TAX CONSIDERATIONS IN ENTITY CHOICE

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12TH ANNUAL
CHOICE & ACQUISITION OF ENTITIES IN TEXAS COURSE
May 23, 2014
San Antonio

CHAPTER 2

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William H. Hornberger practices in the Tax and International sections of Jackson Walker. Mr. Hornberger's tax practice emphasizes transactional and international tax matters and tax controversy issues.

Mr. Hornberger is a Certified Public Accountant.

MEMBERSHIPS

Mr. Hornberger is a member of the American Bar Association; the Dallas Bar Association (2005 Chair of Taxation Section); the Texas Bar Association (2001-2002 Chair of Taxation Section); and the Dallas CPA Society (2008-2009 Chair). He is chairman and a member of the Executive Board for the Texas Society of CPAs. He is also a member of the Holocaust Museum of Dallas and the Real Estate Council of Dallas (2008 and 2011 Executive Committee). He serves as National Corporate Counsel for the National Society of Hispanic MBAs. He also served as a member of the advisory board of the Dallas Chapter of AVANCE, Inc. He was a Board member for the Real Estate Council Foundation (2006-2008) and is a Life Fellow of the Texas Bar Foundation.

COMMUNITY INVOLVEMENT

Mr. Hornberger is a past Board Member of The Covenant School (2003-2009) and an adjunct professor in Taxation at the Southern Methodist University School of Law (1996 and 1998). He was also a member of Leadership Dallas (2006).

WILLIAM H. HORNBERGER

AWARDS

Mr. Hornberger was named the 2013 "Lawyer of the Year" in Tax Law (Dallas) by *Best Lawyers* and is listed in *The Best Lawyers in America* under Tax Law (2003-2014). He was named as one of the "Best Lawyers in Dallas" by *D Magazine* (2007-2009, 2011, 2013) and as a "Super Lawyer" by Thomson Reuters (2003-2013). Mr. Hornberger has also received the Dallas CPA Society "CPA of the Year" award (2006-2007) and "Stanley J. Scott CPE" award (2005). He was the recipient of The Real Estate Council of Dallas "President's Award" (2007).

ADMITTED

- Texas

EDUCATION

Mr. Hornberger received both his B.B.A. degree, *with high honors*, and his J.D. degree, *with honors*, from The University of Texas, and he received his LL.M. in Taxation from New York University.

LANGUAGES

Mr. Hornberger is fluent in the Spanish language.

PUBLICATIONS & SPEAKING ENGAGEMENTS

Mr. Hornberger is a frequent speaker and author on tax topics.

Steven D. Moore - *Partner*

Tax

Education

- B.B.A., *with high honors*, The University of Texas at Austin
- J.D., *with honors*, The University of Texas School of Law
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Court Admissions

- 1989, Texas

Steven D. Moore is a state tax lawyer whose practice includes planning and controversy work emphasizing sales tax, Texas franchise (aka "margin") tax, and insurance premium tax. Mr. Moore is dedicated, from a value-driven perspective, to helping his clients fully comply with and control their tax exposure.

Mr. Moore has extensive experience in state tax planning for multi-state business models, and regularly provides tax strategy advice relating to business acquisitions and divestitures.

An effective negotiator, Mr. Moore works to reach successful and economically viable resolutions to Texas sales, franchise, and insurance premium tax audits. To this end, Mr. Moore handles administrative hearings before the Texas Comptroller of Public Accounts and works with the firm's litigation group to prosecute judicial resolution of Texas tax cases.

Recognized for his depth of expertise in state tax matters, Mr. Moore is one of the state's leading attorneys for guidance on the new Texas margin tax and he frequently speaks on this topic, with ongoing commitments for presentations to Texas State Bar and University of Texas CLE programs.

Representative Matters

- Renewable energy project acquisition and development advice to maximize benefits from state and local tax incentives including Chapter 312 and Chapter 313 abatement work

- Frontier legal project design for new solar electricity business models to reconcile complex regulatory and corporate restrictions with state tax incentives

- Aircraft acquisitions, sales, and ongoing operations modeled to achieve best-available state tax treatment

- In-depth experience helping life insurance companies and P&C insurance companies successfully resolve Texas premium tax and retaliatory tax audits

- SALT work in large business acquisitions to navigate (i) Texas franchise tax results, (ii) preservation of state and local incentives, (iii) nexus concerns, (iv) transfer taxes, (v) occasional sale exemptions, and (vi) successor liability

- Planning and compliance with respect to Texas sales tax on services, including bundled "data processing" transactions

- Non-lobby monitoring and advising on pending and proposed Texas tax legislation and policy

Memberships

Mr. Moore is a past Chair of the State Bar of Texas State and Local Tax Committee. Mr. Moore serves on the board of directors for the Austin Technology Council Community Foundation.

Community Involvement

Mr. Moore has a passion for classical music and dedicates a large part of his time to the arts in Austin. He serves as Chairman of the Board of Trustees of KMFA Radio and is actively involved in fundraisers and other community events to help sustain this non-profit service. Mr. Moore is also a past President and Board member of Austin Community Nursery Schools and has served as an Elder and a Finance Chair with the Central Presbyterian Church.

Publications & Speaking Engagements

Mr. Moore's article "Nexus and State Tax Due Diligence" was published in the Summer 2012 edition of *Texas Journal of Business Law*. He has made numerous speaking presentations to major CLE programs across Texas dealing with various state tax and corporate topics, including "The New Texas Margin Tax."

- Nexus and State Tax Due Diligence
- Texas Margin Tax: Emerging Issues in Texas State Taxation
- Legislative Changes Affecting Business Entities
- TGS-NOPEC Victory in Franchise Tax Case has Broad Implications for Texas Businesses
- Franchise Taxpayers Should Check Account Status Online
- On the Margin: The Impact of the Margin Tax on Landlords and Tenants
- Texas Margin Tax: Planning, Strategies, and More
- Margin Tax: Comptroller Expands Definition of Uncompensated Care
- Planning and Choice of Entity After the New Texas Franchise (Margin) Tax
- The New Margin Tax: Unintended Consequences for Healthcare Providers
- New Texas Law Penalizes Failure to Render Business Personal Property
- Aircraft Taxes: Texas State and Local Tax Enforcement on the Rise
- Texas Taxation of Electronic Commerce

