laws could be classified as a partnership for Federal tax purposes. No further such rulings have been issued since December 17, 1996, when the final check-the-box regulations were issued, because as described below, those regulations generally make classification of an entity as a partnership for Federal tax purposes elective.

4. Final check-the-box regulations

On April 3, 1995, the Service announced in Notice 95-14, 1995-1 C.B. 297, that it was considering repealing the Kintner regulations and replacing them with new regulations that would allow taxpayers to treat domestic unincorporated business entities as partnerships or, alternatively, associations taxable as corporations on an elective basis. The Service also stated that it was considering the possible extension of such treatment to foreign business organizations. Proposed regulations implementing these changes were issued by the Treasury Department on May 13, 1996, and were adopted without fundamental changes as final regulations on December 17, 1996. The final regulations generally are effective January 1, 1997. Because of the elective classification regime they adopt, the regulations are referred to as the "check-the-box" regulations.

The major change made by the check-the-box regulations is to allow tax classification as either a partnership or a corporation to be explicitly elective, subject to minimal restrictions (compared to the prior entity classification regulations[15]), for any domestic nonpublicly traded unincorporated entity with two or more members. In addition, the check-the-box regulations explicitly provide that a single-member unincorporated entity may be disregarded (treated as not separate from its owners). A disregarded entity is treated in the same manner as a sole proprietorship, in the case of an entity

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[11] These elements were important under the prior entity classification regulations, but generally are not relevant under the check-the-box regulations. See Claridy, "The Limited Liability Company: An S corporation Alternative or Replacement?," 4 *Journal of S Corporation Taxation* 202 at 203 (1993). States may revise their LLC statutes to eliminate provisions designed to permit LLCs to be treated as partnerships for Federal tax purposes under the prior entity classification regulations, now that the check-the-box regulations have made partnership status elective. See W. Bagley, "The IRS Steps Back: Entity-Classification Rules Are Relaxed," *Business Law Today*, 41, Jan.-Feb. 1997.

[12] Wyo. Stat., secs. 17-15-101 through 17-15-136 (1977).

[13] Rev. Rul. 88-76, 1988-1 C.B. 260.

[14] See B. Ely and J. Beach, "The LLC Scoreboard," *Tax Notes*, March 10, 1997, p. 1329; L. Ribstein, "The Emergence of the Limited Liability Company," 51 *Business Lawyer* 1 (Nov. 1995); M. Burak, "Vermonters Win with Limited Liability Companies," 24 *Vermont Business Magazine* 10 (June 1996); Hawaii's limited liability company statute is effective April 1, 1997 (Hawaii Rev. Stat., Title 23, ch. 428).

[15] For domestic LLCs organized in States on whose LLC statutes the Service issued revenue rulings, classification as a partnership was generally attainable if the taxpayer so desired, even prior to the check-the-box regulations.

owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation. The check-the-box regulations also differ from the previous regulations in treating certain entities as *per se* corporations for tax purposes.

The final check-the-box regulations retain the rules of the previous regulations for distinguishing "business entities" from trusts. Under the final check-the-box regulations, certain business entities will be classified automatically as corporations.[16] These generally are domestic entities formed under a State corporation statute that describes the entity as a corporation, joint-stock company or in similar terms. They also include insurance companies, organizations that conduct certain banking activities, organizations wholly owned by a State, and organizations that are taxable as corporations under other Code provisions, such as the provisions for publicly traded partnerships (sec. 7704).

Similarly, the check-the-box regulations classify as corporations *per se* certain foreign business entities that are listed in the regulations, including, for example, a U.K. Public Limited Company and a French *Societe Anonyme*.[17] In broad terms, the foreign entities listed in the regulations are corporations that generally are not closely held and the shares of which can be traded on a securities exchange.

The check-the-box regulations provide a grandfather rule under which certain foreign entities in existence on May 8, 1996, are not *per se* classified as corporations. Among the requirements for such grandfather treatment are that (1) the entity's classification was relevant to any person for U.S. tax purposes on May 8, 1996, (2) no such person treated the entity as a corporation for U.S. tax purposes for the taxable year including May 8, 1996, (3) a reasonable basis existed on May 8, 1996, for treating the entity as other than a corporation, and (4) neither the entity nor any member was notified on or before May 8, 1996, that the classification of the entity was under examination by the Service. Foreign business entities formed pursuant to a binding written contract in existence on May 8, 1996, may qualify for grandfather treatment if the above requirements are met as of the date of the entity's formation. The regulations also specify certain situations where a foreign business entity loses its grandfathered status and, thus, is classified *per se* as a corporation.

A domestic or foreign entity that is not *per se* classified as a corporation under the above rules is a so-called "eligible" entity that may elect how it will be classified under the regulations' check-the box regime. An eligible entity with two or more members may elect to be classified as a corporation or a partnership. An eligible entity with a single member may elect to be classified as a corporation or to be "disregarded" (treated as not separate from its owner). If the single owner of a business entity that elects to be disregarded is a bank (as defined in sec. 581), then the special rules applicable

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[16] Under the check-the-box regulations, whether an arrangement is an "entity" for purposes of the check-the-box regime is determined under Federal, not local, law.

[17] An entity is treated as domestic if it is created or organized under the law of the United States or of any State; an entity is treated as a foreign entity if it is not domestic under this definition.

to banks continue to apply as if the wholly-owned entity were a separate entity.

For eligible entities that fail to make an election, the check-the-box regulations include certain "default" rules, which provide the classification that such entities could generally be expected to choose if they filed an election. For all entities in existence prior to January 1, 1997, the default classification is the classification claimed by the entity under the Kintner regulations. There is an exception from this rule for single-member entities that claimed to be a partnership under the Kintner regulations; for such an entity, the default classification is to disregard it (i.e., treat it as not separate from its owner). A foreign entity is treated as in existence prior to January 1, 1997, only if the entity's classification was relevant to any person for U.S. tax purposes during the 60 months prior to that date.

For eligible entities not in existence prior to January 1, 1997, the default rules are as follows. A domestic entity that has multiple members is classified as a partnership. In the case of a domestic single-member entity, the default classification is to disregard the entity as separate from its owner. In the case of foreign entities with multiple members, the default classification is as a partnership if at least one member does not have limited liability, and as an corporation if all members have limited liability. Default treatment for a single-member foreign entity is to treat it as a corporation if the single owner has limited liability, and to disregard it if the owner does not have limited liability.

An eligible entity may make one of the elections permitted under the check-the-box regulations by filing Form 8832 with the appropriate Internal Revenue Service Center. Taxpayers may specify the date as of which the election is to become effective, provided that the effective date is not more than 75 days prior to the date on which the election is filed nor more than 12 months thereafter. An entity may file its initial election at any time, but the regulations generally prohibit filing of more than one election to change an entity's classification during any 60-month period.

The preambles to both the proposed and the final check-the-box regulations state that the Treasury Department and the Service will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of Code provisions and U.S. tax treaties. The preamble to the final regulations also states that the Treasury Department and the Service are actively considering issuing guidance on the tax consequences of conversions by election from partnership to corporate classification and corporate to partnership classification.

B. Analysis

1. Legal authority for the check-the-box regulations

In general

The check-the-box regulations are issued under definitional sections of the Code that relate to partnerships and corporations. The statutory definition of a partnership provides that it "includes a syndicate, group, pool, joint venture, or other unincorporated orga-

nization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title [the Internal Revenue Code], a trust or estate or a corporation" (sec. 7701(a)(2)). The statutory definition of a corporation provides that it "includes associations, joint-stock companies, and insurance companies" (sec. 7701(a)(3)).

The authority of the Treasury Department to issue regulations providing for an elective entity classification regime under this statutory language has been questioned. Even some who welcome the result under the regulations have expressed concern about the authority of the Treasury to promulgate them.[18]

The statutory source of authority for issuing the regulations provides that the Secretary of the Treasury is authorized to "prescribe all needful rules and regulations for the enforcement of this title [the Internal Revenue Code]" (sec. 7805). Regulations issued pursuant to this authority are referred to as interpretive regulations.

In examining the legal authority issue, a threshold question is the standard of review imposed by the courts in assessing the validity of regulations. Many commentators have analyzed the body of case law relating to agency interpretations of statutory provisions.[19] The standard commonly referred to is that set forth by the Supreme Court in the *Chevron* case,[20] in which the Court applied a two-step process for review: first, whether the plain meaning of the statute determines the issue, and then, whether the agency's interpretation is a permissible construction of the statute. The second step in this analysis is viewed as according considerable judicial deference to agency interpretations. The *Chevron* case did not involve tax regulations, and it has been suggested that the standard set forth in that case has not been applied consistently in judicial review of tax regulations.[21] The Court has, however, applied a standard requiring interpretive tax regulations to be a reasonable interpretation of the statute.[22]

Other factors are relevant to an analysis of the validity of the check-the-box regulations as a way to determine whether an entity is an association treated as a corporation. The Kintner regulations, which preceded the check-the-box regulations, were in effect for nearly 36 years. It could be argued that Congress tacitly approved the four-factor test set forth in the Kintner regulations, or that Congress implicitly reserved to itself the power to modify that test, and that the Treasury Department's authority to replace the Kintner regulations was thereby restricted. The 1987 legislation

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[18] "The simplicity and flexibility of the check-a-box Regulations have evoked virtually universal approbation and support from private practitioners and taxpayers. . . . Lost in the applause is any serious examination of how a rule that permits substantively identical entities to elect to be classified as either an association taxable as a corporation or a partnership can be promulgated under the interpretive authority granted to the Treasury by sec. 7805. . . . It is, of course, inevitable that some owners of interests in entities subject to the check-a-box rules will discover that a particular classification election has worked to their detriment. . . . [A] challenge to the validity of the regulations may ensue. While the combination of circumstances that would prompt such a challenge is highly unusual, the probability of a challenge being successful is high if the right circumstances are present." W. McKee, W. Nelson and R. Whitmire, *Federal Taxation of Partnerships and Partners,* 3-102 (3rd ed. 1997), para. 3.08.

[19] See, e.g., articles cited in J. Coverdale, "Court Review of Tax Regulations and Revenue Rulings in the Chevron Era," 64 *Geo. Wash. L. Rev.* 35, note 3 (1995).

[20] *Chevron, USA, Inc. v. Natural Resources Defense Council,* 467 U.S. 837 (1984).

[21] See Coverdale, supra, at 58 and at note 121.

[22] *National Muffler Dealers Assn. v. U.S.,* 440 U.S. 472 (1979). See E. Aprill, "Muffled Chevron: Judicial Review of Tax Regulations," 3 *Fla. Tax Rev.* 54 (1996).

treating publicly traded partnerships as corporations for Federal tax purposes could be viewed as implicit support for those regulations. On the other hand, it could be argued that no such Congressional intent can be presumed without a specific indication of approval of the Kintner regulations. It could also be argued that "sharp breaks" with a long-standing regulatory interpretation may be consistent with the agency's administrative ability to respond to changing circumstances.[23]

It could be argued that the Treasury Department's authority to issue interpretive regulations does not include the ability to determine tax policy, but merely to interpret the policy set forth in the statute; therefore, an interpretation as expansive as the creation of an elective entity classification regime arguably exceeds the authority of the tax administrator. In response, it could be asserted that, in actual practice, the Kintner regulations had come to be so readily manipulated by tax practitioners as to be effectively elective, so that the adoption of an affirmatively elective regime is a change in form rather than in substance from the former regulations.

A related question involves whether any interpretation of what constitutes an "association" taxable as a corporation is already governed by the Supreme Court's decision in *Morrissey v. Commissioner*, 296 U.S. 344 (1935). That case involved an organization established as a trust under State law and reclassified by the Service as an association taxable as a corporation. Beneficial interests in the entity were evidenced by transferable share certificates, representing both common and preferred interests, held by hundreds of persons. The Supreme Court concluded that the organization was properly taxed as a corporation, given the entity's centralized control and continuity of life, the limited liability of the shareholders, and the fact that the entity essentially was conducting a business enterprise. The Court reasoned that the entity resembled a corporation. The case is said to have set forth the corporate resemblance test referred to in the Kintner regulations that were in effect prior to the check-the-box regulations.

Some might argue that the *Morrissey* decision requires the Treasury Department to apply a corporate resemblance test in any regulations for determining whether an entity is an association taxable as a corporation. On the other hand, it has been argued that the check-the-box regulations in fact represent an implementation of the corporate resemblance test,[24] when viewed in conjunction with the present-law rules generally treating publicly traded partnerships as corporations.[25] The publicly traded partnership rules could be viewed as reflecting a determination by Congress that public trading is an effective index of whether an entity resembles

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[23] See *Rust v. Sullivan*, 500 U.S. 173 (1991). This case did not involve tax regulations, however. See C. Cooper, M. Carvin, and V. Colatriano, "The Legal Authority of the Department of the Treasury to Promulgate a Regulation Providing for Indexation of Capital Gains," 12 *Va. Tax Rev.* 631, 642 (1993) (arguing that the term "cost" could be interpreted in regulations to permit indexation, even though it had not previously been so interpreted).

[24] V. Fleischer, "'If It Looks Like a Duck': Corporate Resemblance and Check-the-Box Elective Tax Classification," 96 *Columbia L. Rev.* 519 (1996).

[25] See the description of the present-law rules treating publicly traded partnerships as corporations, Part II. A., above.

a corporation.[26] Furthermore, others point to the standard of review articulated in the *Morrissey* case as granting the Treasury Department considerable leeway to devise a different test.[27] It could be added that the rise of LLCs, which generally provide owners with limited liability, has arguably made almost meaningless the attempt to determine corporate resemblance for non-publicly traded unincorporated entities, if limited liability is not the sole determinant.

Congressional action to establish authority for the check-the-box regulations[28]

To resolve the issue of the Treasury Department's authority to promulgate the check-the-box regulations, it has been suggested that Congress ought to establish by specific legislation that the regulations are authorized. The New York State Bar Association Tax Section's analysis of the authority issue, while concluding that there is adequate authority for an elective system even in the absence of specific legislation authorizing the check-the-box regulations, recommended such legislation to avoid disputes as to authority, "because situations undoubtedly will arise where taxpayers will be tempted to take the position that the regulations are invalid."[29]

Concern has been expressed that any specific legislative re-enactment of the regulations would be undesirable, for several reasons. A specific legislative re-enactment could limit the flexibility of the Treasury Department to respond to issues that may arise in the future under the elective regime. Another concern is that any delay in such a specific re-enactment might cast doubt on the ability of taxpayers to rely with certainty on the final check-the-box regulations. Similarly, the certainty and simplicity provided to taxpayers by the regulations could be reduced if the legislative version of the regime were substantially different from the rules set forth in the final regulations.

On a different point, it could be said that the regime established under the check-the-box regulations is not completely elective, because entities eligible to elect either corporate or partnership status under the regulations generally are unincorporated domestic entities. A State-law corporation is not eligible to elect partnership status under the check-the-box regulations. If an elective entity classification is fully permissible within the Treasury Department's regulatory authority, then some might argue that corporations, as

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[26] See Report of the House Committee on the Budget to accompany H.R. 3435, H. Rept. 100-391, 100th Cong., 1st Sess. 1066 (1987), stating in Reasons for Change, "Publicly traded partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners as a practical matter resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity for the duration of the conduct of the business enterprise."

[27] The Court stated, "As the statute merely provided that the term 'corporation' should include 'associations,' without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction. Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision." 296 U.S. 344 at 354-355.

[28] See the proposals in Part III.A of this pamphlet.

[29] New York State Bar Section of Taxation, "Report on the 'Check the Box' Entity Classification System Proposed in Notice 95-14" 37, Tax Rept. #845 (August 30, 1995). Possible proposals are described in Part III. A of this pamphlet.

well as unincorporated entities, should be able to elect either corporate or partnership Federal tax status.

A response would be that permitting corporations to elect pass-through treatment for tax purposes would give rise to large-scale erosion of the corporate tax base (particularly if the tax cost of making the election were relatively modest). Further, Congress could not have intended a fully elective regime, including an election of partnership tax status for corporations, because it relatively recently enacted rules treating publicly traded partnerships as corporations for Federal tax purposes, out of concern about erosion of the corporate tax base.[30] Finally, it could be said that it is unnecessary (as a matter of statutory interpretation) to permit incorporated entities to elect partnership status, because an incorporated entity is clearly treated as a corporation for Federal tax purposes under the statute. Only the issue of whether an entity is an "association" treated as a corporation for Federal tax purposes is determined under the elective regime of the check-the-box regime.

2. Impact of the check-the-box regulations

In general

The advent of an affirmatively elective regime for determining whether an entity is a corporation or a partnership raises a number of issues. The principal impact is that taxpayers may now choose with greater simplicity and lower compliance costs whether they will pay two levels of tax on business income under the corporate tax rules, or whether they will pay only one level of tax under the partnership tax rules (or as a disregarded single-member entity). While it is argued that the entity classification regulations in effect prior to the check-the-box regulations were manipulable and were effectively elective for well-advised taxpayers, an affirmatively elective regime may make this choice much more broadly available to all businesses. At the same time, increased use of LLCs, a form of business entity that can provide limited liability to all owners yet be treated as a partnership for tax purposes, also makes the attractiveness of electing partnership status broader.

In addition, several other types of issues arise as a result of providing an affirmatively elective entity classification regime. One set of issues relates to whether the policy of many existing tax rules that depend on an entity's status is violated by making that status elective. A second group of issues stems from the increased importance of the present-law rules treating publicly traded partnerships as corporations, and the exception from such treatment that is provided to partnerships with a broad category of passive-type income. Thirdly, and more broadly, the check-the-box regulations call into question whether the tax law should continue to provide parallel, but differing, pass-through treatment for business entities that are partnerships and other entities (such as S corporations). Eliminating needlessly redundant rules could simplify the tax law. These is-

[30] When the publicly traded partnership rules were enacted in 1987, the legislative history stated, "The recent proliferation of publicly traded partnerships has come to the committee's attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base." Report of the House Committee on the Budget to accompany H.R. 3435, H. Rept. 100-391, 100th Cong., 1st Sess. 1065 (1987).

sues are not the only ones raised by the check-the-box regulations, but represent some of the questions it may be appropriate for Congress to consider in the long term, in light of the current state of the entity classification rules.

Impact on existing tax rules

The check-the-box regulations make many other tax results, which depend on the tax status of an entity, also effectively elective for more taxpayers. In some cases under the prior regulations, well-advised taxpayers may have been able to achieve particular tax results, virtually by choice, that less sophisticated taxpayers may not have attained. In some cases, transaction costs for attaining a particular tax result may have been sufficiently high that attaining such a result was cost-effective only for especially large-scale transactions. The check-the-box regulations generally eliminate the need to meet the four-factor test of the Kintner regulations in order to achieve partnership status. Assuring that an entity lacks limited liability (one of the four factors) in order to have pass-through tax treatment, for example, no longer need hamper business arrangements where insulation of the owners from the entity's liabilities is central to the arrangement.

The check-the-box regulations facilitate transactions that could not usually be done (or could be done only in a convoluted or expensive manner) under prior law, but now may be accomplished more simply, efficiently or cheaply. The question is not whether efficiency is generally preferable to convolution. Rather, the question is whether the purpose of other tax rules that depend on the taxpayer's status as a partnership or corporation is violated by applying those rules only at the taxpayer's choice. The check-the-box regulations could have the long-term effect of drawing attention to rules that may have become elective (whether under the new regulations or under prior law), and of sparking a re-thinking of the rationale for such rules in some cases.

As described above in Part I of this pamphlet, the check-the-box regulations provide that single member entities may be disregarded, effectively providing for a classification of entity that has been called a "nothing."[31] Disregarding an entity may serve as an alternative to partnership form as a means to achieve pass-through tax treatment. Treating an entity as a "nothing" may give a different tax result than would treating the entity as either a corporation or a partnership. At the same time, if the disregarded entity is an LLC, it may provide protection for the owner from the entity's liabilities. Similarly, a disregarded foreign entity may be treated for tax purposes like a branch rather than a separate corporation or partnership.

The check-the-box regulations may in some cases be more limiting than the prior entity classification regulations were. The list of foreign entities that are now treated as *per se* corporations for Federal tax purposes may include some entities for which partnership tax status could have been achieved under the four-factor test of the prior regulations. For those foreign entities that are not in-

[31] M. Schler, "Initial Thoughts on the Proposed 'Check-the-Box' Regulations," *Tax Notes*, June 17, 1996, p. 1679; D. Miller, "The Tax Nothing," *Tax Notes*, February 3, 1997, p. 619.

cluded on the list of *per se* corporations, the check-the-box regulations may provide more flexibility or certainty than the prior regulations.

Particularly significant issues are raised by the check-the-box regulations in the international context, some examples of which follow. These issues are not addressed in the proposals in Part III of the pamphlet (which relate to the taxation of partners and partnerships), but rather are discussed for purposes of illustrating generally the types of issues raised by simplified and liberalized electivity of partnership status and by the elective "nothing" status for Federal tax purposes.

For example, a foreign entity's status as a corporation, a partnership or a "nothing" can have significant consequences under the subpart F rules of the Code. Under the subpart F rules, the U.S. 10-percent shareholders of a controlled foreign corporation are required to include in income currently their shares of certain earnings of the controlled foreign corporation, whether or not the earnings are distributed to the shareholders. If a subsidiary of a controlled foreign corporation distributes a dividend, the dividend generally is currently includable by the U.S. shareholders. By contrast, were the subsidiary to qualify as a partnership or a "nothing," its earnings may not be included in income currently by the U.S. owner, making current inclusion, or not, a matter of choice. While there are necessarily trade-offs that must be made in choosing one tax status over another, taxpayers are likely to choose the status that is expected to provide the most favorable results in the particular circumstances. Moreover, if an entity can be converted without significant tax consequences from one form to another when changed circumstances make the second form more favorable, the trade-offs can be minimized.

Another example relates to the present-law rules providing deferral of income earned by foreign subsidiaries of U.S. taxpayers (other than income subject to the subpart F rules or other rules requiring current inclusion). Commentators have argued that, far more simply than under prior entity classification regulations, a taxpayer can elect pass-through status under the check-the-box regulations for those entities where a tax savings would result from ending deferral. This might be attractive, for example, if the inclusion allows the crediting of foreign tax in addition to the credits needed to shelter the income so included. Passthrough of income of a partnership or "nothing" could be preferable to actual repatriation of the income, because upon repatriation the income might be subject to foreign withholding tax.[32]

Another example of the ripple effect that easier electivity of pass-through status has in the international context involves the foreign tax credit. Several aspects of the foreign tax credit rules are affected. First, a shareholder of a foreign corporation is allowed a "deemed paid" credit for the foreign taxes of the corporation only if the corporation is a controlled foreign corporation, or if the share-

[32] M. Schler, supra, at 1687; R. Avi-Yonah, "To End Deferral as We Know It: Simplification Potential of Check-the-Box," *Tax Notes*, January 13, 1997, p. 219, 220 ("The check-the-box regulations mean the end of deferral—but only on an elective basis, i.e., only for those foreign entities for which the taxpayer chooses to end it"). Other tax planning opportunities have been discussed; see H. Mogenson and D. Benson, "IRS Issues Final Check-the-Box Regs—Tax Simplification Creates Planning Opportunities," *Tax Notes International*, December 30, 1996, p. 2159.

holder is a 10-percent or greater U.S. corporate shareholder. By electing either partnership or "nothing" status,[33] the U.S. owners of the entity would be eligible for a credit for their allocable shares of the entity's taxes, without similar limitations.

Second, a dividend received by a U.S. corporation from a foreign corporation in which it owns a 10-percent or greater stock interest, but which is not a controlled foreign corporation,[34] goes in a separate "basket" for foreign tax credit limitation purposes. This basket contains only dividends from a single corporation, and thus frequently has the result that foreign taxes either in this basket or other baskets cannot be credited, due to "excess" taxes in the basket. Electing partnership status for the entity relieves these concerns, because a 10-percent partner's income from a partnership is not allocated to a special basket for foreign tax credit purposes, but rather is allocated among all of the partner's baskets based on the allocable share of partnership income in each category.[35]

Thirdly, in calculating foreign source income for purposes of the foreign tax credit limitation, a U.S. corporation or consolidated group generally must allocate its interest expense between domestic and foreign source income based on the proportion of the corporation's or group's assets that generate income in each category. The stock of a foreign corporate subsidiary is included in the group's assets for purposes of the parent group's allocation. Interest paid by the foreign corporate subsidiary is not included in this calculation. However, if a foreign entity owned by a U.S. group chooses partnership or "nothing" status, the entity's interest expense and assets generally are both taken into account for purposes of the corporate owner's interest allocation. These aspects of the interest allocation calculation can significantly increase the U.S. corporate owner's foreign tax credit limitation, as compared to the treatment that would apply to a foreign subsidiary.

The check-the-box regulations have an impact on choice of entity that extends beyond choosing between corporate or partnership status, in situations when a "nothing" may yield greater tax savings than either of them. For example, a "nothing" may have benefits in the international tax area for both sourcing of income and foreign tax credit purposes when a business is sold. Sale of a "nothing" is treated as a direct sale of the underlying assets, which can yield the benefits of increased foreign source income, or lower foreign source loss, than a sale of similar stock or a partnership interest.[36]

The option to disregard a single-member entity does not only give taxpayers an effective choice between the rules for corporations and the rules for branches or sole proprietorships. It effectively gives such entities *three* options for Federal tax classification, because

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[33] In this and the following examples, the foreign corporation would not be permitted to elect partnership or "nothing" status if it is on the list of *per se* corporations.

[34] Thus, this rule applies to dividends received from foreign corporations in which the shareholder owns a 10-percent or greater interest, but which is not more than 50 percent owned by the dividend recipient and other 10-percent U.S. shareholders.

[35] The 10-percent threshold does not apply to individual general partners. Thus, all of such a partner's distributive share of partnership income is allocated among the partner's baskets.

[36] In addition, "nothing" treatment may have benefits of saving foreign, as opposed to U.S., taxes. When a "nothing" becomes the obligor on a debt instrument to its U.S. owner, interest on the debt may be deductible by the "nothing" for foreign tax purposes, but is not includible by the owner for U.S. purposes because the debt of the "nothing" to its owner presumably is disregarded.

the partnership rules can be elected if a second *de minimis* member is added. For example, if a U.S. corporate group were considering forming a foreign entity that would hold an interest in a foreign corporation, it might choose a "nothing" rather than a partnership in order to ensure the availability of the deemed paid foreign tax credit with respect to dividends from such foreign corporations. Choice of a "nothing" would avoid any uncertainty regarding the extent to which a U.S. corporation may claim foreign tax credits for foreign taxes paid by a foreign corporation that is owned by the U.S. corporation through a foreign partnership.[37]

By contrast, if the new entity were to act as a dealer in property, the owner might use a structure where a *de minimis* interest is held by a related corporation, so that partnership status rather than "nothing" status would result. If a "nothing" were used as a dealer, this status could taint transactions of the rest of the corporation with ordinary income treatment and other consequences of dealer status. However, dealer status for a partnership is determined solely at the partnership level, and thus would not affect other transactions of a corporate owner.

The foregoing examples illustrate the indirect effect of broad electivity of the entity classification rules on other tax rules whose application is dependent on the taxpayer's tax status. Over time, as the check-the-box regulations are implemented by taxpayers and the Service, it is probable that more cases of rules made elective by simplified electivity of an entity's tax status will become known.[38] These examples serve to suggest that it would be appropriate to review the rationale for present-law rules that may have been made more easily elective after the check-the-box regulations. To the extent that increased electivity is inconsistent with the underlying rationale for any particular present-law rules that are affected, it would be appropriate to consider addressing the issue, for example, by eliminating the electivity of those rules or by modifying the rules.

Importance of publicly traded partnership rules and exceptions

Another set of issues raised by the check-the-box regulations arises because they make the rules treating publicly traded partnerships as corporations more important. The four-factor test of the prior regulations required that, to obtain conduit tax treatment as a partnership, taxpayers had to take into account whether the entity had centralized management, continuity of life, or free transferability of interests, and whether the owners of the entity all had limited liability. These regulatory tests applied in addition to the statutory test for determining whether the partnership's interests are publicly traded.

Under the check-the-box regulations, however, centralized management, continuity of life, free transferability of interests, and lim-

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[37] The Service recently stated that it was continuing to consider the circumstances in which a foreign tax credit should be allowed with respect to stock held through a foreign partnership. See the preamble to the final regulations under section 902 with respect to the deemed paid foreign tax credit, T.D. 8708 (Jan. 7, 1997).