News

- Jackson Walker Represents Google in $200 Million Wind Energy Investment

- Jackson Walker Represents Buffalo Studios in Sale of Leading Facebook Game Bingo Blitz
- Jackson Walker Wins Key Victory for Clients Before TCEQ
- Steve Moore Published in 'Texas Journal of Business Law'
- Stephanie Chandler, Gary Fowler, Alex Frutos, and Steve Moore Speak at Advanced Business Law Course
- Steve Moore Speaks on Dominant State And Local Taxes In Texas
- Bryon Egan, Willie Hornberger and Steve Moore Speak at the State Bar of Texas Choice and Acquisition of Entities in Texas Course
- Steve Moore Named to Austin Technology Council Community Foundation's Board of Directors
- Steve Moore Speaks on Nexus and State Tax Due Diligence in M&A Transactions and Multistate Business Models
- Byron Egan and Steve Moore Speak on Legislative Changes Affecting Business Entities
- Jackson Walker Wins Texas Supreme Court Victory for Client in Franchise Tax Case
- Byron Egan, Willie Hornberger and Steve Moore Speak on Choices of Entity and M&A
- Steve Moore Speaks on Understanding Property, Sales & Franchise Tax
- Willie Hornberger and Steve Moore Speak on Margin Tax
- Byron Egan, Willie Hornberger and Steve Moore Speak on Choices of Entity
- Jackson Walker Sponsors State Bar of Texas Annual Meeting
- Byron Egan, Tom Groves, Willie Hornberger, Steve Moore, and Bob Richardson Speak at Choice of Entity Conference

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CHOICE OF ENTITY: TAX OVERVIEW[1]

I: INTRODUCTION.

This outline discusses certain relevant federal income and Texas state tax considerations relating to the selection of an entity for engaging in business or investment. The outline begins with a discussion of the classification of entities for federal tax purposes and, in particular, the check-the-box regulations. It then provides a summary of some of the principal tax considerations relating to sole proprietorships, C corporations, partnerships, limited liability companies and S corporations. This outline does not address the taxation of trusts and estates, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, cooperatives, exempt organizations or insurance companies.

[1]The author thanks the late Larry L. Bean of Jackson Walker L.L.P. for providing helpful comments and suggestions with respect to the original version of this outline. The author also thanks Nelson H. Hunt for his assistance in the preparation of this updated version of the outline.

II: CLASSIFICATION OF ENTITIES FOR FEDERAL TAX PURPOSES.

A. Background. The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes.[2] For example, a partnership is defined to include 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 that is not a trust or estate or a corporation.[3] A corporation is defined to include associations, joint-stock companies, and insurance companies.[4]

B. Final Check-The-Box Regulations. On December 17, 1996, the IRS adopted final entity classification changes (known as the "check-the-box regulations"), generally effective as of January 1, 1997.[5] Under the prior regulations, the classification of an unincorporated organization as a partnership or a corporation depended on whether the entity had a majority of certain prescribed corporate characteristics.[6] The check-the-box regulations replaced these rules with a four-step process for classifying an entity for federal tax purposes.

1. Step One: Determine Whether a Separate Entity Exists for Federal Tax Purposes. The first step in the check-the-box classification process is to determine whether there is a separate entity for federal tax purposes (which is a matter of federal tax law).[7]

a. General Principles.

(1) Federal Tax Law Controls Whether Entity Is Separate from Owners. The issue of whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.[8]

(2) Certain Joint Undertakings May Constitute Separate Entities for Tax Purposes. The check-the-box regulations retain the pre-check-the-box rules regarding joint undertakings. Certain joint undertakings that are not entities under local law may nonetheless constitute separate entities for federal tax purposes. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the individuals actively carry on a trade, business, financial operation, or venture and divide the profits

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[2]Treas. Reg. § 301.7701-1(a)(1).

[3]I.R.C. § 7701(a)(2).

[4]I.R.C. § 7701(a)(3).

[5]Treas. Reg. §§ 301.7701-1(f), 301.7701-2(e), 301.7701-3(f)(1).

[6]Former Treas. Reg. §§ 301.7701-2 and -3; *Larson v. Commissioner*, 66 T.C. 159 (1976), acq. 1979-2 C.B.1.

[7]T.D. 8697, 1997-2 I.R.B. 12; Notice of Proposed Rulemaking, PS-43-95, 1996-1 C.B. 865, 866 [hereinafter "Reg. Notice"].

[8]Treas. Reg. § 301.7701-1(a)(1).

therefrom.[9] For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent; however, a joint undertaking "merely to share expenses" does not create a separate entity.[10] By way of example, the regulations state that a separate entity would not exist for federal tax purposes if two or more persons jointly constructing a ditch merely to drain surface water from their properties. As another example, the regulations provide that "mere co-ownership of property" that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.[11]

(3) Certain Single-Owner Organizations Can Choose Whether to be Recognized. Under the check-the-box regulations, certain organizations (discussed below) that have a single owner can choose to be recognized or disregarded as entities separate from their owners.[12] If an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.[13]

b. Determining Whether a Partnership Exists for Federal Income Tax Purposes. The following discussion explores the definition of a partnership for federal income tax purposes.

(1) Internal Revenue Code and Treasury Regulations. The Internal Revenue Code does not define the term "partnership," but rather furnishes nonexhaustive lists of what a partnership includes and excludes.[14] Section 761(a) of the Code provides, in part, as follows:

> A partnership 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 . . . a corporation or a trust or estate.[15]

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[9]Treas. Reg. § 301.7701-1(a)(2).

[10]Treas. Reg. § 301.7701-1(a)(2).

[11]Treas. Reg. § 301.7701-1(a)(2); *see also* Rev. Proc. 2002-22, 2002-1 C.B. 733 (specifies conditions under which the Revenue Service will consider a request for ruling that an undivided fractional interest in rental real property is not an interest in a business entity).

[12]Treas. Reg. § 301.7701-1(a)(4).

[13]Treas. Reg. § 301.7701-2(a).

[14]*See* I.R.C. §§ 761(a), 7701(a)(2); *Sierra Club, Inc. v. Commissioner*, 103 T.C. 307, 322 (1994), *aff'd in part and rev'd in part on other grounds,* 86 F.3d 1526 (9th Cir. 1996).

[15]*See also* I.R.C. § 7701(a)(2) (identical to I.R.C. § 761(a)).

The Code also does not define the term "partner" but rather furnishes a nonexhaustive list of the types of persons that are included within the term partner. Section 761(b) of the Code provides that the term "partner" means a member of a partnership.[16]

The regulations provide that a joint venture or other contractual arrangement may create a partnership for federal tax purposes if the individuals actively carry on a trade, business, financial operation, or venture and divide the profits therefrom.[17] In determining whether an arrangement constitutes a partnership for federal income tax purposes, the regulations, consistent with established case law, provide that the determination is a matter of federal tax law and does not depend on whether the organization is recognized as a separate entity under state law.[18] Thus, certain joint undertakings that are not entities under state law may nonetheless constitute separate entities for federal tax purposes.

The regulations provide additional guidance on when a partnership is formed "through subtle distinctions set forth in examples in the regulations."[19] One principle derived from these examples is that a partnership is formed if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. A joint undertaking, however, "merely to share expenses" does not create a separate entity.[20] Thus, a partnership does not exist where two persons joint construct a ditch to drain water from their properties. Similarly, no partnership exists by virtue of the "mere co-ownership of property" that is maintained, kept in repair, and rented or leased.[21]

(2) Case Law. There is extensive case law on the question of what constitutes a partnership for federal income tax purposes.

(a) U.S. Supreme Court Established Intent Test in *Tower* and *Culbertson* Cases. The landmark U.S. Supreme Court cases addressing what constitutes a valid partnership for federal income tax purposes are *Commissioner v. Tower*[22] and *Commissioner v. Culbertson*.[23] In these cases, the Supreme Court provided general principles for determining whether persons have joined together as partners in a partnership for federal income tax purposes. The primary inquiry is whether the parties intended to, and did in fact, join

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[16]*See* Treas. Reg. § 1.761-1(b); *see also* I.R.C. § 7701(b) (partner includes member in a partnership).

[17]Treas. Reg. § 301.7701-1(a)(2); T.D. 8697, 1997-2 I.R.B. 12; Reg. Notice, 1996-1 C.B. at 866.

[18]Treas. Reg. § 301.7701-1(a)(1); *see Alhouse v. Commissioner*, 62 T.C.M. (CCH) 1678, 1680 (1991), *affd. sub nom. Bergford v. Commissioner*, 12 F.3d 166 (9th Cir. 1993).

[19]*Alhouse*, 62 T.C.M. (CCH) at 1680.

[20]Treas. Reg. § 301.7701-1(a)(2).

[21]Treas. Reg. § 301.7701-1(a)(2); *see also* Rev. Proc. 2002-22, 2002-1 C.B. 733 (specifies conditions under which the Revenue Service will consider a request for ruling that an undivided fractional interest in rental real property is not an interest in a business entity).

[22]327 U.S. 280 (1946).

[23]337 U.S. 733 (1949).

together to operate a business and share in its profits or losses or both. The inquiry is essentially factual and all relevant facts and circumstances must be examined. The determination of whether an arrangement constitutes a partnership is controlled by federal tax law, regardless of how the parties are treated under state law.[24]

In *Tower*, the Supreme Court upheld the Tax Court's conclusion that a valid partnership had not been established, stating:

> When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention is a question of fact, to be determined from testimony disclosed by their "agreement, considered as a whole, and by their conduct in execution of its provisions.[25]

In *Culbertson*, the Supreme Court reiterated the *Tower* intent test and emphasized that the test is concerned specifically with intent rather than objective indicia, stating:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[26]

Both *Culbertson* and *Tower* were family partnership cases. While family partnerships present some problems not present in non-family partnerships,[27] the case law holds that the general principles set out in *Tower* and *Culbertson* apply to all partnership situations.[28]

(b) Factors Adopted by the Tax Court for Determining Intent. In the 1964 case of *Luna v. Commissioner*,[29] the Tax Court distilled the principles set forth by the U.S. Supreme Court in *Tower* and *Culbertson* to set forth the following

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[24]*See Commissioner v. Tower*, 327 U.S. 280, 286 (1946); *Sierra Club, Inc. v. Commissioner*, 103 T.C. 307 (1994), *aff'd in part and rev'd in part on other grounds,* 86 F.3d 1526 (9th Cir. 1996); *Reinberg v. Commissioner*, 90 T.C. 116 (1988); *Koss v. Commissioner*, 57 T.C.M. (CCH) 882, 890 (1989) ("Thus, whether a partnership or joint venture exists depends on whether the parties intended to, and *did in fact*, join together for the present conduct of an undertaking or enterprise." (Emphasis in original.)).

[25]327 U.S. at 286-287 (citations omitted).

[26]337 U.S. at 742; *see Estate of Smith v. Commissioner*, 313 F.2d 724 (8th Cir. 1963).

[27]*See generally* I.R.C. § 704(e); Treas. Reg. § 1.704-1(e).

[28]*Estate of Smith*, 313 F.2d 724, 728-29 (8th Cir. 1963); *James*, 16 T.C. at 939.

[29]42 T.C. 1067, 1077-1078 (1964).

factors as relevant in evaluating whether parties intend to create a partnership for federal income tax purposes (the "*Luna* Factors"):

> 1. The agreement of the parties and their conduct in executing its terms;
>
> 2. The contributions, if any, which each party has made to the venture;
>
> 3. The parties' control over income and capital and the right of each to make withdrawals;
>
> 4. Whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
>
> 5. Whether business was conducted in the joint names of the parties;
>
> 6. Whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers;
>
> 7. Whether separate books of account were maintained for the venture; and
>
> 8. Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

The courts continue to employ the *Luna* factors as a guide in determining whether a partnership exists for federal income tax purposes.[30] None of the *Luna* factors, however, is conclusive of the existence of a partnership.[31] The principles used to determine whether there is a partnership for federal tax purposes are equally applicable to determine whether there is a joint venture for federal tax purposes.[32]

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[30] *See, e.g., Boca Investerings Partnership v. U.S.*, 167 F.Supp.2d 298 (D.D.C. 2001), *rev'd on other grounds*, 314 F.3d 625 (D.C. Cir. 2003); *Sierra Club, Inc. v. Commissioner*, 103 T.C. at 323, *aff'd in part and rev'd in part on other grounds*, 86 F.3d 1526 (9th Cir. 1996); *Comtek Expositions, Inc. v. Commissioner*, 85 T.C.M. (CCH) 1280, 1290 (2003), *aff'd*, 93 AFTR 2d 2004-2537 (2nd Cir. 2004).

[31] *Burde v. Commissioner*, 352 F.2d 995, 1002 (2d Cir. 1965), *affg.* 43 T.C. 252 (1964); *McDougal v. Commissioner*, 62 T.C. 720, 725 (1974); *Comtek Expositions, Inc.*, 85 T.C.M. (CCH) at 1293.

[32] *Sierra Club, Inc. v. Commissioner*, 103 T.C. at 323, *aff'd in part and rev'd in part on other grounds*, 86 F.3d 1526 (9th Cir. 1996); *Luna v. Commissioner*, 42 T.C. 1067, 1077 (1964); *Beck Chem. Equip. Corp.*, 27 T.C. at 848-849; *Comtek Expositions, Inc.*, 85 T.C.M. (CCH) at 1280.

(c) Examining the *Luna* Factors. An examination of the case law that has developed since the Tax Court issued the *Luna* decision in 1964 is helpful for purposes of determining whether an arrangement among two or more persons constitutes a partnership for federal income tax purposes. While an exhaustive review of the case law in this area is beyond the scope of this outline,[33] certain basic principles emerge from a review of cases in the area.

i) Agreement of the Parties and Their Conduct in Executing Its Terms. The existence of a formal signed partnership agreement between the parties may constitute evidence that the parties intended to enter into a partnership but is not conclusive of the issue.[34] The courts appear to give greater weight to an agreement that defines in some depth the rights and obligations of the parties to the partnership.[35]

The absence of any explicit agreement is not determinative of the absence of a partnership for federal income tax purposes.[36] Moreover, parties may constitute a partnership for

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[33]For an excellent summary of the case law in the area, *see* William S. McKee, et al., *Federal Taxation of Partnerships and Partners*, ¶ 3.02 (3d ed. 2007) [hereinafter "*McKee"*].