[38] As noted above in Part II.A.4 (describing the check-the-box regulations), the preamble to the check-the-box regulations stated that the Treasury Department and the Service will continue to monitor the uses of partnerships in the international context.

ited liability of owners generally are irrelevant. To a much greater degree, the issue of whether an entity must be treated as a corporation now depends on whether the entity is subject to the rules relating to public trading.[39] These rules include a significant exception for entities, 90 percent of whose income falls into a broad category labeled "passive-type income." At the same time, present law provides pass-through treatment for several specialized types of entities if they meet detailed requirements designed to limit the favorable treatment to activities approved for such treatment by Congress.

The publicly traded partnership rules specifically provide that an entity that would meet certain securities registration requirements if it were a corporation does not qualify for passthrough status as a partnership by meeting the "passive-type income" exception, but rather may achieve passthrough status only by qualifying under the RIC rules. The rules governing taxable mortgage pools have a similar effect, by treating an entity that meets statutory tests describing mortgage pools, but that is not a REMIC, as a separate corporation. Thus, a mortgage pool generally can achieve conduit treatment by satisfying the requirements for a REMIC, but not as a publicly traded partnership under the "passive-type income" exception.

No similar rule applies explicitly in the case of a real estate investment trust ("REIT") or a financial asset securitization investment trust ("FASIT"), although under the entity classification rules in effect prior to the check-the-box regulations, partnership status may not have been as attractive as meeting the special rules for passthrough treatment accorded these specialized entities, based on both tax and non-tax concerns.

Under the check-the-box elective regime, entities of these types might in some cases be able to meet the passive-type income exception and obtain pass-through treatment even though their interests are publicly traded and their activities do not satisfy the statutory requirements of the otherwise applicable specialized pass-through regime. Partnership status still may not be an attractive option in some cases because of other tax rules that might give unfavorable results to foreign or tax-exempt investors in the entity,[40] or for other reasons. Nevertheless, this possibility raises the question of whether there is a continuing need for all of the specialized pass-through systems currently provided, and if so, whether potentially increased electivity of those sets of rules under the check-the-box regulations should be addressed.[41]

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[39] It is debatable whether the publicly traded partnership rules are better viewed as a backstop to the entity classification rules as they existed in 1987, or as a fundamental policy determination that public trading (and the resulting access to public capital markets) is the most important factor in deciding whether an entity should be taxed as a corporation.

[40] For example, a tax-exempt entity might become subject to unrelated business income tax with respect to a business activity conducted by a partnership, or with respect to certain debt-financed income of a partnership (secs. 512(c) and 514), whereas a tax-exempt holder of a sufficiently small interest in a REIT may not (sec. 856(h)(3)(C)). As another example, a foreign person might be subject to withholding at the highest applicable rate of tax with respect to effectively connected income earned through a partnership (sec. 1446), whereas this withholding rule does not apply to income that is not earned through a partnership.

[41] See American Law Institute, *Federal Income Tax Project--Taxation of Pass-Through Entities, Memorandum No. 2* (September 2, 1996) (G. Yin and D. Shakow, reporters).

Need for multiple sets of rules for pass-through entities

A similar set of issues relates to whether there is a continuing need in the tax law for parallel pass-through systems for general business activities.[42] Although S corporations (and their shareholders) generally are treated similarly to partnerships (and their partners), significant differences exist, some of which favor S corporations while others favor partnerships.

For example, the items of income, gain, loss, deduction or credit of a partnership generally are taken into account by a partner pursuant to the partnership agreement (or in accordance with the partners' interests in the partnership if the agreement does not provide for an allocation) so long as such allocation has substantial economic effect.[43] Because of the one-class-of-stock rule for S corporations (sec. 1361(b)(1)(D)), the items of income, gain, loss, deduction or credit of an S corporation cannot be separately allocated to a particular shareholder, but are taken into account by all the shareholders on a per-share, per-day basis. Thus, partnerships generally are considered to be a more flexible vehicle for purposes of allocating particular entity-level items to investors.

Another important difference making partnerships more flexible than S corporations is the treatment of entity-level debt, for purposes of the owner's basis in his interest. A partner includes partnership-level debt in the basis of his interest (sec. 752), whereas an S corporation shareholder does not (sec. 1367). The amount of the partner's or S corporation shareholder's basis in his interest serves as a limit on the amount of losses that can be passed through (secs. 704(d), 1366(d)), which makes increases in basis for entity-level debt important.

The sale of stock in an S corporation generally results in capital gain or loss to the selling shareholder. The sale of an interest in a partnership also generally gives rise to capital gain or loss, but gives rise to ordinary income to the selling partner to the extent attributable to unrealized receivables and certain inventory items (sec. 751).

The distribution of appreciated property by an S corporation to a shareholder (as a dividend, in redemption of shares, or in liquidation) is treated as a taxable sale of such property. Any gain is allocated to all the shareholders on a per-share, per day basis and increases the shareholders' adjusted bases in their shares. The distributee shareholder then reduces his basis by the amount of the distribution (i.e., fair market value of the distributed property) and takes a fair market value basis in the property. By contrast, the distribution of appreciated property by a partnership to a partner generally is not treated as a taxable sale of the property (sec. 731).

An existing C corporation may elect to be treated as an S corporation on a tax-free basis, subject to certain special rules. Converting C corporations are subject to corporate-level tax on the recapture of LIFO benefits,[44] on certain built-in gains recognized

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[42] Eliminating the two-tier corporate tax system, perhaps through some form of corporate integration, could also minimize the need for multiple sets of rules for pass-through entities, but is beyond the scope of this discussion.

[43] Sections 704(a) and (b). The determination of whether an allocation has substantial economic effect is complex (Treas. Reg. sec. 1.704-1(b)(2)).

[44] Section 1363(d).

within a 10-year period after conversion,[45] and on certain passive investment income earned while the corporation retains its former C corporate earnings and profits.[46] The conversion of a C corporation to a partnership (or sole proprietorship) is treated as a liquidation of the entity, taxable to both the corporation and its shareholders.

The rules of subchapter C generally apply to an S corporation and its shareholders. Thus, for example, an S corporation may merge into a C corporation (or vice versa) on a tax-free basis. Similar rules do not apply to combinations of C corporations and partnerships.

Individual partners treated as general partners generally are subject to self-employment tax on their distributive shares of partnership income. Shareholders of an S corporation are not subject to self-employment tax on S corporation earnings, but are subject to payroll tax to the extent they receive salaries or wages from the corporation.

Partnerships, LLCs treated as partnerships, and S corporations may be treated differently for State income or franchise tax purposes.

Continuing utility of S corporations

If an LLC can provide limited liability to all owners and achieve pass-through status as a partnership under the check-the-box regulations (or under the Service's prior revenue rulings on LLCs), the need for S corporations could be questioned. Particularly in light of the growing use of LLCs, it could be argued that the great flexibility of the partnership tax rules outweigh the principal advantage of S corporations: relative simplicity. Thus, it is argued that the rules for S corporations could be repealed without detriment to taxpayers.[47]

Others say the continued existence of subchapter S is worthwhile. A corporate charter is a prerequisite imposed by regulators for some trades or businesses (e.g., for depository institutions or to hold certain licenses), and LLCs may not meet such regulatory requirements. Moreover, the corporate form is a familiar, time-tested format, while the LLC form is new and unfamiliar (particularly where a business undertakes interstate commerce). Subchapter S supporters further point out that the rules of subchapter S are much simpler than the rules of subchapter K.[48] Others point to specific advantages of subchapter S over the partnership tax rules

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[45] Section 1374. For a discussion of how section 1374 allows the conversion of a C corporation to S corporation status to be treated more favorably than the liquidation of a C corporation into a sole proprietorship or a partnership, despite the economic equivalence of the transactions, see, letter to Chairman Dan Rostenkowski from Ronald A. Pearlman, Chief of Staff of the Joint Committee on Taxation, recommending several simplification proposals, reprinted in Committee on Ways and Means, *Written Proposals on Tax Simplification*, (WMCP 101-27), May 25, 1990, p. 24. In his 1995 and 1997 budget messages to the Congress, President Clinton recommended that section 1374 be repealed for C corporations above a certain size.

[46] Section 1375.

[47] W. Schwidetzky, "Is It Time to Give the S Corporation a Proper Burial?" 15 *Virginia Tax Review* 591 (1996).

[48] However, it must be pointed out that partners of a partnership may opt for a simple, subchapter S-like structure if they so desire. It could be said that the check-the-box regulations expand the appeal of subchapter S, because prior to those regulations, only entities structured as corporations for State law purposes could elect S corporation status, whereas now, a State-law partnership or LLC can be classified as a corporation for tax purposes and elect S status (provided applicable requirements are met).

(primarily the ability to convert from C to S corporation status generally without current corporate tax on appreciation, and the availability of the tax-free reorganization rules for business combinations and reorganizations). At least until LLC interests are as easily issued in capital markets as traditional corporate stock, the S corporation may continue to be an attractive vehicle in which to start a business, if it is anticipated that it will later go public. Finally, any repeal of subchapter S would require rules providing for the treatment of existing S corporations.[49]

Whether or not it is advisable to retain both the partnership rules and the S corporation rules, some argue that the complexity of either regime is excessive for small businesses, and a new, much simpler pass-through system should be provided for small businesses that would be consistent with the new simplicity for choice of entity under the check-the-box regulations.[50] A significant question, under such an approach, is the definition of a small business, which could depend on the number of owners, the value of the entity's assets, the amount of its gross or net income (if any), or some combination of these or other factors. Related questions involve the treatment of businesses that grow (or fluctuate in size), crossing the definitional line, and the treatment of tax attributes imported from a more complex tax regime. Weighing of simplicity against accuracy of income measurement and allocation would be a factor in designing the simpler regime.

Others would argue that there is nothing inherently complex in the application of the partnership tax rules to most small business transactions. Small businesses today can achieve the effect of a simplified partnership regime for most common business arrangements. Mandating the use of specific rules for small business would deny them the flexibility of present law partnership rules, and, it could be argued, would represent a competitive disadvantage relative to larger businesses.

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[49] See, for example, the letter of July 25, 1995, from Leslie B. Samuels, Assistant Treasury Secretary (Tax Policy) to Senator Orrin Hatch, suggesting possible legislative proposals to allow S corporations to elect partnership status or to apply the check-the-box regulations to S corporations.

[50] American Law Institute, *Federal Income Tax Project--Taxation of Pass-Through Entities, Memorandum No. 2*, supra, 96-105.

III. POSSIBLE PARTNERSHIP PROPOSALS

Business transactions and tax planning in the partnership area have become more sophisticated since the bulk of the present-law partnership rules were enacted in 1954. Some provisions of Subchapter K may give anomalous results, may have unforeseen problems in application, or may have become anachronistic. Because of the possible increased utilization of partnerships due to the growth of LLCs and the simple electivity of partnership status under the check-the-box regulations, these types of issues merit increased scrutiny. Following is a discussion of possible changes to provisions of the tax law governing partnerships that could be considered.

A. Provide Legislative Authorization for Check-the-Box Rules or Codify Elective Entity Classification

Present Law

The check-the-box regulations are issued under definitional sections of the Code that relate to partnerships and corporations. The statutory definition of a partnership provides that it "includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation" (sec. 7701(a)(2)). The statutory definition of a corporation provides that it "includes associations, joint-stock companies, and insurance companies" (sec. 7701(a)(3)).

The statutory source of authority for issuing the regulations provides that the Secretary of the Treasury is authorized to "prescribe all needful rules and regulations for the enforcement of this title [the Internal Revenue Code]" (sec. 7805). Regulations issued pursuant to this authority are referred to as interpretive regulations.

Under the check-the-box regulations, an eligible entity may elect how it will be classified. An eligible entity with two or more members may elect to be classified as either a corporation or a partnership. An eligible entity with a single member may elect to be classified as a corporation or to be disregarded (treated as not separate from its owner).

An eligible entity generally is an unicorporated domestic entity. Thus, an eligible entity does not include an entity that is classified automatically as a corporation under the check-the-box regulations. An organization is classified automatically as a corporation if it is a domestic entity formed under a State corporation statute that describes the entity as a corporation, joint-stock company or in similar terms, an insurance or banking company, an organization wholly owned by a State, or an organization that is taxable as a corporation under other applicable rules (such as the rules generally treating publicly traded partnerships as corporations).

Possible Proposals

First alternative proposal

The first alternative proposal would grant authority to the Treasury Department to issue regulations providing for a method of determining whether an entity is an association taxable as a corporation. No specific regime would be specified in this grant of authority.[51]

Second alternative proposal

The second alternative proposal would legislatively re-enact the check-the-box regulations. Thus, the provisions of those regulations would be codified.

Third alternative proposal

The third alternative proposal would provide that the meaning of an entity eligible to elect to be treated either as a corporation or a partnership would be expanded to include any domestic entity that is treated automatically as a corporation under the check-the-box regulations. Rules would be provided for allocating corporate income among owners. This proposal would address the criticism that the current check-the-box regime is not fully elective for domestic entities because corporations cannot elect to be treated as partnerships under the current regulations.

Allowing existing corporations to elect partnership status may raise administrative, revenue and equity concerns. Because it may not be feasible to allocate entity income among existing stock interests, the proposal would require a corporation to formally liquidate and reorganize as an unincorporated business. Under present law, many corporations have not undergone such transactions because of the applicable corporate and shareholder taxes. In order to address revenue concerns, the proposal could impose a "toll charge" (possibly payable in installments) upon a corporate-to-partnership conversion based upon a portion of the gains that would be recognized on a fully taxable corporate liquidation. Different toll charges would apply to electing C corporations and S corporations. Furthermore, the proposal could be limited to non-publicly traded domestic corporations or to corporations below a certain size, and could be provided only for limited time.

B. Require Partnership Basis Adjustments Upon Distributions of Property and Modify Basis Allocation Rules

Present Law

In general

The partnership provisions of present law generally permit partners to receive distributions of partnership property without recognition of gain or loss (sec. 731).[52] Rules are provided for deter-

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[51] See New York State Bar Section of Taxation, "Report on the 'Check the Box' Entity Classification System Proposed in Notice 95-14," supra, at 37.