[34]*See, e.g., S & M Plumbing Co. v. Commissioner*, 55 T.C. 702, 707 (1971) ("On June 29, 1962, S & M and Ten Oaks, as Harry's nominee, executed an agreement which specifically stated that the parties were thereby entering a joint venture for the performance of two construction contracts for the board of education."); *Hunt v. Commissioner*, 59 T.C.M. (CCH) 635, 645 (1990) ("N. B., W. H., Lamar, and PIC (Placid's wholly-owned subsidiary) entered into a formal partnership agreement, the execution of which suggests that the parties intended to enter into a bona fide partnership.").

[35]*See Clifton v. Commissioner*, 70 T.C.M. (CCH) 1175, 1178 (1995) ("Although a partnership certificate was signed by both petitioner and Daro, the terms of the agreement relate exclusively to the Orad joint checking account. The agreement is a one-page document that addresses the relationship of petitioner, Daro, and the bank relative to the joint checking account; the document does not address the signatories' business relationship, if any. Accordingly, we find that this agreement alone does not demonstrate petitioner's and Daro's intent to carry on a business as partners."); *Mayhew v. Commissioner*, 63 T.C.M. (CCH) 1984, 1987 (1992) ("Initially, the parties' agreement contained provisions that are inconsistent with an agreement between co-owners. In this respect, it termed as "salary" petitioner's rights to draw against future profits, and contemplated that petitioner would receive "ownership in one of the companies in some form" subsequent to the Fairways project."); *Hunt*, 59 T.C.M. (CCH) at 645 ("The agreement provided for (i) the contribution of significant amounts of capital by both Placid and the Hunts; (ii) the management and control of PIL's assets; (iii) the sharing of profits and losses from the business; (iv) the manner and order of cash distributions by PIL; and (v) the allocation for Federal income tax purposes of income, gain, loss, deductions, and credits resulting from such operations."); *Wheeler v. Commissioner*, 37 T.C.M. (CCH) 883, 890 (1978) ("The agreement between the parties seems fairly clear in this case. It specifically stated: 'The parties hereto are associated in a joint venture, under the name of "Perrault and Wheeler," for the purpose of holding, developing, and managing real property for investment purposes.'").

[36]*McManus v. Commissioner*, 65 T.C. 197, 210 (1975), *aff'd* 583 F.2d 443 (9th Cir. 1978); *Demirjian v. Commissioner*, 54 T.C. 1691 (1970), *aff'd* 457 F.2d 1 (3d Cir. 1972); *Sierra Club, Inc. v. Commissioner*, 103 T.C. 307 at 324 ("We do not find the absence of any explicit acknowledgment of joint venture status to be determinative."), *aff'd in part and rev'd in part on other grounds*, 86 F.3d 1526 (9th Cir. 1996); *Cohen v. Commissioner*, 15 T.C. 261, 272 (1950) ("The absence of an express agreement to share in losses is not material, since such an agreement may be implied from their agreement to share profits."); *Comtek Expositions, Inc.*, 85 T.C.M. (CCH) 1280, 1290 (2003) ("The existence or lack of a written agreement is not determinative of whether a joint venture existed between petitioner and Crocus."); *Baker v. Commissioner*, 74 T.C.M. (CCH) 744, 747 (1997) ("It is true that there was no written partnership agreement. However, the lack of a written agreement is not

federal income tax purposes even though they expressly disclaim any intention to enter into a partnership relationship for federal income tax purposes.[37]

Under the Treasury regulations, a partnership agreement may be oral or written.[38] In *Beck Chem. Equip. Corp. v. Commissioner*,[39] the Tax Court found there was a joint venture on the basis of an oral agreement between the parties.[40]

The Tax Court also looks to the actual conduct of the parties to see if it supports the existence of an agreement between the parties.[41] In a 1975 General Counsel Memorandum, the

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dispositive. We have previously held that a partnership existed without a written agreement where other evidence indicated that two or more individuals intended to and did operate as a partnership.").

[37]*See Haley v. Commissioner*, 203 F.2d 815, 856 (5th Cir. 1953) ("[E]ven though it was expressly stated that the parties did not intend to enter into a joint venture or partnership, if the agreements and the conduct of the parties thereunder plainly show the existence of such relationship, and the intent to enter into it, it will nevertheless be held to exist for tax purposes."); *Estate of Koen v. Commissioner*, 14 T.C. 1406, 1409 (1950) ("Even if we adopt his testimony, however, as to the agreement he made with Koen, the circumstances leading up to that agreement, and the manner in which it was to be performed, including his statement to the effect that he had no intention of entering into a partnership with Koen, the legal status of the business as a joint venture is not contradicted."); *Comtek Expositions, Inc.*, 85 T.C.M. (CCH) at 1290-91 ("Petitioner and respondent agree that both petitioner and Crocus made significant contributions to foreign trade shows. This Luna factor supports the finding of a joint venture between petitioner and Crocus during the taxable periods at issue."); *Duley v. Commissioner*, 41 T.C.M. (CCH) 1521, 1528-29 (1981) ("It is possible for a partnership to be created without any announced intention of the parties to do so."); *Kelly v. Commissioner*, 29 T.C.M. (CCH) 1090, 1102 (1970) ("It is well settled that 'neither local law *nor the expressed intent of the parties* as to the legal nature and effect of their *** agreements are conclusive as to the existence or nonexistence of a partnership *** for Federal tax purposes.'"); *Baughn v. Commissioner*, 28 T.C.M. (CCH) 1447, 1456 (1969) ("Individuals may constitute a partnership for tax purposes even though they expressly disclaim any intention to enter into a partnership relation.").

[38]Treas. Reg. § 1.761-1(c).

[39]27 T.C. 840 (1957).

[40]27 T.C. at 843, 849-853; *see also Ayrton Metal Co. v. Commissioner*, 34 T.C. 464, 472 (1960) ("[T]he terms of a joint venture may be informal and need not be reduced to writing."), *aff'd in part and rev'd in part on other grounds*, 299 F.2d 741 (2d Cir. 1962); *Comtek Expositions, Inc.*, 85 T.C.M. (CCH) at 1290 ("Even though petitioner claims there was an oral agreement between petitioner and Crocus to an equal split of net profits from foreign trade shows conducted from 1990 to 1996, petitioner has not introduced any documentary or testimonial evidence of the existence of any such alleged oral agreement. Petitioner has provided no evidence to show that it and Crocus did in fact split net profits equally. * * * This Luna factor weighs against the finding of a joint venture between petitioner and Crocus during the taxable periods at issue.").

[41]*Evans v. Commissioner*, 447 F.2d 547, 551 (7th Cir. 1971) ("Partnerships, for tax purposes, have been implied from conduct of the parties, in the absence of any written agreement and even where the parties deny any intent to form one."); *Estate of Smith*, 313 F.2d at 731 ("[T]he name given to a relationship in the contract or agreement is not conclusive on the issue of what it really is."); *Mayhew*, 63 T.C.M. (CCH) at 1987 ("It appears that SMLA termed the agreement a "joint venture" merely to obtain petitioner's services, not out of any intent to actually enter into a joint venture until sometime subsequent to the Fairways project. Additionally, the notes made by a representative of SMLA at or near the time of sale terming petitioner's share of the proceeds a 'bonus' suggest that SMLA viewed the proceeds as compensation for services."); *Wheeler*, 37 T.C.M. (CCH) at 890 ("The actual conduct of the parties supported the existence of a joint venture agreement between the parties. It was petitioner who exercised his authority on a day-to-day basis in selecting subcontractors, signing subcontracts, approving payrolls, approving interim payments to subcontractors, approving payments for materials, approving change orders in

Revenue Service, citing *Tower*, stated that the "mere fact" a person "is characterized as a general partner in the partnership agreement and in the certificate of limited partnership is not binding for federal income tax purposes."[42]

ii) The Contributions, If Any, Which Each Party Has Made to the Venture. This factor from *Luna* examines the contributions made by each party for evidence of intent to constitute a partnership. If a party fails to contribute either capital or services, this fact alone would seem to make it highly unlikely that the person should be recognized as a partner for federal income tax purposes.[43] G.C.M. 36,961 (Dec. 21, 1976) states that "[t]his [factor from *Luna*] standing alone is ambiguous. Presumably the [*Luna*] Court was not suggesting that the failure to make contributions of any kind is merely one factor to be considered in determining whether someone is a partner, for it is fundamental that a person must contribute either capital or services in order to be considered a partner."[44]

G.C.M. 36,961 cites *Tower* and *Culbertson* for the proposition that a person must contribute either capital or services in order to be considered a partner. In *Tower*, the Supreme Court determined that the evidence justified the Tax Court's holding that no partnership existed between a husband and wife. Viewing the question as one of whether the parties had jointly earned the income, the Court held that a partnership is created: "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business, and when there is community of interest in the profits and losses." In *Culbertson*, the Supreme Court stated:

> Unquestionably a court's determination that the services contributed by a partner are not "vital" and that he has not participated in "management and control of the business" or contributed "original capital" has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners. But such a determination is not conclusive, and that is the vice in the 'tests' adopted by the Tax Court. It assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the

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construction, and negotiating the F.H.A. commitments among other things. While any one of these duties may not raise one to the status of a joint venturer, the total authority granted to petitioner was certainly consistent with such status.").

[42]G.C.M. 36,142 (Jan. 20, 1975); *see also* Rev. Rul. 75-31, 1975-1 C.B. 10 (in holding that it is not a partner for federal income tax purposes, ruling states that "*H* has no interest and will never have an interest in any item of income, gain, loss, deduction, credit or capital of *X*, nor will it have any beneficial interest in the receipts, investments or other property of *X* during the operation or upon the liquidation of *X*. Therefore, under these circumstances *H* will not be considered a partner of *X* for Federal income tax purposes."); G.C.M. 36,113 (Dec. 19, 1974) ("[W]e do not believe that the rights and obligations of the individuals designated general partners' under the partnership agreement of *** sufficiently establish that they are in fact general partners. The fact that a party is called a "partner" in the Agreement, for example, is insufficient in itself to support that conclusion; the question here is whether that formal indicia has substance.").

[43]*See McKee*, ¶ 3.02[5][b][ii] ("[I]n a non-capital intensive venture, the performance of services in connection with the venture's business is virtually essential to establish a person as a partner, although a person might also legitimately claim partner status if he provided something else of value (such as business contacts).").

[44]Emphasis added.

> partnership. If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient. The *Tower* case did not purport to authorize the Tax Court to substitute its judgment for that of the parties; it simply furnished some guides to the determination of their true intent.

A factor that evidences a partnership is a party's contribution to, and ownership of capital in, the partnership.[45] Contribution of capital to a partnership where capital is a material income-producing factor virtually assures that the contributor will be treated as a partner.[46] Section 704(e)(1) of the Code provides that a person will be recognized as a partner for the purposes of Subtitle A of the Code if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. Treas. Reg. § 1.704-1(e)(1)(v) provides that, for purposes of section 704(e), a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.

The contribution of valuable services to a partnership has also been held to be indicative of a partnership arrangement.[47] Moreover, in Rev.Rul. 54-84,[48] the Service held that the combination of service and capital partners, the absence of loss sharing, and title being held to venture property by one venturer (the one who made the capital contributions) was not fatal to the existence of a joint venture.

iii) The Parties' Control Over Income and Capital and the Right of Each to Make Withdrawals. The exercise by the parties of mutual or

[45] *Lausterer v. Commissioner*, 69 T.C.M. (CCH) 2247 (1995); *Hunt*, 59 T.C.M. (CCH) at 648 (partnership; general partner contributed substantial cash, note and services; other partners contributed various assets; values ascribed by parties for capital account purposes were reasonable); *Kelly*, 29 T.C.M. (CCH) at 1102.

[46] *Evans*, 54 T.C. at 51; *McKee,* ¶ 3.02[5][b][ii]("If, on the other hand, capital is a material income–producing factor in a venture's business, the ownership of an interest in venture capital, coupled with an interest in venture profits, virtually assures that the owner of such capital will be treated as a partner, absent extenuating factors indicating that the owner is actually a creditor or lessor.").

[47] *Wheeler,* 37 T.C.M. (CCH) at 891 ("[W]e believe petitioner's contribution of his skill and know-how in developing commercial realty and Perrault's contribution of the capital necessary to get the projects under way were essential elements of the business enterprise. While not entirely free from doubt, we believe the totality of the relationship between the parties must be viewed as a joint venture."); *See generally McKee,* ¶ 3.02[5][b][ii] ("Alternatively, a person's status as a partner may be confirmed by the performance of valuable services on behalf of the venture, or by making credit available to the partnership.")