[52] Exceptions to this nonrecognition rule apply: (1) when money (and the fair market value of marketable securities) received exceeds a partner's adjusted basis in the partnership (sec. 731(a)(1)); (2) when only money, inventory and unrealized receivables are received in liquidation

Continued

mining the basis of the distributed property in the hands of the distributee, and for allocating basis among multiple properties distributed, as well as for determining adjustments to the distributee partner's basis in its partnership interest. Property distributions are tax-free to a partnership. Adjustments to the basis of the partnership's remaining undistributed assets are not required unless the partnership has made an election that requires basis adjustments both upon partnership distributions and upon transfers of partnership interests (sec. 754).

Partner's basis in distributed properties and partnership interest

Present law provides two different rules for determining a partner's basis in distributed property, depending on whether or not the distribution is in liquidation of the partner's interest in the partnership. Generally, a substituted basis rule applies to property distributed to a partner in liquidation.[53] Thus, the basis of property distributed in liquidation of a partner's interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)).

By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap (sec. 732(a)). Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction). In a non-liquidating distribution,[54] the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed and is reduced by the amount of any money distributed (sec. 733).

Present law does not provide for a partial liquidation of a partnership interest. A distribution that is not in complete liquidation of a partner's interest is treated as a current distribution, even if the distribution has the effect of reducing the partner's interest in the partnership.[55]

Allocating basis among distributed properties

In the event that multiple properties are distributed by a partnership, present law provides allocation rules for determining their bases in the distributee partner's hands. An allocation rule is needed when the substituted basis rule for liquidating distributions ap-

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of a partner's interest and loss is recognized (sec. 731(a)(2)); (3) to certain disproportionate distributions involving inventory and unrealized receivables (sec. 751(b)); and (4) to certain distributions relating to contributed property (secs. 704(c) and 737). In addition, if a partner engages in a transaction with a partnership other than in its capacity as a member of the partnership, the transaction generally is considered as occurring between the partnership and one who is not a partner (sec. 707).

[53] When the current statutory provisions were being considered in 1954, the House version provided for carryover basis in the distributee partner's hands, and allowed a corresponding loss to the partner on the liquidating distribution. Report of the House Ways and Means Committee to accompany H.R. 8300, H. Rept. No 1337, 83rd Cong., 2d Sess. at A228 (1954). This approach was abandoned for the present-law substituted basis rule.

[54] No provision is made for the reduction in basis of the partner's partnership interest in a liquidating distribution, as its interest is liquidated as a result of the distribution.

[55] See McKee, Nelson and Whitmire, *Federal Taxation of Partners and Partnerships*, supra, 19-12, para. 19.02[3].

plies, in order to assign a portion of the partner's basis in its partnership interest to each distributed asset. An allocation rule is also needed in a non-liquidating distribution of multiple assets when the total carryover basis would exceed the partner's basis in its partnership interest, so a portion of the partner's basis in its partnership interest is assigned to each distributed asset.

Present law provides for allocation in proportion to the partnership's adjusted basis. The rule allocates basis first to unrealized receivables and inventory items in an amount equal to the partnership's adjusted basis (or if the allocated basis is less than partnership basis, then in proportion to the partnership's basis), and then among other properties in proportion to their adjusted bases to the partnership (sec. 732(c)).[56] Under this allocation rule, in the case of a liquidating distribution, the distributee partner can have a basis in the distributed property that exceeds that partnership's basis in the property.[57]

Partnership's basis in remaining undistributed assets

No gain or loss is recognized to a partnership on the distribution of property (sec. 731(b)). Nevertheless, no adjustment is required to a partnership's basis in its remaining undistributed assets, following a distribution of property to a partner, unless the partnership has an election under section 754 of the Code in effect.

An electing partnership decreases the basis of its remaining property to take account of any increase in the basis in the distributee partner's hands, compared to the basis the partnership had in the property. This preserves future taxation to the other partners to the extent built-in gain was eliminated in the hands of the distributee partner, who in a liquidating distribution takes a substituted basis in the distributed property and will never, therefore, be taxed on that built-in gain.[58] The amount of the decrease in the basis of remaining partnership property equals (1) the excess of the distributee's basis in the distributed property over the partnership's adjusted basis in the distributed property immediately before the distribution, plus (2) the amount of any loss recognized by the distributee partner.[59]

Similarly, an electing partnership increases the basis of its remaining property to take account of the extent to which the distributee's basis is less than the partnership's basis was in the same property. This preserves a future loss (or reduces a future

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[56] A special rule allows a partner that acquired a partnership interest by transfer within two years of a distribution to elect to allocate the basis of property received in the distribution as if the partnership had a section 754 election in effect (sec. 732(d)). The special rule also allows the Service to require such an allocation where the value at the time of transfer of the property received exceeds 110 percent of its adjusted basis to the partnership (sec. 732(d)). Treas. Reg. sec. 1.732-1(d)(4) generally requires the application of section 732(d) where the allocation of basis under section 732(c) upon a liquidation of the partner's interest would have resulted in a shift of basis from non-depreciable property to depreciable property.

[57] " . . .[T]he effect of these rules may be to give the distributee a basis in distributed assets (other than unrealized receivables and inventory) in excess of the partnership's basis for the same assets. . . . The failure of these rules to take fair market into account puts a high premium on tax planning in connection with in-kind liquidating distributions." McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, supra, 19-35, para. 19.06.

[58] See W. Andrews, "Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions," 47 *Tax Law Review* 3, 18 (Fall 1991).

[59] The general rule is that loss is not recognized by a distributee partner on a distribution of partnership property, except that a loss may be recognized in a liquidating distribution consisting of nothing other than money, unrealized receivables and inventory.

gain) for the other partners, and can arise in a liquidating or non-liquidating distribution where the distributee partner's basis in its partnership interest is less than the partnership's total adjusted basis in the distributed properties.[60] The amount of the increase in the basis of remaining partnership property equals (1) the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution, over the basis of the distributed property to the distributee partner, plus (2) the amount of gain recognized by the distributee partner on the distribution.[61]

Allocating basis among partnership's remaining assets

For purposes of allocating basis to remaining partnership assets following a distribution of property by an electing partnership, increases and decreases are divided into two categories: (1) capital assets and property used in the trade or business; and (2) other assets (sec. 755(b)). Adjustments are made to partnership property in the same category as that of the distributed property giving rise to the adjustment (Treas. reg. sec. 1.755-1(b)(1)).

Within each category of assets, adjustments are made among the assets so as to reduce proportionately the difference between the fair market value and the adjusted basis of each asset in the category. If the adjustment increases basis, assets with an adjusted basis in excess of value are not adjusted, and if the adjustment decreases basis, assets with a value in excess of adjusted basis are not adjusted (Treas. Reg. sec. 1.755-1(a)(1)(ii) and (iii)). The basis of an asset cannot be reduced below zero. If an adjustment is allocated to a category of property in which the partnership has no property, or if a negative adjustment cannot be fully absorbed by the basis of property in the category, the adjustment is applied to subsequently acquired property in the category (sec. 755(b) and Treas. Reg. sec. 1.755-1(b)(3)). Under these rules, it is possible that a required basis adjustment might never be applied to any property held by the partnership.

Examples [62]

Because the present-law rules do not require the partnership to adjust the basis of its assets upon a distribution of property (absent a sec. 754 election), anomalous results can arise. For example, assume a joint venture between corporations X and Y is operated in partnership form. X contributed a business with a basis of 40 and value of 100 to the partnership. The business has 2 assets, a depreciable asset with a basis of 25 and value of 10 and land with a basis of 15 and value of 90. Y contributed other assets with a basis equal to value, 100. Assume, for simplicity, that neither value nor basis has changed since the partnership was formed. In year 6, the 40-basis business is distributed to Y in complete liquidation of Y's partnership interest. The partnership has no section 754 election in effect.

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[60] See Report of the Senate Committee on Finance to accompany H.R. 8300, S. Rept. No. 1622, 83rd Cong., 2d Sess. 394 (1954).

[61] Generally, gain is not recognized to a distributee partner, except to the extent that any money and the fair market value of marketable securities distributed exceeds the adjusted basis of its partnership interest immediately before the distribution.

[62] For simplicity, these examples refer to two partners. Assume that the partnerships are not terminated by the distributions.

Y has a substituted basis of 100 in the distributed business. This represents a step-up of 60 over the basis of the business in the partnership's hands. The 100 is allocated in the ratio of 25 to 15 (the ratio of the partnership's basis in the assets). Thus, Y has a 62.50 basis in the depreciable asset, and a 37.50 basis in the land. Because the partnership has no section 754 election in effect, there is no downward adjustment to the partnership's 100 basis in its remaining assets to take account of the 60 basis step-up to Y. X, however, has a low basis (40) in its partnership interest.[63]

In addition to basis shifts, present law can give rise to duplication of basis. For example, assume a joint venture between corporations A and B is operated in partnership form. A contributes a depreciated business with a basis of 200 and a value of 100. B contributes 100 in cash. In year 6, the 100 cash is distributed to A in liquidation. No section 754 election is in effect.

Because A had a 200 basis in its partnership interest, and receives only cash in complete liquidation of his interest, under present law A is allowed a loss of 100. Because no section 754 election is in effect, the partnership does not adjust the 200 basis of the business it still holds downward to reflect the loss taken by A. If the partnership sells the business for its value of 100, it, too, will recognize the loss of 100. Only when B liquidates or disposes of its partnership interest will offsetting gain be recognized.[64]

Possible Proposals

In general

The proposals generally would make inside partnership basis adjustments mandatory (rather than optional, as under present law), and would make corollary changes to the rules governing allocation of basis among assets, in the case of certain distributions of partnership property. Two alternative proposals are described. Under the first alternative proposal, the calculation of the inside basis adjustments, and the circumstances in which such adjustments would be required, would be modified from present law. In addition, changes to the rules governing allocation of asset basis would be made. Under the second alternative, present law would be retained as to the calculation of the inside basis adjustments; the adjustments would be required for liquidating distributions, but would remain optional for non-liquidating distributions as under present law. Like the first proposal, the second alternative would change the rules governing allocation of asset basis.

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[63] This example is based on a transaction described as "basis strip I" in Freeman and Stephens, "Using a Partnership When a Corporation Won't Do: The Strategic Use and Effects of Partnerships to Conduct Joint Ventures and Other Major Corporate Business Activities," 68 *Taxes* 962, 993-995 (Dec. 1990). Freeman and Stephens state: "What this means, of course, is that the partnership should not be liquidated. If the high basis assets are sold by the partnership, no gain will be recognized by Y unless the proceeds are distributed out of the partnership. Instead, X could reinvest the proceeds, through the partnership, in other operations. With a high basis in the assets inside the partnership, generally it will not make much difference to X that it has the low outside basis." Id. at 995.

[64] This example is based on a transaction described as "multiple losses I" in Freeman and Stephens, supra, at 997.

First alternative proposal

In general, the first alternative proposal would provide for mandatory adjustments to partnership basis in remaining partnership property following certain distributions of property to a partner, generally those that reduce the partner's interest.[65] Secondly, the proposal would modify the calculation of these partnership basis adjustments so that the adjustments properly reflect the difference between the partnership's adjusted basis in the property distributed, and the reduction in the partner's share of the adjusted basis of partnership property.[66] Thirdly, the proposal would modify the rules by which the partnership allocates the adjustments among assets, changing both the definition of asset categories and the method by which allocations are made; basis adjustments would first be allocated to non-depreciable capital assets. Fourthly, the proposal would modify the rules by which a distributee partner allocates basis among distributed assets, again changing both the definition of asset categories and the basis on which allocations are made among assets.[67] This proposal would apply to distributions of partnership property in complete or partial liquidation of a partner's interest in the partnership.

Examples[68]

The proposal would modify the result in the first example, above (the joint venture between X and Y in which the distributee, Y, has a basis step-up of 60). Under the proposal, after the distribution, Y would still have a substituted basis of 100 in the business. The basis increase would be allocated only to non-depreciable capital assets, so Y would have a basis of 25 in the depreciable asset (its basis in the partnership's hands), and 75 in the land (reflecting the entire basis increase of 60). Under the proposal, the partnership would be required to reduce the basis of its remaining assets from 100 to 40, preserving the unrealized appreciation in the hands of the partnership.

In the second example (involving a joint venture between A and B in which cash is distributed), the proposal would give the following result: A would have a loss of 100 (as under present law), and the partnership would have to adjust the basis of its remaining assets downward by 100. The duplication of the loss would not occur under the proposal.

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[65] Mandatory partnership basis adjustments in the event of a partnership distribution were recommended in the American Law Institute's 1984 study of partnership tax rules, American Law Institute, *Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners* 214, (R. Cohen, reporter, 1984). See also Cohen and Hoberman, "Partnership Taxation: Changes for the '90s," 71 *Taxes* 882, 885-6 (Dec. 1993).

[66] The American Bar Association recommended that a partnership's optional basis adjustments for undistributed partnership property should reflect the difference between the partnership's basis in the distributed property and the reduction in the distributee partner's proportionate share of the adjusted basis of undistributed partnership property, in its 1974 Recommendation 1974-9, 27 *Tax Lawyer* 869 (1974).

[67] This set of changes was recommended by Professor William Andrews of Harvard Law School in his article, "Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions," supra, and also by Noel Cunningham in "Needed Reform: Tending the Sick Rose," 47 *Tax Law Review* 77 (Fall 1991). See also examples of anomalies arising under the present-law rules as illustrated in Freeman and Stephens, supra, 993-5.

[68] For simplicity, these examples refer to two partners. Assume that the partnerships are not terminated by the distributions.

Mandatory partnership basis adjustments following property distribution

The proposal would eliminate the present-law electivity of partnership basis adjustments following certain distributions of partnership property, in the case of distributions in complete or partial liquidation of a partner's interest. The proposal would provide a look-through rule in the case of tiered partnerships, so the adjustments would be made in each successive lower-tier partnership, to the extent the asset whose basis would be adjusted is itself a partnership interest.

Calculation of partnership basis adjustments to remaining assets

Under the proposal, following a distribution of property, a partnership would adjust the basis of its undistributed property by the difference between (1) the partnership's adjusted basis in the property distributed (plus the amount of any money distributed), and (2) the amount by which the distributee partner's proportionate share of the adjusted basis of partnership property is reduced by the distribution. Thus, the partnership's basis is increased by the excess of (1) over (2), and decreased by the excess of (2) over (1), as the case may be.

A partner's proportionate share of the adjusted basis of partnership property would be calculated in the same manner as under the present-law provision relating to partnership basis adjustments following a transfer, by sale or exchange, of a partnership interest in a partnership with a section 754 election in effect (sec. 743(b)). Regulations under that provision provide that a partner's share of the adjusted basis of partnership property is equal to the sum of its interest as a partner in partnership capital and surplus, plus its share of partnership liabilities (Treas. reg. sec. 1.743-1(b)(ii)). This calculation is based on capital accounts maintained by the partnership; the partnership makes this calculation based on information it keeps, and without regard to information kept by the partner.

To illustrate, assume a partnership has $11,000 cash, property with a basis of $19,000 and a value of $22,000, and no liabilities. Assume that A receives the $11,000 cash in liquidation of its entire 1/3 interest in the partnership. Under the proposal, the partnership basis in its undistributed property would be increased by $1,000 (the excess of $11,000 distributed over $10,000 (A's 1/3 share of the partnership's basis in its property)) to $20,000.[69]

Allocating basis among partnership's remaining assets

The proposal would modify the categories of partnership assets, and would also modify the ratio for allocating basis adjustments among categories of assets. The proposal also provides for gain or

[69] These are the facts in Example (1) of Treas Reg. sec. 1.734-1(b)(1). Unlike present law, the $1,000 amount of the partnership's adjustment is not dependent upon A's basis in its partnership interest.

loss recognition if the basis adjustment cannot be applied to partnership property.[70]

First, the proposal would provide that the first category of assets to which an adjustment is made is non-depreciable capital assets, and the second category is all other partnership properties.[71] A non-depreciable capital asset would be defined as a capital asset or property used in a trade or business (within the meaning of section 1231(b)) other than property of a character subject to an allowance for depreciation, amortization, or depletion. In the case of an increase to partnership basis, however, the increase would be allocated only to non-depreciable capital assets, and not to other partnership property, so that basis would not be shifted to assets that give rise to either an immediate ordinary loss (if sold) or disproportionately large depreciation deductions.

Second, the proposal would provide that basis adjustments are allocated among properties within the category so as to reduce proportionately the difference between the fair market value and the basis of the assets. Then, any remaining basis adjustments are allocated in proportion to the respective fair market value of the assets (if the adjustment is an increase), or in proportion to the respective bases of the assets (if the adjustment is a decrease). This method of allocation has the effect of preserving future gain or loss for the partners remaining after the distribution.

Third, if a positive adjustment could not be made because the partnership holds no non-depreciable capital assets, the partnership would be treated as recognizing a long-term capital loss in the amount of the required adjustments. If a negative adjustment could not be made because the partnership holds no non-depreciable capital assets or has insufficient basis in such capital assets, then adjustments would be made to the basis of other property in the amount of the prevented adjustments. If a negative adjustment could not be made because the partnership has insufficient basis in assets (other than money), the partnership would be treated as recognizing a long-term capital gain in the amount of the prevented adjustments.[72]

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[70] The section 754 election would still be needed under the proposal, because the partnership basis adjustments provided in section 743 would remain elective. The proposal would not make those adjustments mandatory.

[71] Professor Andrews would provide more categories: non-depreciable capital assets, depreciable property, and inventory items. Even finer distinctions could be drawn, for example, between different classes of depreciable property, or between LIFO inventory and other inventory. The purpose of these rules would be to "prohibit reallocation of basis from non-depreciable capital assets to depreciable property, as well as reallocation from capital gain to ordinary income property." Andrews, supra, at 38. It could be argued that the most accurate rule would be to require basis adjustments first to property inside the partnership that is in the same category as the distributed property to which the adjustment is attributable. This increased accuracy could be criticized as giving rise to excessive complexity.

[72] It could be said that adding a new occasion on which gain or loss is recognized is inconsistent with the general nonrecognition treatment accorded partnership distributions, and that gain or loss should consequently not be recognized, even if theoretically recognition would be appropriate. It could also be said that increasing opportunities for recognition of gain and especially of loss could create new opportunities for manipulation of the rules. As an alternative to immediate gain or loss recognition in the event of a prevented basis adjustment, the proposal could provide that the partnership defers recognition for a period, or alternatively, that the partnership maintains the prevented adjustment as an amount that would be applied to increase the basis of non-depreciable capital assets acquired later, or as another alternative, that the partnership amortizes the long-term capital gain or loss ratably over some period (such as the period over which intangible assets may be amortized), subject to present-law capital loss limitations. Unlike an intangible asset under section 197, however, the basis increase should not be treated as an ordinary item. This deferral of gain or loss differs from the Andrews proposal, supra, at 34.

Basis allocation rules for distributee partners

Under the proposal, the basis of distributed property in the hands of the distributee partner would be determined under rules similar to the inside basis adjustments for partnerships. First, all property other than non-depreciable capital assets would be treated in the same manner that unrealized receivables and inventory are treated under present law. Allocations of a basis increase or decrease would be made first (and only, in the case of an increase) to non-depreciable capital assets, and any remaining decrease would be applied to the basis of other property distributed. This would parallel the rule for allocation of basis adjustments inside the partnership under the proposal. These rules would apply in the case of the distributee partner regardless of whether the partnership is required to make basis adjustments to its remaining assets or to allocate basis among its assets.

Second, the proposal would allocate the partner's required basis adjustment among distributed assets within the category so as to reduce proportionately the difference between the fair market value and the basis of the assets. Then, any remaining basis adjustments are allocated in proportion to the respective fair market value of the assets[73] (if the adjustment is an increase), or in proportion to the respective bases of the assets (if the adjustment is a decrease).

Third, in the case of an increase that cannot be applied to the basis of a distributed non-depreciable capital asset, a long-term capital loss would be allowed to the partner (similarly to the rules of present law).[74]

Partial liquidations

The proposal would provide that the distribution rules currently applicable to complete liquidations of partnership interests would also apply to partial liquidations. A distribution in partial liquidation would be defined as a distribution that reduces the distributee partner's percentage share of partnership capital (resulting from the distribution or a series of related distributions). The portion of the partnership interest reduced would be treated as a separate interest in determining gain or loss and in determining the basis of the distributed property to the partner.[75]

A partnership would be required to adjust the basis of its remaining assets when the distributee partner is considered to have exchanged all or part of his partnership interest for assets distributed by the partnership. Unlike present law, under which partner-

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[73] See McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, supra, at para. 19.06, page 19-35, note 121 ("Allocation of the portion of the basis in excess of the partnership's basis in the distributed assets according to their relative market values would be a conceptually sound approach, and would eliminate the strange results and manipulation possibilities in [present law]. Allocation of basis according to fair market value was the rule under the 1939 Code, however, and dissatisfaction with this approach is what let to the current statutory scheme.").

[74] If there were concern about new loss recognition rules upon the distribution of partnership property, rules similar to the rules for addressing prevented adjustments to basis of assets inside the partnership could be applied. (See footnote 72, supra.)

[75] Present law provides that a partner recognizes loss upon a distribution in liquidation where no property other than money, marketable securities, unrealized receivables and inventory is distributed (sec. 731(a)(2)(B)). This loss recognition rule would apply to partial liquidations as well, under the proposal. Expanding loss recognition may raise manipulation concerns; the partial liquidation approach might be viewed as increasing complexity or making changes to the partnership tax rules that are out of proportion to their purpose of correcting the operation of the basis rules for distributions.

ship basis adjustments are made[76] only in the case of distributions not resulting in carryover basis to the distributee partner,[77] the partnership would be required to make basis adjustments regardless of the manner in which the distributee partner's basis in the distributed property is determined.

In the event of a partial liquidation, the distributee partner's basis would be allocated between the distributed property and the portion of its basis remaining after the distribution, unlike present law (where no concept of partial liquidation of a partnership interest applies). For example, assume that partner A, with a basis and value for its partnership interest of $100, receives a distribution of property with a value of $50 and an adjusted basis to the partnership of $60. A's interest in the partnership is reduced by one-half as a result of the distribution. Under the proposal, the distribution would be treated as a liquidation of an interest of A with a basis of $50. A's basis in the distributed property would be $50, and A's basis in his remaining partnership interest would be $50 (as opposed to the $60 basis in distributed property and $40 basis in A's partnership interest under present law).[78]

Second alternative proposal

Mandatory partnership basis adjustments following property distribution

The second alternative proposal would apply mandatory inside partnership basis adjustments only to distributions of property in complete liquidation of the distributee's interest in the partnership. Inside partnership basis adjustments for current distributions would remain optional (to the same extent as under present law), and would be covered by the current section 754 election.

This proposal affects a range of transactions that is narrower than those subject to the present-law rules for partnerships with a section 754 election in effect. Those present-law rules apply not only to liquidating distributions but also to current distributions where the distributee partner's basis is capped by its basis in its partnership interest.[79] Because current distributions in which the cap on the distributee's basis applies (sec. 732(a)(2)) give rise to increases to the inside basis of partnership property, however, it may not be necessary to require that partnerships make these adjustments unless they elect to do so (as under present law).

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[76] Provided a section 754 election is in effect.

[77] I.e., those in which the partner's basis in the distributed property is determined under section 732(a)(2) or 732(b), as provided in section 734(b).

[78] Also under the proposal, the partnership would have a basis adjustment to its undistributed properties to the extent that the $60 basis in the distributed property differed from the reduction of A's distributive share of the adjusted basis of partnership property by reason of the distribution.

[79] This proposal could be easily adapted to apply to the same circumstances in which present-law adjustments for electing partnerships are required under section 734(b). Thus, as under present law for a partnership with a section 754 election in effect, an inside basis adjustment would be required in the case of a distribution of property in liquidation of a partner's interest, and a non-liquidating distribution of property in which the partner's basis in the property is determined with reference to the partner's basis in the partnership, and would also apply to the extent of gain recognized by the partner on a cash distribution in excess of its basis in its partnership interest, and loss recognized by the partner on a liquidating distribution. No adjustment would be required for a current cash distribution to the extent the amount of cash does not exceed the amount of the partner's basis in its partnership interest.

This proposal is also narrower than the first proposal (which applies in the case of both complete and partial liquidations of a partnership interest). This proposal does not address the situation in which the partner's interest may have been reduced in exchange for the distributed property (in actual economic terms). As a result, there may be a misallocation of basis between the distributed property and the remaining basis of the partner's interest, and there may be no requirement of inside partnership basis adjustments in some cases when there has been a reduction in the partner's share. On the other hand, this approach applies in the most significant type of distribution -- liquidating distributions -- where basis shifting and loss duplication may be possible under present law, without adding the complexity of the partial liquidation concept.

Like the first alternative, this proposal would provide a look-through rule in the case of tiered partnerships, so the adjustments would be made in each successive lower-tier partnership, to the extent the asset whose basis would be adjusted is itself a partnership interest.

Calculation of partnership basis adjustments to remaining assets

The calculation of partnership basis adjustments to remaining assets would be made as under the present-law rules (sec. 734(b)) applicable to a partnership with a section 754 election in effect, in the case of a liqudating distribution. As under present law, the amount of any decrease in the basis of remaining partnership property would equal (1) the excess of the distributee's basis in the distributed property over the partnership's adjusted basis in the distributed property immediately before the distribution, plus (2) the amount of any loss recognized by the distributee partner. The amount of an increase (if any) in the basis of remaining partnership property would equal (1) the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution, over the basis of the distributed property to the distributee partner, plus (2) the amount of gain (if any) recognized by the distributee partner on the distribution.

Allocating basis among partnership's remaining assets

Like the first proposal, this proposal would modify would modify the categories of assets for which basis adjustments are required and the ratio for allocating basis adjustments among categories of assets. The first category of assets (and the only category, for basis increases) to which an adjustment is made would be non-depreciable capital assets, and the second category would be all other partnership properties. Basis adjustments would be allocated among properties within the category so as to reduce the difference between the fair market value and the basis of the assets. Remaining basis adjustments would be allocated in proportion to the respective fair market value of the assets (if the adjustment is an increase), or in proportion to the respective bases of the assets (if the adjustment is a decrease).

This proposal, like the first proposal, provides for gain or loss recognition if the basis adjustment cannot be applied to partnership property.[80]

Basis allocation rules for distributee partners

The basis allocation rules for distributee partners that would apply under the first alternative proposal also would apply under this proposal. Thus, as under the first proposal, the basis of distributed property in the hands of the distributee partner would be determined under rules similar to the inside basis adjustments for partnerships.

C. Require Basis Adjustments to Assets When the Partnership Distributes Certain Stock to a Corporate Partner

Present Law

Basis of property distributed by a partnership

The basis to a partner of property distributed by a partnership depends on whether or not the property was distributed in liquidation of the partner's interest. Generally, a substituted basis rule applies to property distributed to a partner in liquidation. Thus, the basis to the distributee partner of property distributed in liquidation of its partnership interest is equal to the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 732(b)). By contrast, generally, a carryover basis rule applies to property distributed to a partner other than in liquidation of its partnership interest, subject to a cap. Thus, in a non-liquidating distribution, the distributee partner's basis in the property is equal to the partnership's adjusted basis in the property immediately before the distribution, but not to exceed the partner's adjusted basis in its partnership interest (reduced by any money distributed in the same transaction) (sec. 731(a)(1) and (2)).

In a non-liquidating distribution, the partner's basis in its partnership interest is reduced by the amount of the basis to the distributee partner of the property distributed (and by the amount of any money distributed) (sec. 733).

Tax-free liquidation of corporate subsidiary

Present law generally provides that no gain or loss is recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation in which it holds 80 percent of the stock (by vote and value) (sec. 332). The distribution in liquidation of the 80-percent-owned subsidiary either must take place within one year or must be one of a series of distributions taking place within three years pursuant to a plan of liquidation (sec. 332(b)).

The basis of property received by a corporate distributee in the distribution in complete liquidation of the 80-percent-owned sub-

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[80] If there were concern about adding new gain or loss recognition provisions in the case of partnership distributions, which generally are tax-free, rules similar to the rules for addressing prevented adjustments to basis of assets inside the partnership, as described above under the first proposal, could be applied. (See footnote 72, supra.)

sidiary is a carryover basis, i.e., the same as the basis in the hands of the subsidiary (provided no gain or loss is recognized by the liquidating corporation with respect to the distributed property) (sec. 334(b)).