[48] 1954-1 CB 284.

joint control over income and capital and the assumption of mutual responsibilities for the venture are factors that evidence the existence of a partnership.[49]

iv) Whether Each Party Was a Principal and Coproprietor, Sharing a Mutual Proprietary Interest in the Net Profits and Having an Obligation to Share Losses, or Whether One Party Was the Agent or Employee of the Other, Receiving for His Services Contingent Compensation in the Form of a Percentage of Income. Another factor indicating the formation of a partnership is that each party is a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to shares losses.

a) Sharing of Profits. The Tax Court has held that one of the central features of a partnership is the sharing of profits as coproprietors.[50] While the sharing of profits is not conclusive on the existence of a partnership, there are a series of Tax Court cases where the Tax Court has stated that one of the essential principles of a partnership is an agreement to share profits.[51] Moreover, one U.S. Bankruptcy

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[49] *Sierra Club, Inc. v. Commissioner*, 103 T.C. at 324, *aff'd in part and rev'd in part on other grounds*, 86 F.3d 1526 (9th Cir. 1996); *Comtek Exposition, Inc.*, 85 T.C.M. (CCH) at 1291 ("Petitioner and Crocus did not have mutual or joint control over capital and income generated by foreign trade shows. During the taxable periods at issue, petitioner or ECI collected and controlled fees from exhibitors located outside the former Soviet Union, which accounted for 90 percent of all foreign trade show fees, and Crocus collected and controlled fees from exhibitors located in the former Soviet Union, which accounted for the remaining 10 percent of all foreign trade show fees. Nothing in the record indicates that Crocus had control over or a right to make withdrawals or to receive distributions or payments from the share of receipts collected by petitioner and ECI during the taxable periods at issue."); *Lausterer*, 69 T.C.M. (CCH) at 2250 ("The testimony showing the parties' control over income and capital and the right to make withdrawals was that Ms. Kern saw Mr. Muffley and petitioner splitting the income; and the individuals from the various establishments indicated that typically either Mr. Muffley or petitioner, not both, would deal with a particular establishment. This indicates to us that Mr. Muffley and petitioner were in mutual control over the business."); *Hunt*, 59 T.C.M. (CCH) at (factor in favor of partnership was that partnership actively managed assets during its two years of operation).

[50] *Federal Bulk Carriers, Inc. v. Commissioner*, 66 T.C. 283, 293 (1976) "(Above all, however, it is the absence of the central feature of a joint venture—a proprietary interest in the net profits of the enterprise coupled with an obligation to share its losses—which leads us to conclude that a joint venture did not exist."), *aff'd,* 558 F.2d 128 (2d Cir. 1977)

[51] *Sierra Club, Inc. v. Commissioner*, 103 T.C. at 327 ("On the facts before us, we are unable to conclude that petitioner possessed a mutual proprietary interest in any net profits. Simply put, petitioner's participation in the financial risk and reward factors attendant to Chase Lincoln's extension of credit to cardholders was too limited to constitute a mutual proprietary interest in the net profits of that activity. The SC-ABS agreement entitled petitioner to contingent compensation, measured in chief by total cardholder sales volume. It did not entitle petitioner to a share in the net profit of a joint venture."), *aff'd in part and rev'd in part on other grounds,* 86 F.3d 1526 (9th Cir. 1996); *S & M Plumbing Co.*, 55 T.C. at 702 (agreement to share profits is one of four basic attributes which are indicative of a joint venture); *Podell*, 55 T.C. at 429 (agreement to share profits but not necessarily losses is one of four basic attributes which are indicative of a joint venture); *Wm. J. Lemp Brewing Co. v. Commissioner*, 18 T.C. 586, 596 (1952) ("The agreement in question makes no mention of sharing either profits or losses. That there is no provision for sharing losses is not controlling, but the element of profit sharing is an important factor in determining whether a joint venture exists."); *Form Builders, Inc., v. Commissioner*, 58 T.C.M. (CCH) 1415, 1417 (1990) ("Having examined all the relevant facts and circumstances of this case, we find that no partnership existed between petitioner and the Shoen children. Most notably, we find that their arrangement lacked a joint profit motive, a fundamental aspect of the "joining together in the present conduct of an enterprise" required by *Culbertson*.");

Court that has recently taken up the issue held, "as a matter of law, that for purposes of federal income taxation, while the presence of a sharing of profits (and not merely gross receipts) is not, by itself, conclusive of whether an arrangement constitutes a joint venture, such sharing of profits must nonetheless be present in order for a joint venture to exist; i.e., the sharing of profits is a necessary, but not sufficient, condition for a finding that a joint venture exists."[52]

There are some general counsel memoranda from the 1970s suggesting that the Service also views the sharing of profits as a necessary (but not sufficient) condition for finding a partnership for federal income tax purposes. For example, in G.C.M. 36,113 (Dec. 19, 1974), the Service stated:

> We believe that the absence of any interest in profits or losses alone conclusively establishes that no partnership relationship has been created between the individuals and the other members of *** Certainly it can be no more plainly demonstrated that a party has not joined other "for the purpose of carrying on business and sharing in the profits or losses or both" than that they have been pointedly excluded from the profits or losses of the enterprise.

In G.C.M. 36,436 (Sept. 25, 1975), the Service confirmed that "[a] sharing of profits, however, is not alone sufficient to make partners or joint venturers out of participants in a business enterprise . . . A profit share in a business enterprise can be received by an employee or independent contractor as compensation for services without the employee or independent contractor becoming a partner in the enterprise."[53]

Relatively recent field service advice issued by the Service acknowledge a profit sharing requirement. In F.S.A. 200128037 (July 16, 2001), the Service characterized the sharing of profits, together with the contribution of capital and its risk of loss, and the sharing of control over the enterprise, as the "hallmarks of a partnership." In F.S.A. 1995-10 (May 18, 1995), the

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Allison v. Commissioner, 35 T.C.M. (CCH) 1069, 1077 (1976) (no partnership was formed in the absence of a joint profit motive); *Kazdin v. Commissioner*, 28 T.C.M. (CCH) 432, 434 (1969) ("Of critical significance is the absence of any agreement to share profits and losses . . . That there were no actual profits to share is immaterial. The key is that if there had been profits, they would have been shared."); *Mayer v. Commissioner*, 13 T.C.M. (CCH) 391, 393 (1954) ("This sharing of profits is evidence of a partnership, but in itself it is not sufficient to prove a partnership, particularly where there was no sharing of the losses."); s*ee generally McKee* et al., Federal Taxation of Partnerships and Partners, ¶ 3.02[2] (3d ed. 2004) ("Generally, the most important factor is evidence that the participants in an arrangement intended to join together to make and share profit as coproprietors.").

[52]*In re Acme Music Co. Inc.*, 196 B.R. 925, 934 (1996); *see also Place v. Commissioner*, 17 T.C. 199 (1951) ("Nor has petitioner submitted sufficient evidence of the normal attributes of a joint venture or partnership. The sharing of profits is not in itself sufficient."), *aff'd*, 199 F.2d 373 (6th Cir. 1952), *cert. denied*, 344 U.S. 927 (1953).

[53]*See* Rev. Rul. 75-43, 1975-1 C.B. 383; *cf.* Priv. Ltr. Rul. 8222008 (2/24/1982) ("A sharing of profits, however, is not alone sufficient to make partners out of participants in a business enterprise. A profit share in a business enterprise can be received by an employee or independent contractor as compensation for services without the employee or independent contractor becoming a partner in the enterprise." (Citations omitted.)). Private letter rulings are not binding as "precedent," but they often represent a substantial indication of the position of the Revenue Service on an issue.

Service stated that "[t]he sharing of profits seems to be required." In F.S.A. 1999-835, the Service stated that:

> The hallmarks of a partnership or joint venture are the sharing of profits, the contribution of capital and its risk of loss, and the sharing of control over the enterprise. *Reinberg v. Commissioner*, 90 T.C. at 137. * * * An overview of the case law by McKee, et al., has discerned three requisites that generally must be satisfied for a commercial undertaking to be classified as a partnership for federal tax purposes. First, there is a requirement of profit motive. Second, the parties must contemplate that the profits will be shared jointly. Finally, the parties must be sharing the profits as coproprietors. The third requisite is the ultimate, as well as the most elusive, distinction between a partnership and other profit-sharing arrangements.[54]

In Rev. Rul 75-31[55], the Service concluded that a general partner with no interest in capital or profits and with no beneficial or entrepreneurial interest in the partnership would not be treated as a partner for federal income tax purposes. In Rev. Rul. 75-31, D, a real estate management corporation, formed X, a limited partnership, and became the managing general partner. D then organized a corporation, H, with nominal capital to receive certain desired financing for the project. All the stock of H was owned by D. H and X executed a Declaration of Interest stating that (1) H had acquired and would continue to hold title to the project as a general partner of and on behalf of X; (2) X has the equitable interest in the project, notwithstanding that H holds legal title to such project; (3) H has no interest, and will never have any interest in the items of income, gain, loss, deduction, credit or capital of X, nor will it have any beneficial interest in any receipts, investment or other property of X; and (4) H became a general partner of X pursuant to, and solely for the purpose of, certain regulatory requirements. The Declaration further stated that all loan proceeds, all income realized in the operation of the project which is subject to the lien of mortgage, and all required equity capital of X, will be deposited in accounts in the name of H as general partner of X, but that H will have no equitable interest in such proceeds, income or capital directly or as a partner of X; that subject to regulatory limits, H would, upon direction of X, sell, assign, or otherwise transfer the project property to X's designee; and that upon repayment of the loan, H would forthwith convey legal title to such project to X and thereafter dissolve.

Rev. Rul. 75-31 concludes that "H has no interest and will never have an interest in any item of income, gain, loss, deduction, credit or capital of X, nor will it have any beneficial interest in the receipts, investments or other property of X during the operation or upon the liquidation of X. Therefore, under these circumstances H will not be considered a partner of X for Federal income tax purposes." G.C.M. 36,142 (Jan. 20, 1975), concurring with Rev. Rul. 75-31, states that

> As noted above, the LPHC characterized as a general partner of X in the documents it executes on behalf of X, and the partnership agreement and certificate of limited partnership both characterize the LPHC as a general partner

[54] Citations omitted.

[55] 1975-1 C.B. 10.

> of X. The mere fact, however, that the LPHC is characterized as a general partner in the partnership agreement and in the certificate of limited partnership is not binding for Federal income tax purposes. Although many factors must be considered in determining if a partnership exists and whether a particular party is a partner, the sharing of profits is generally given more weight than the other factors considered. Furthermore, we are unaware of any case in which a party that lacked an interest in both profits and losses of the enterprise was held to be a partner.
>
> In the instant case, not only does the LPHC not share in the profits of the venture, but it will make no capital contribution and will not become entitled to share in any distribution of capital. Further it has no beneficial interest in any property held by X. The LPHC has absolutely no entrepreneurial interest in X. Based on these facts we believe that the LPHC should not be treated as a partner of X for Federal income tax purposes. Instead, it must be viewed as an agent or nominee acting on behalf of X.[56]

Two private letter rulings provide some insight into how the Service might view non-economic members of an LLC. Although private letter rulings are not binding as precedent, such rulings often represent a substantial indication of the position of the Service on an issue. In Private Letter Ruling 199911033, the Revenue Service addressed the federal income tax classification of an LLC with two members. The facts of the ruling are as follows: A grantor trust ("Trust") was engaged in a deferred like-kind exchange. In arranging financing for the replacement property, the lender insisted that legal title to the replacement property be held by a bankruptcy remote entity. To satisfy this requirement, Trust proposed the formation of an LLC with two members, Trust and a corporation wholly owned by Trust ("Member2"). To protect the interests of the lender (the "Lender"), one of the members of the Board of Directors of Member2 would be a representative of Lender. The Replacement Property would be transferred directly to the LLC.

The principal terms of the LLC Operating Agreement (the "Agreement1") were as follows: (1) Except as otherwise provided in the Agreement1, all decisions of the LLC would be made solely by Trust; (2) for so long as the loan from Lender was outstanding, without the approval of Member2 (whose Board of Directors vote was required to be unanimous) the LLC would not (1) file or consent to the filing of a bankruptcy or insolvency petition or otherwise institute insolvency proceedings; (2) dissolve, liquidate, merge, consolidate, or sell substantially all of its assets; (3) engage in any business activity other than those specified in its Certificate of Formation; (4) borrow money or incur indebtedness other than the normal trade accounts payable and any other indebtedness expressly permitted by the documents evidencing and securing the loan from Lender; (5) take or permit any action that would violate any provision of any of the documents evidencing or securing the loan from Lender; (6) amend the Certificate of Formation concerning any of the preceding items; or (7) amend any provision of Agreement1 concerning any of the preceding items. Items 2 and 7 required the prior written consent of the Lender.

With the exception of the foregoing rights, Member2 would have no other rights relating to the management of the LLC. Agreement1 provided that all profits, losses, and credits of the

[56]Citations omitted.

LLC would be allocated to Trust. In addition, all distributions of net cash flow and capital proceeds would be made entirely to Trust. Furthermore, upon the dissolution of LLC, Trust would wind up the affairs of LLC in any manner permitted or required by law, provided that the payment of any outstanding obligations owed to Lender would have priority over all other expenses or liabilities.

For federal income tax classification purposes, the Service concluded that the LLC would be treated as owned entirely by Trust and disregarded as an entity separate from its owner. The Service, citing *Tower*, *Culbertson* and *Luna*, stated that the members of the LLC did not join together to form a partnership for federal tax purposes. The Service cited Agreement1 as evidence of the parties' lack of intent to operate a business and share profits and losses. According to the Service, Member2 was a member of LLC for the sole limited purpose of preventing Trust from placing LLC into bankruptcy on its own volition. Member2 had no interest in LLC's profits or losses and neither managed the enterprise nor had any management rights other than those limited rights described above. Thus, for federal tax purposes, the Service determined that the LLC would not be treated as a partnership between Trust and Member2 but rather as being owned solely by Trust. Trust represented that the LLC would not elect to be treated as a corporation; therefore, the Service treated the LLC as a disregarded single-member LLC.