Basis adjustments under involuntary conversion rules

Under section 1033, gain realized by a taxpayer from certain involuntary conversions of property is deferred to the extent the taxpayer purchases property similar or related in service or use to the converted property within a specified period of time. The replacement property may be acquired directly or by acquiring control of a corporation (generally, 80 percent of the stock of the corporation) that owns replacement property.

The taxpayer's basis in the replacement property generally is the same as the taxpayer's basis in the converted property, decreased by the amount of any money received or loss recognized on the conversion (or increased by the amount of any gain recognized on the conversion).

If the taxpayer satisfies the replacement property requirement of section 1033 by acquiring stock in a corporation, the corporation generally is required to reduce its adjusted bases in its assets by the amount by which the taxpayer reduces its basis in the stock to reflect its basis in the converted property. No increase in the basis of the corporation's assets is provided under the provision.

No such basis adjustment requirement applies to a corporation to which a partnership has contributed property, and whose stock is distributed to a corporate partner in liquidation of its partnership interest. Thus, under present law, it may be possible for a partnership to replicate the basis of its assets in the hands of its partners without incurring Federal income tax.[81]

For example, assume that a partnership has two 50-percent corporate partners, A and B. A contributes high-basis property to the partnership (land with a basis and value of 100), and B contributes low-basis property (a building with a basis of 0 and a value of 100). The partnership, in turn, contributes the land to a 100-percent-owned corporation, S. Assume that, more than 5 years later,[82] the partnership is completely liquidated and the low-basis building is distributed to A, while the stock of S is distributed to B. A takes a substituted basis for the building, so its basis in the building is stepped up to 100. B takes a substituted basis in the S stock of 0, but if it liquidates S, B takes S's basis in the land, or 100.

Possible Proposal

The proposal would provide that if stock of a corporation is distributed by a partnership to a corporate partner, and the corporate partner owns 80 percent or more (by vote and value), directly or indirectly, of the stock as a result of the partnership's distribu-

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[81] See Andrews, "Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions," supra at 21. Cf. McKee, Nelson and Whitmire, *Federal Taxation of Partners and Partnerships*, supra, para. 9.03[1][a].

[82] The pre-contribution gain rules of sections 704(c)(1)(B) and 737 require the contributing partner to include pre-contribution gain in income in the event of a distribution within 5 years after the contribution of appreciated property to the partnership.

tion[83] (whether solely as a result of the distribution, or as a result of the distribution combined with acquisitions of stock within one year before or after the distribution), then the corporation (whose stock was distributed) must reduce[84] the basis of its assets.[85] The amount of the reduction to asset basis would the amount by which the stock basis is reduced as a result of the distribution.

The basis reduction would be allocated among the corporation's assets in proportion to the respective bases of the assets in the corporation's hands.

Alternatively, the proposal could require the basis adjustment only in cases where the partnership created the distributed corporation.

D. Limit Partnership Terminations

Present Law

Under present law, a partnership is considered as continuing, for Federal income tax purposes, if it is not terminated. A partnership is considered as terminated for Federal income tax purposes in only two circumstances. First, a partnership is terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership (sec. 708(b)(1)(A)). Second, a partnership is terminated if, within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits (sec. 708(b)(1)(B)). All sales and exchanges within any 12-month period are aggregated, for this purpose.

Treasury regulations provide that a termination by sale or exchange of 50 percent or more of the partnership capital or profits interests within a 12-month period is deemed to be a distribution of the partnership's properties to the partners, and a contribution of the partnership properties to a new partnership (Treas. Reg. sec. 1.708-1(b)(1)(iv)). The deemed distribution may give rise to significant tax consequences, such as recognition of gain by partners and changes to the basis and holding period of partnership property.

In addition, apart from the effects of the deemed distribution, the termination of a partnership can have other significant tax effects, including closing of the partnership's taxable year, and starting a new recovery period for partnership property for depreciation purposes. In general, the transferee is treated the same as was the transferor in a contribution to or distribution from a partnership, for purposes of computing depreciation; however, this "step-in-the-shoes" rule with respect to depreciation deductions does not apply

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[83] The proposal would be applied after the application of the present-law rules requiring a contributing partner to include in income pre-contribution gain in the event of a distribution within 5 years after the contribution of appreciated property to the partnership.

[84] A rule requiring an increase in the corporation's basis in its assets is not needed because the corporate partner's basis in property distributed by the partnership (i.e., the stock) is not eliminated, so long as the corporate partner does not liquidate the corporation whose stock it received.

[85] This proposal would be necessary to avoid circumvention of Possible Proposal B (relating to requiring partnership basis adjustments upon distributions of property and modifying basis allocation rules), above, which is intended to eliminate basis shifting. Note that Possible Proposal B, above, includes a rule to look through tiers of partnerships in applying the mandatory inside basis adjustments.

in the case of a partnership termination (sec. 168(i)(7)(B)).[86] This result of a partnership termination is viewed as a limitation on trafficking in partnerships owning property with favorable depreciation periods.[87]

Proposed Treasury regulations would provide that a termination by sale or exchange of 50 percent or more of the partnership capital or profits interests within a 12-month period would have a different result than the deemed distribution and re-contribution of partnership property as under the regulations currently in effect. Rather, under the proposed regulations, the terminated partnership would be deemed to contribute its assets and liabilities to a new partnership in exchange for interests in the new partnership, which would be deemed distributed to the partners in liquidation of the terminated partnership (Prop. Treas. Reg. sec. 1.708-1(b)(1)(iv)). This approach would eliminate consequences of a partnership termination that are attributable to the deemed distribution of partnership assets. The proposed regulations would not alter the effect of the termination on depreciation of partnership property, which is determined by statute.[88]

Possible Proposal

In lieu of the present-law rule that a partnership is terminated on the sale or exchange within a 12-month period of 50 percent or more of the total interests in partnership profits and capital (in the aggregate), the proposal would provide that a partnership is terminated in the event that, in one transaction (or a series of related transactions), there is a sale or exchange of 50 percent or more of the total interests in partnership capital or profits. Unrelated transactions within a 12-month period would not be aggregated as under present law. For example, under the proposal, if any person or persons acquire a 50-percent interest or greater in partnership capital or profits in one transaction (or a series of related transactions) that is a sale or exchange, the acquiror would have no more favorable depreciation deductions with respect to partnership property than if it had acquired the property directly (i.e., not through a partnership). The proposal addresses the concern that a partnership may be terminated inadvertently by numerous sales of small interests in a partnership within a 12-month period.

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[86] Anti-churning rules (which generally are intended to prevent access to favorable depreciation rules under 1981 and 1986 legislation) apply under section 168 to certain depreciable partnership property after a termination, with the result, generally, that the partnership cannot have more favorable depreciation treatment than before the termination. (See sec. 168(f)(5).) In the case of intangible assets under section 197, a "step-in-the-shoes" rule also applies for certain transactions (including contributions to and distributions from a partnership), to the extent that the adjusted basis of the property in the hands of the transferee does not exceed its basis in the hands of the transferor, but no separate rule for partnership terminations is provided (sec. 197(f)(2)).

[87] "Section 708(b)(1)(B) came into the Code in 1954, apparently to prevent trafficking in partnerships with advantageous taxable years . . . . Subsequent changes in the Code have greatly reduced the ability of partnerships to adopt or retain favorable taxable years. Thus, the original purpose of section 708(b)(1)(B) has been eliminated in large measure. The provision serves a similar function under current law, however, in that it impedes trafficking in partnerships that own assets with favorable accelerated cost recovery system (ACRS) recovery periods." McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, supra, para. 12.03, p. 12-7.

[88] See the preamble to the proposed section 708(b)(1)(B) regulations, May 13, 1996.

E. Modify the Rules Taxing Pre-Contribution Gain

Present Law

Under present law, if a partner contributes appreciated property to a partnership, no gain is recognized to the contributing partner at the time of the contribution. The contributing partner's basis in its partnership interest is increased by the basis of the contributed property at the time of the contribution. The pre-contribution gain is reflected in the difference between the partner's capital account and its basis in its partnership interest ("book/tax differential").

If the property is subsequently distributed to another partner within 5 years of the contribution, the contributing partner generally recognizes gain as if the property had been sold for its fair market value at the time of the distribution (sec. 704(c)(1)(B)). Similarly, the contributing partner generally includes pre-contribution gain in income to the extent that the value of other property distributed by the partnership to that partner exceeds its adjusted basis in its partnership interest, if the distribution by the partnership is made within 5 years after the contribution of the appreciated property (sec. 737).[89]

These rules do not apply in the case of a charitable contribution of partnership property, which is not treated as a distribution. If the partnership disposes of appreciated property (that was contributed by a partner) by contributing the appreciated property to charity, the contributing partner is not required to recognize pre-contribution gain. Taxpayers may take the position that some of the charitable contribution deduction is allocated to the non-contributing partner, although this result would not have been achieved had the contributing partner given the property to the charity directly. The Service has ruled that a charitable contribution of partnership property decreases the basis of partners' interests in the partnership (but not below zero), to the extent of each partner's share of the basis of the property that was contributed to charity (Rev. Rul. 96-11, 1996-4 I.R.B. 28).

Possible Proposal

First alternative proposal

This proposal[90] would eliminate the 5-year limit under present law. Thus, a partner that contributes appreciated property to a partnership would be subject to tax on the pre-contribution gain in the event of any subsequent distribution of either the appreciated property to another partner or other property to the contributing partner.

Second alternative proposal

The second alternative proposal would extend the 5-year limit under present law. Thus, a partner that contributes appreciated property to a partnership would be subject to tax on the pre-con-

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[89] The 5-year limit may encourage retention of partnership property until gain recognition can be avoided. See "Time Warner May Get a Big Tax Break, Thanks to Accounting," *New York Times*, March 18, 1997, p. D-10.

[90] See Cohen and Hoberman, "Partnership Taxation: Changes for the '90s," supra, at 885, questioning whether the 5-year rule of present law is an adequate shield against abuse.

tribution gain in the event of a distribution of the appreciated property to another partner, or a distribution of other property to the contributing partner, if such a distribution occurs within 10 years after the partner's contribution of the appreciated property.

Third alternative proposal

The third proposal would provide that the present-law rule requiring inclusion of pre-contribution gain by the contributing partner applies in the case of a charitable contribution of the appreciated property by the partnership.

F. Eliminate the Substantial Appreciation Requirement for Inventory of a Partnership

Present Law

Under present law, upon the sale or exchange of a partnership interest, any amount received that is attributable to unrealized receivables, or to inventory that has substantially appreciated, is treated as an amount realized from the sale or exchange of property that is not a capital asset (sec. 751(a)).

Present law provides a similar rule to the extent that a distribution is treated as a sale or exchange of a partnership interest. A distribution by a partnership in which a partner receives substantially appreciated inventory or unrealized receivables in exchange for its interest in certain other partnership property (or receives certain other property in exchange for its interest in substantially appreciated inventory or unrealized receivables) is treated as a taxable sale or exchange of property, rather than as a nontaxable distribution (sec. 751(b)).

For purposes of these rules, inventory of a partnership generally is treated as substantially appreciated if the fair market value of the inventory exceeds 120 percent of adjusted basis of the inventory to the partnership (sec. 751(d)(1)(A)). In applying this rule, inventory property is excluded from the calculation if a principal purpose for acquiring the inventory property was to avoid the rules relating to inventory (sec. 751(d)(1)(B)).

Possible Proposal

The proposal would eliminate the requirement that inventory be substantially appreciated in order to give rise to ordinary income under the rules relating to sales and exchanges of partnership interests and certain partnership distributions.[91] This would conform the treatment of inventory to the treatment of unrealized receivables under these rules.

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[91] The ALI study on partnership rules referred to the substantial appreciation requirement as subject to manipulation and tax planning (American Law Institute, *Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners*, supra, at 26. In 1993 the definition of substantially appreciated inventory was modified, and the present-law test relating to a principal purpose of avoidance was added (Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, sec. 13206(e)(1)). Nevertheless, the substantial appreciation requirement is still criticized as largely ineffective on at least two grounds (McKee, Nelson and Whitmire, *Federal Taxation of Partners and Partnerships*, supra, sec. 16.04[2]: (1) that it applies only to inventory items and not unrealized receivables and so does not insulate most partnerships from section 751; and (2) it may operate to exclude large amounts of ordinary income from section 751 if the partnership's profit margin is below 20 percent.

G. Close Partnership Taxable Year with Respect to Deceased Partner

Present Law

The taxable year of a partnership closes with respect to a partner whose entire interest is sold, exchanged or liquidated, but generally not upon the death of a partner (sec. 706(c)).[92] A decedent's entire share of items of income, gain, loss, deduction and credit for the partnership taxable year in which death occurs is taxed to the decedent's estate or successor in interest, rather than to the decedent on his or her final tax return. See *Estate of Hesse v. Commissioner*, 74 T.C. 1307, 1311 (1980).

Possible Proposal

The proposal would provide that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise.[93] The proposal would not be intended to change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

H. Limit Partnership Allocations Made After the End of the Taxable Year to Allocations of Service Income of a Service Partnership

Present Law

Generally, where the application of a tax provision depends on private contractual relationships, it is the contractual relationships in effect during the taxable year in question that govern. However, for purposes of the Code provisions for taxation of partnerships, the partnership agreement for any taxable year is deemed to include all modifications agreed to on or before the due date, not including extensions, of the partnership return for the taxable year (sec. 761(c)). With regard to allocations of partnership income, deductions and losses among the partners, this provision effectively allows partners to take a "second look" at the allocations contained

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[92] Treasury regulations provide that if a sale or exchange occurs on the date of the partner's death under the terms of an agreement existing at that date, then the taxable year of the partnership with respect to that partner closes upon the date of death. Treas. Reg. sec. 1.706-1(c)(3)(iv). This provision of the regulations does not apply absent such an agreement. If the partnership year closed automatically with respect to a deceased partner, any need for such agreements would be reduced.

[93] This proposal was passed twice by the Congress as part of bills that were vetoed: first in 1992 in H.R. 11, the Revenue Act of 1992 (vetoed by President Bush); and second, in 1995 in H.R. 2491, the Balanced Budget Act of 1995 (vetoed by President Clinton). The ALI recommended a proposal to close the partnership taxable year for a deceased partner in its 1984 study (American Law Institute, *Federal Income Tax Project: Subchapter K: Proposals on the Taxation of Partners*, supra, 71-84 (Proposal D). Since 1984, when the ALI study was published, legislative changes have required most partnerships to adopt a calendar year (see sec. 706(b)), reducing the possibility of bunching. The part of the ALI proposal aimed at avoidance of bunching in the case of fiscal-year partnerships is no longer of particular relevance in the great majority of cases. Consequently, income and deductions are better matched if the partnership taxable year closes upon a partner's death and partnership items are reported on the decedent's last return.

in a partnership agreement with full information as to the specific tax situation of each partner for the taxable year.[94]

Possible Proposal

For purposes of the partnership tax provisions, a partnership agreement could include only modifications adopted on or before the last day of the partnership's taxable year. Because of the greater difficulty of monitoring receipt of income for services,[95] an exception would be provided for the service income of partnerships that are primarily engaged in the performance of services. For the service income of such partnerships, a rule similar to that of present law would apply.

I. Modify Treatment of Guaranteed Payments

Present Law

A guaranteed payment made by a partnership to a partner for services, or for the use of capital, is treated in the same manner as if made to a non-partner for purposes of inclusion of the payment in income by the recipient, and deduction and capitalization by the partnership (sec. 707(c)). For all other purposes, guaranteed payments are treated in the same manner as a distributive share of partnership income. A guaranteed payment is a payment that is determined without regard to partnership income.

Payments for capital

With respect to payments for capital, this treatment of guaranteed payments must be contrasted both with payments that are deemed to be made in a non-partner capacity and with allocations of partnership income.

When a partner enters into a capital transaction with its partnership, such as a *bona fide* loan, which is deemed to be other than in its capacity as partner, the transaction is treated by both the partner and the partnership in the same manner as a transaction between the partnership and a non-partner (sec. 707(a)). Thus, assuming loan treatment, payments to the partner are deductible by the partnership as interest, and both the partnership and the partner are subject to the original issue discount rules.

A partner contributing capital to a partnership for which no guaranteed payment is received, and which is not deemed to be in a non-partner capacity, may be compensated for such contribution by its allocable share of partnership income. Allocations of partnership income retain the character, such as capital gain, that they had at the partnership level. A partner includes allocations of taxable income from a partnership only in the taxable year in which, or with which, the partnership's taxable year terminates.

Several commentators have questioned the continued viability of a concept of guaranteed payments for partnership capital (sec. 707(c)) separate from the concept of payments for partnership cap-

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[94] McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, supra, sec. 11.04.

[95] American Law Institute, *Federal Income Tax Project: Taxation of Pass-Through Entities*, Memorandum No. 2, supra, at 84.

ital deemed to be in a non-partner capacity (sec. 707(a)).[96] The distinction between the two concepts creates administrative complexity for the Service and has led to considerable litigation, sometimes with inconsistent results.[97] As described above, guaranteed payments for capital (sec. 707(c)) are treated differently from payments deemed made to a non-partner (sec. 707(a)), chiefly with regard to treatment of the payments as interest for tax purposes, but also with regard to timing of income and deductions. The lack of a clear conceptual difference between guaranteed payments for capital and deemed non-partner payments, combined with the disparities in their tax treatment, gives rise to numerous planning possibilities.[98] For these reasons, several commentators have recommended repeal of the statutory concept of guaranteed payments to partners, at least with regard to payments for capital.[99]

Payments for services

Different rules apply to guaranteed payments for services and payments for services deemed performed in a non-partner capacity. A deemed non-partner payment is treated in the same manner as a service payment made to a person who is not a partner (sec.707(a)).[100] Unlike a guaranteed payment, timing of deemed non-partner payments is governed by the partner's and the partnership's own accounting methods, subject to limitations on the timing for deductions (sec. 267). Under various Code sections, deemed non-partner payments may be deducted or capitalized by the partnership, or, alternatively, disallowed (e.g., as start-up expenses (sec. 195), investment expenses (sec. 212) or business expenses (sec. 162)).

By contrast, timing of guaranteed payments for services is governed by the rules for allocations of partnership income described above; thus, such payments are includible in the year of the partner in which, or with which, the partnership year ends. Guaranteed payments are includible as ordinary income by the partner (sec. 61) and are deductible by the partnership as business expenses (sec. 162), unless subject to capitalization (sec. 263).

Partners frequently render services for their partnerships which are different in character from services provided by non-partners, and thus which do not qualify as performed in a non-partner capacity (sec. 707(a)). However, commentators have pointed to planning possibilities raised by the differences in character and timing of guaranteed payments and deemed non-partner payments.[101]

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[96] E.g., S. Banoff, "Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K", 70 *Taxes* 820 (1992); P. Postlewaite and D. Cameron, "Twisting Slowly in the Wind: Guaranteed Payments After the Tax Reform Act of 1984", 40 *Tax Lawyer* 649 (1986).

[97] E.g., *Pratt v. Commissioner*, 64 T.C. 203 (1975), *rev'd on other grounds* 550 F.2d 1023 (5th Cir.) (holding payments based on partnership gross, rather than net, income can be guaranteed payments); Rev. Rul. 81-300, 1981-2 C.B. 143 (reaching the opposite conclusion); see also S. Banoff, supra, at 830-4.

[98] M. Davis and M. Vogel, "Guaranteed Payments: Strategies for Avoiding Pitfalls in Their Use", 2 *Journal of Partnership Taxation* 332 (1986): Banoff, supra at 852 to 874.

[99] Postlewaite and Cameron, supra, at 696-703; Banoff, supra, at 874-879.

[100] This same treatment may apply if a partner performs services for a partnership and there is a related direct or indirect allocation and distribution to the partner (sec. 707(a)(2)(B)).

[101] E.g., J. Banish, "Using Guaranteed Payments to Compensate Service Partners has Numerous Advantages", 11 *Journal of Partnership Taxation* 115 (1994).

Possible Proposal

The proposal would repeal the present-law provisions governing guaranteed payments made to a partner for capital. Thus, a guaranteed payment to a partner with respect to capital would be treated according to its substance either as a deemed non-partner payment (sec. 707(a)), or as an allocation of partnership income to the recipient partner combined with a distribution (sec. 704(b)). It is expected that most guaranteed payments for capital would qualify as deemed non-partner payments that would be characterized as interest on debt for Federal tax purposes.

The proposal would retain the present-law concept of guaranteed payments for services, but would amend the treatment of such payments to conform with non-partner service payments. For service payments, the proposal would retain the present-law concepts of both guaranteed payments for services and payments for services that are performed in a non-partner capacity. However, the proposal would treat both types of payments in the same manner, applying the present-law rules for deemed non-partner payments under section 707(a), such as inclusion of such payments in gross income under the recipient's method of accounting.

J. Modify Employment and Self-Employment Tax and Income Tax Withholding Treatment of Partners

Present Law

As part of the Federal Insurance Contributions Act ("FICA"), a tax is imposed on employees and employers up to a maximum amount of employee wages. The tax is composed of two parts: old-age, survivor, and disability insurance ("OASDI") and Medicare hospital insurance ("HI"). The OASDI tax rate is 6.2 percent on both the employer and employee (for a total rate of 12.4 percent) on the first $65,400 of wages (for 1997), and the HI tax rate is 1.45 percent on both the employer and employee, with no wage cap.

Similarly, under the Self-Employment Contributions Act ("SECA"), a tax is imposed on an individual's net earnings from self-employment ("NESE"). The SECA tax rate is the same as the total FICA rates for employers and employees (i.e., for 1997, 12.4 percent for OASDI and 2.9 percent for HI), and OASDI is capped at the same level. In general, the OASDI portion of FICA and SECA tax are coordinated to the extent the individual has both wages and NESE during the year.

The cap on wages and NESE subject to the OASDI portion of FICA and SECA taxes is indexed to changes in the average wages in the economy. A $135,000 cap on wages and NESE subject to the HI tax was repealed for wages and income received after December 31, 1993.

Whether an individual is subject to FICA or SECA taxes depends on whether the individual is an employee.[102] The Service has ruled that a partner cannot be treated as an employee for FICA pur-

[102] In general, whether an individual is an employee is determined under a common-law facts and circumstances test that seeks to determine whether the individual is subject to the control of the service recipient, not only as to the nature of the work performed, but also as to the circumstances under which it is performed. Under this test, a partner acting as such is not considered an employee, and therefore is subject to SECA taxes rather than FICA taxes.

poses.[103] Although the ruling is not specific, it could be read to exempt from FICA tax even partners whose payments for services are subject to section 707(a), which treats them for general tax purposes as if received by a non-partner. Section 707(a) treats payments for services received by a partner in the same manner as if received by a non-partner if the services are deemed to be performed in a non-partner capacity. Payments to a partner that are treated as non-partner payments under section 707(a) also are not specifically excluded from NESE for SECA tax purposes.[104]

The NESE of a general partner in a partnership is the partner's distributive share from any trade or business of the partnership, adjusted for certain items of income that are passive in nature (e.g., rentals of real estate, dividends, and interest are excluded from NESE unless such amounts are received in the course of a trade or business of a dealer in the related property). If a general partner's distributive share is a net loss, it may be deducted from NESE under these rules.

The distributive share of a limited partner generally is excluded from NESE except to the extent the distributive share is a guaranteed payment for services actually rendered to or on behalf of the partnership (sec. 707(c)). When Congress enacted this exclusion, many State's laws did not allow limited partners to participate in the partnership's trade or business to the extent that such laws allow limited partners to participate today.[105] In addition, LLCs, for which there is generally no distinction between general and limited members as a matter of State law, have come into use. LLCs may generally elect treatment as partnerships for Federal income tax purposes under the check-the-box regulations.

On January 13, 1997, the Treasury Department issued proposed regulations interpreting the limited partner exclusion, which provide, *inter alia*, that an individual will not be treated as a limited partner for NESE purposes if one of the following tests is met: (1) he has personal liability for the debts of the partnership, (2) he has authority to contract on behalf of the partnership, or (3) he participates in the partnership's trade or business for more than 500 hours during the tax year. A special rule in the proposed regulations provides that service partners in service partnerships will never be treated as limited partners for NESE purposes (prop. Treas. reg. sec. 1.1402(a)-2).

Possible Proposal

The proposal would treat partners as employees for FICA tax purposes and income tax withholding purposes with respect to any payments for services they receive from the partnership that are guaranteed payments (sec. 707(c)) or are deemed to be non-partner payments for general tax purposes (sec. 707(a)). The proposal would exclude both of these types of payments from NESE for SECA tax purposes.

The proposal also would modify the NESE rules with regard to the distributive shares of limited partners and owners of LLCs that

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[103] Rev. Rul. 69-184, 1969-1 C.B. 256.

[104] See G. Karch, "Equity Compensation By Partnership Operating Businesses," 74 *Taxes* 722 (1996).

[105] See the preamble to proposed Treasury regulations section 1.1402(a)-2 (January 13, 1997).

are classified as partnerships for Federal income tax purposes. Due to the changes in many States' laws allowing limited partners to participate in partnership activities, and the development of LLCs that can be classified as partnerships for Federal income tax purposes, the NESE rules would be amended to provide that all or a portion of a limited partner's or LLC owner's distributive share would be included in NESE if he participates substantially in the partnership's or LLC's trade or business. For a limited partner or LLC owner who performs services for a service partnership or LLC, all of his distributive share would be included in NESE.

For non-service entities, the distributive share of a limited partner or LLC owner who participates in the partnership's or LLC's trade or business for more than a particular number of hours would be included in NESE except to the extent it represents a reasonable rate of return on his capital account. A reasonable return for this purpose could, for example, be the average monthly balance of the limited partner's or LLC owner's capital account for the taxable year multiplied by an interest rate determined by reference to the applicable federal rate. A limited partner's or LLC owner's distributive share would be allocated equally between NESE and the return on his capital account until the statutory rate of return was met. For example, if the limited partner had a distributive share of $10,000, a $100,000 average balance in his capital account, and the statutory rate of return for the year were 10 percent, $5000 of the distributive share would be included in NESE (the remaining $5000 being treated as a return on his capital account). If the distributive share of a limited partner or LLC owner meeting the number-of-hours test were a net loss, this would be deducted from NESE under rules similar to the current rules for general partners.

K. Require Partial Recognition of Gain on Transfer of Marketable Securities to a Partnership or Corporation

Present Law

A contribution of property to a partnership generally does not result in recognition of gain or loss to the contributing partner (sec. 721(a)). When contributed property is disposed of by the partnership, pre-contribution gain or loss must be allocated to the contributing partner (sec. 704(c)).

A contribution of property to a corporation does not result in gain or loss to the contributing shareholder if the contributor is part of a group of contributors who own 80 percent of the voting stock of each class of stock entitled to vote (sec. 351).

Sections 351(e)(1) and 721(b) provide exceptions to the general rule for deferral of pre-contribution gain and loss. Gain and loss is recognized upon a contribution by a shareholder to a corporation that is an investment company (section 351(e)(1)). Gain, but not loss, is recognized upon a contribution by a partner to a partnership that would be treated as an investment company if the partnership were a corporation (section 721(b)). Under Treasury regulations, a contribution of property by a shareholder to a corporation, or by a partner to a partnership, is treated as a transfer to an investment company only if (1) the contribution results, directly or indirectly, in a diversification of the transferor's interests, and (2)

the transferee is (a) a regulated investment company ("RIC"), (b) a real estate investment trust ("REIT"), or (c) a corporation more than 80 percent of the assets of which by value (excluding cash and non-convertible debt instruments) are readily marketable stocks or securities or interests in RICs or REITs that are held for investment (Treas. Reg. sec. 1.351-1(c)(1)). In the case of contributions on or after May 2, 1996, a contribution of stock or securities to an investment company is not treated as resulting in diversification (and, thus, does not result in gain recognition under the above rules) if each transferor transfers a "diversified portfolio of stock and securities", within the meaning of section 368(a)(2)(F) with certain modifications (Treas. Reg. sec. 1.351-1(c)(6)).[106] Thus, under present regulations, a partner contributing marketable securities to a partnership or a shareholder contributing marketable securities to a RIC can avoid immediate gain recognition if either (1) the transferee does not meet the definition of an investment company because at least 20 percent of its assets are of types that do not count toward the 80-percent test or (2) the marketable securities transferred meet the regulations' definition of a "diversified portfolio of stocks and securities" (even if the transferee qualifies as an investment company).

Present law provides generally that a partner does not recognize gain or loss upon a distribution of non-cash property by a partnership (sec. 731(a)(1)). An exception to this nonrecognition rule provides that gain is recognized upon a distribution of marketable securities, where the fair market value exceeds the partner's basis in its partnership interest immediately before the distribution (sec. 731(c)). For this purpose, marketable securities are treated like cash, because marketable securities are nearly as easily valued and as liquid as cash. No comparable rule, however, applies in the case of the contribution of marketable securities to a partnership or a corporation.

Thus, under present law and regulations, a partner may without current taxation contribute a diversified portfolio of stock and securities to an investment partnership, and a shareholder may without current taxation contribute a diversified portfolio of stock and securities to a RIC. These transactions have the effect of a disposition of the contributing partner's or shareholder's ownership interest in some of the marketable securities contributed in exchange for an interest in other assets.[107]

On February 26, 1997, Representative Kennelly introduced a bill, H.R. 846, which, in addition to provisions designed to require gain recognition in other financial transactions, contains a provision re-

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[106] This rule also applies to earlier contributions at the taxpayer's election.

[107] Of particular concern is the reappearance of "swap funds", many of which are structured as partnerships. The *New York Times* reports:

> Also booming is a tax gimmick the Government thought it had killed almost 30 years ago—the swap fund.
>
> Also known as an exchange fund or a diversification fund, a swap fund uses partnership tax breaks to help wealthy investors diversify their assets without paying capital gains taxes. The theory is simple: Partners can swap property tax-free into a partnership in exchange for partnership shares. So could they not also swap securities tax-free into a partnership so that each contributing investor could own shares in a diversified portfolio without creating a tax bill?
>
> "Wealthy, Helped by Wall St., Find New Ways to Escape Tax on Profits", *New York Times*, December 1, 1996, p.1.

quiring the determination of whether a company is an investment company to be made by taking into account all stocks and securities, whether or not readily marketable.

Possible Proposal

The proposal would require partial gain recognition on a contribution of marketable securities to a partnership or corporation where, as a result of the contribution (and any other contributions and distributions which are part of the same plan or the same transaction) more than 20 percent of the assets of the transferee (by value) consist of marketable securities or money or both. Marketable securities would be defined as in the current rules governing partnership liquidations (sec. 731(c)(2)). The proposal would not apply to a contribution where gain is recognized to the contributing partner or shareholder under present-law rules for investment companies (sec. 351(e)(1) and 721(b)). There would also be an exception for contributions by a RIC to either a partnership all of the interests of which are owned by RICs, or to a RIC all of the stock of which is owned by RICs.

If the 20-percent test under the proposal is met, the contributing partner or shareholder would be treated as recognizing gain as if it sold a portion of the marketable securities contributed for their fair market value at the time of contribution. The portion treated as sold would be calculated separately for each class of securities of each issuer that is contributed and would be the excess of (1) the number of securities of that class and issuer contributed over (2) the contributing partner's or shareholder's capital interest in the securities of the same class and issuer as a result of the contribution (and other contributions and distributions in the same plan or transaction).[108]

For example, if a partner contributed 100 shares of appreciated common stock in company X to a partnership and, as a result of the contribution, the partner had a 50 percent capital interest and the partnership had 150 shares of X common stock, the partner would be treated as if it had sold 25 shares of X common stock. For purposes of determining both the securities contributed and the partner's or shareholder's capital interest in securities as a result of the contribution, the constructive ownership rules of section 731(c)(2)(B) would apply. The portion of any contributed securities that is treated as sold under the proposal would be governed by rules similar to those for contributions treated as sales under sections 351(e)(1) and 721(b). The remaining portion of such securities would be treated as a contribution governed by section 351(a) or, alternatively, sections 721(a) and 704(c).

The proposal would retain the present-law rules governing contributions to corporations and partnerships that qualify as investment companies, in order to require *full* recognition of gain on such contributions. However, the proposal would direct the Treasury

[108] For a partnership, the contributing partner's capital interest in any class of securities would be the proportion of the total number of securities of the same class and issuer owned by the partnership that is the same as the proportion of the total capital accounts of the partnership after the contribution (taking into account other transactions pursuant to the same plan and any revaluation of capital accounts) that is accounted for by the capital account of the contributing partner. For a corporation, the contributing shareholder's capital interest would be determined under similar rules.

Secretary to modify the definition of an investment company in the current regulations so that all marketable securities as defined in section 731(c)(2) (including non-convertible debt instruments) are counted toward the test that more than 80 percent of the entity's assets consist of readily marketable stock or securities or certain other assets (Treas. Reg. 1.351-1(c)(1)). This revision would lessen the possibility under present law that a fund can avoid being treated as an investment company by choosing investments that do not count toward the 80-percent test. The proposal also would direct the Treasury Secretary to reverse the provision of the present regulations, except as it applies to contributions to partnerships or corporations where all of the contributors are RICs, that treats a contribution of a diversified portfolio of stock and securities to an investment company as not resulting in gain recognition (Treas. Reg. 351-1(c)(6)).

Some distinctions between the proposal and H.R. 846 should be noted. First, H.R. 846 would take into account only stocks and securities for purposes of determining whether an entity is an investment company, but would repeal the present-law requirement that stock and securities be readily marketable. H.R. 846 would apparently not change the 80-percent test of the Treasury Regulations for this determination. It would also not change the present-law rule that non-convertible debt instruments are not counted toward the 80-percent test.

The proposal would significantly expand the stock, securities and other interests that are counted toward the investment company definition, but would do so in a manner different from H.R. 846. Because the proposal would reference the definition of "marketable securities" under section 731(c)(2), all "actively traded" stock and securities, foreign currencies, notional principal contracts, derivatives and non-security debt instruments would be counted toward the 80-percent test. The proposal would also count interests in actively traded precious metals and certain interests in entities that own any of the above-described items, except to the extent provided in Treasury regulations. The proposal also differs from H.R. 846 in that, in addition to amending the investment company definition under current law, it would also require partial gain recognition on contributions of marketable securities to certain partnerships or corporations that do not meet the investment company definition, as described above.

L. Deny Installment Sale Treatment for All Readily Tradable Debt

Present Law

The installment method generally permits a taxpayer to recognize as gain on a disposition of property only that proportion of payments received in a taxable year which is the same as the proportion that the gross profit bears to the total contract price (sec. 453). The installment method is not available, however, if a sale is made for an evidence of indebtedness that is readily tradable, and that is issued by a corporation or a government or political subdivision, because receipt of such indebtedness is treated as payment on the installment note (sec. 453(f)(3)). As stated in the legislative his-

tory, the "rationale for the provision essentially is that there is no reason for postponing the gain where a seller of property receives something which is the equivalent of cash." [109]

No similar provision prohibits use of the installment method where readily tradable indebtedness of a partnership or an individual is received.[110]

Possible Proposal

Installment sale treatment would be denied for all sales where the debt received is readily tradable under current rules, regardless of the nature of the issuer. If readily tradable debt of a partnership is received in a sale, for example, the partnership's debt would be treated as payment, and the installment method would not be available.

M. Recognize Cancellation of Indebtedness Income Realized on Satisfaction of Debt with Partnership Interest

Present Law

No Code provision requires a partnership to realize cancellation of indebtedness income when it transfers a partnership interest to a creditor in satisfaction of a debt. A creditor is generally entitled to a bad debt deduction when it accepts property in full satisfaction of indebtedness, in an amount equal to the excess of the creditor's basis in the debt over the fair market value of the property received.

In the case of a corporation, a transfer of stock in satisfaction of a corporate debt gives rise to cancellation of indebtedness in the amount that would be realized if the debt were satisfied with money equal to the fair market value of the stock (sec. 108(e)(8)). Prior to enactment of this statutory provision, there was case law authority that a corporation did not realize cancellation of indebtedness income when it transferred stock to a creditor in satisfaction of a debt.[111] Some commentators have viewed this case law authority as applicable to partnerships by analogy.[112] If applicable to partnerships, this authority would prevent a partnership from realizing cancellation of indebtedness income upon a transfer of a partnership interest in satisfaction of a partnership debt.

Where the partnership debt being satisfied is nonrecourse indebtedness, it is possible that an additional argument against realization of cancellation of indebtedness income could be made based on the *Fulton Gold* line of cases.[113] Under those cases, a reduction in

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[109] S. Rep. No. 91-552, 91st Cong., 1st Sess.146 (1969).

[110] See Freeman and Stephens, supra, at 969.

[111] E.g., *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), aff'd, 156 F. 2d 122 (1st Cir. 1946), acq. 1947-1 C.B. 3; *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), nonacq. 1943 C.B. 28, aff'd, 140 F.2d 382 (1st Cir. 1944); *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946), acq. 1947-1 C.B. 4; *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), acq. 1943 C.B. 1.

[112] E.g, H. Ahrens, "Restructuring Partnership Indebtedness: the Debt-for-Equity Exception in the Partnership Arena", 13 *Va. Tax R.* 329 (1993); K. Burke, "Partnership Debt-Equity Exchanges; *Kirby Lumber* and Subchapter K", 47 *Tax Law.* 13 (1993).

[113] *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934). *See also American Seating Co. v. Commissioner*, 14 B.T.A. 328, *aff'd in part and rev'd in part*, 50 F.2d 681 (7th Cir. 1931); *Hiatt v. Commissioner*, 35 B.T.A. 292 (1937); and *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940).

nonrecourse indebtedness was not treated as giving rise to cancellation of indebtedness income on the basis that there was no freeing of the debtor's assets. The Service does not follow this line of authority.[114] Other rules, such as the special rules for purchase-money debt, may prevent realization of income upon cancellation of non-recourse indebtedness (sec. 108(e)(5)).

When cancellation of indebtedness income is realized by a partnership, it is allocated among the partners in accordance with their distributive shares. A partner who is allocated cancellation of indebtedness income is entitled to exclude it if the partner qualifies for one of the various exceptions to recognition of such income, including the exception for insolvent taxpayers or that for qualified real property indebtedness of taxpayers other than C corporations (sec. 108(a)). The availability of each of these exceptions is determined at the partner, rather than the partnership, level.

Possible Proposal

Under the proposal, when a partnership transfers a partnership interest to a creditor in satisfaction of a debt, the partnership would realize cancellation of indebtedness income in the amount that would be realized if the debt were satisfied with money equal to the fair market value of the partnership interest. Any cancellation of indebtedness income realized under the proposal would be allocated solely among the partners who held interests immediately prior to the satisfaction of the debt. Under the proposal, no inference would be intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of a partnership debt.

The proposal would also clarify that the *Fulton Gold* line of cases is overruled.

N. Apply Earnings-Stripping Rules to Partnerships and S Corporations

Present Law

Under the earnings stripping provision, the deduction for certain interest paid by a corporation to a related person may be disallowed (sec. 163(j)). If the provision applies to a corporation for a taxable year, it disallows deductions for certain amounts of "disqualified interest" paid or accrued by the corporation during that year. A deduction disallowed under the provision is treated as disqualified interest paid or accrued in the succeeding taxable year.

In order for the earnings stripping provision to apply to a corporation for a taxable year, two thresholds must be exceeded. To exceed the first threshold, the corporation must have excess interest expense. Excess interest expense is the excess (if any) of the corporation's net interest expense over the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward from a prior year. Excess limitation is the excess (if any) of 50 percent of adjusted taxable income over net interest expense. To exceed the second threshold, the corporation must have a ratio of debt to equity as of the close of the taxable year in ques-

[114] Rev. Rul. 91-31, 1991-1 C.B. 19.

tion (or on any other day prescribed by the Treasury Secretary in regulations) that exceeds 1.5 to 1. According to the legislative history, "the operative effect of the earnings stripping provision is to deny deductions for interest expenses deemed to be excessive under the criteria of the provision. Where the deductions are for interest paid to tax-exempt related parties, net income is shifted from the payor to the related party." [115]

Despite this general statement of the purpose of the earnings stripping provision, the provision does not apply to interest paid by partnerships.[116] Proposed Treasury regulations provide that a corporate partner's proportionate share of the liabilities of a partnership is treated as debt of the corporate partner for purposes of applying the earnings stripping limitation to its own interest payments (Prop. Treas. reg. sec. 1.163(j)-3(b)(3)) . Moreover, interest paid or accrued by a partnership is treated as interest expense of a corporate partner, with the result that a deduction for the interest expense may be disallowed if that expense would be disallowed under the earnings stripping rules if paid by the corporate partner itself. (Prop. Treas. reg. sec. 1.163(j)-2(c)(5)). The Proposed Treasury regulations also provide that the earnings stripping rules do not apply to S corporations (Prop. Treas. reg. sec. 1.163(j)-1(a)(i)). Thus, under present law and proposed regulations, a partnership or S corporation generally is allowed a deduction for interest paid or accrued on indebtedness that it issues that would be disallowed under the earnings stripping rules in the case of a C corporation.

Possible Proposal

Under the proposal, the deduction for interest paid or accrued by partnerships and S corporations would be subject to disallowance under the earnings stripping rules if the partnership or S corporation meets the tests that would apply under present law if the partnership or S corporation were a C corporation. Thus, for example, the deduction for interest paid by a partnership to a related person that is exempt from tax would be disallowed if the partnership's debt/equity ratio exceeds 1.5 to 1 and the partnership's interest expense exceeds 50 percent of the partnership's adjusted taxable income. As a result, no deduction for this interest would be available to any of the partners. Although an S corporation cannot have foreign shareholders, "disqualified interest" subject to the earnings stripping rules would include interest paid to tax-exempt organizations that are shareholders of the S corporation and interest paid to other related parties as defined under the current rules.

The proposal would incorporate a rule attributing partnership debt to a corporate partner for purposes of applying the earnings stripping rules to the corporation (a rule that is in Prop. Treas. Reg. sec. 1.163(j)-3(b)(3)). The rule attributing partnership interest expense to corporate partners for possible disallowance under the earnings stripping rules (currently in Prop. Treas. Reg. sec. 1.163(j)-2(c)(5)) would apply under the proposal only after the earnings stripping rules had been applied at the partnership level. If an interest expense of the partnership were disallowed under the

[115] H. Rep. No. 103-111, 103d Cong., 1st. Sess. 682 (1993).
[116] See Freeman and Stephens, supra, at 971.

proposal, there would be no deduction allocated to the corporate partners. If the interest deduction were not disallowed at the partnership level, the amount allocated to a corporate partner would again be subject to disallowance under the proposed regulations based on the corporate partner's own attributes.

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