PLR 199914006 also involves the classification of an LLC for federal income tax purposes. The facts in this ruling are as follows: PRS, a general partnership, contributed property to an LLC in exchange for a 100 percent interest in the LLC. PRS also owned 100 percent of the voting stock of a corporation ("MemberB"). MemberB became a member of the LLC without holding a membership interest. (The ruling states that, pursuant to the relevant state statute, a person could be admitted to an LLC as a member and could receive an LLC interest without making a contribution or being obligated to make a contribution to the LLC. The statute also provided that, unless otherwise provided in an LLC agreement, a person could be admitted to an LLC as a member without acquiring an interest in the LLC.)

Under the LLC Operating Agreement ("Agreement2"), MemberB was not entitled to receive any distributions, income, gain, profit, loss, deduction, credit, or other sum from the LLC. Except as noted below, MemberB had no management, approval, voting, consent, or veto rights in connection with the LLC. MemberB could not transfer, sell, assign, hypothecate, or otherwise encumber its interest in LLC, nor could it withdraw from the LLC. MemberB's rights were limited to approving any act by LLC: (1) to engage in any business or activity beyond its stated purpose; (2) to file a voluntary or involuntary petition for bankruptcy; (3) to voluntarily dissolve, liquidate, consolidate, or merge with any other entity; (4) to sell substantially all of LLC's assets; or (5) to amend LLC's certificate of formation, its stated purpose, or its governing agreement regarding dissolution and liquidation. MemberB was also required to continue LLC's business in the event of PRS's bankruptcy. PRS paid MemberB to join LLC under these conditions.

For federal income tax classification purposes, the Service concluded that the LLC would be treated as owned entirely by PRS and disregarded as an entity separate from its owner. The Service, citing *Tower*, *Culbertson* and *Luna*, stated that the members of the LLC did not join together to form a partnership for federal tax purposes. The Service cited AgreementB as evidence of the parties' lack of intent to operate a business and share profits and losses. According to the Service, MemberB had no interest in the LLC's profits or losses and neither managed the enterprise nor had any management rights other than those limited rights described above. Thus, for federal income tax purposes, the Service determined that PRS and MemberB would not be treated as partners of MemberB. Instead, the LLC would be treated as being owned solely by PRS. PRS represented that the LLC would not elect to be treated as a corporation; therefore, the Service treated the LLC as a disregarded single-member LLC.

Although there are a number of Tax Court cases and some official and unofficial Revenue Service authority indicating that a sharing of profits is required in order for a partnership to exist, the Service has taken the position in the past that the presence or absence of a profit motive is but one factor to be considered in determining the existence of a partnership.[57] In *Brannen v. Commissioner*,[58] a tax shelter partnership that was not engaged in business for profit under Section 183 was treated as a partnership. In finding a partnership, the Tax Court appears to rely on *Madison Gas & Electric Co. v. Commissioner*[59] for the proposition that a joint profit motive is not required to find a partnership.

In *Madison Gas & Electric Co.*, Madison Gas and Electric ("MGE") entered into a joint power supply agreement with two other utilities to construct and own together a nuclear generating plant.[60] The three utilities entered into this relationship as tenants in common with undivided ownership interests.[61] The agreement provided that electricity produced would be distributed to each utility in kind in proportion to each utility's ownership interest.[62] Each utility would then sell its own share of electricity. This power was not offered for sale by the utilities collectively. Furthermore, each utility paid a proportionate share of the expenses based upon percentage ownership.[63] MGE argued that a tenancy in common does not meet the business activities test of a partnership unless co-tenants anticipate earning and sharing a single joint cash profit.[64] The Tax Court held that the arrangement in Madison Gas established an unincorporated organization that carried on a business, financial operation, or venture, which falls within the

[57] *See Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980); *cf.* Private Letter Ruling 7903084 (Oct. 20, 1978) ("Not all activities conducted jointly by persons are treated as separate entities for tax purposes. Regulations under section 7701 of the Code set forth criteria for determining whether individuals engaging in common activities are entities for tax purposes and for distinguishing between organizations which are taxable as trusts, partnerships or corporations However, those criteria were developed without reference to, and do not definitively cover, unincorporated organizations (other than trusts) that are engaged in not-for-profit activities.").

[58] *Brannen v. Commissioner*, 78 T.C. 471, 512 n. 16 (1982), *aff'd*, 722 F.2d 695 (11th Cir. 1984).

[59] 633 F.2d at 515-516, *affg*. 72 T.C. at 562-565.

[60] 72 T.C. at 531.

[61] *Id.* at 532, 537-538.

[62] 72 T.C. at 536; 633 F.2d at 513.

[63] 72 T.C. at 533; 633 F.2d at 514.

[64] 72 T.C. at 559-561.

statutory definition of "partnership" under section 761(a) of the Code.[65] The Court stated that the mere intention not to be treated as a partnership was insufficient to avoid partnership classification. The Court then stated that the Code definition of partnership does not require joint venturers to share in a single joint cash profit. It held that any profit motive requirement is met by a distribution of profits in kind.[66] Therefore, the arrangement was classified as a partnership for federal tax purposes.[67] The Court reasoned as follows:

> First, the statute does not require a profit motive; rather it merely requires "an unincorporated organization, through or by means of which any business, financial operation, or venture is carried on." The business activity or profit motive test is important in distinguishing partnerships from the mere coownership of property. However, this test is not the only test for what constitutes a partnership for Federal tax purposes. Second, the test of business activity or profit motive for purposes of finding a Federal tax partnership is clearly met in the situation at hand where a group of business organizations decide to band together to produce with economies of scale a common product to be distributed to the members of the venture in kind.[68]

On appeal, the Seventh Circuit affirmed the Tax Court's decision, stating that "while distribution of profits in-kind may be an uncommon business arrangement, recognition of such arrangements as tax partnerships is not novel."[69] The Service has continued to cite *Madison Gas & Electric* in factually similar situations to find a partnership.[70]

In F.S.A. 1995-10, the Service recognized the position it has taken that profit motive is but one factor to be considered in determining whether a partnership exists and even concludes that the Tax Court may have "embraced this position:"

> The sharing of profits seems to be required. In *Allison v. Commissioner*, 35 T.C.M. (CCH) 1069 (1976), the Tax Court held that no partnership was formed in the absence of a joint profit motive. *See also*, *S & M Plumbing Co. v. Commissioner*, 55 T.C. 702 (1971), *acq*., 1971-2 C.B. 1; and *Podell v. Commissioner*, 55 T.C. 429 (1970). The Service has taken the position, however, that the presence or absence of a profit motive is but one factor to be considered. *See Madison Gas and Electric Co. v. Commissioner*, 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980); and Private Letter Ruling 7903084. The Tax Court may have embraced this position. *See Brannen v. Com*missioner, 78 T.C. 471 (1982), *aff'd* 722 F.2d 695 (11th Cir. 1984).[71]

[65] 72 T.C. at 562-563.

[66] 72 T.C. at 562.

[67] *Madison Gas*, at 563.

[68] 72 T.C. at 562.

[69] 633 F.2d at 516.

[70] *See, e.g.,* Priv. Ltr. Rul. 9504001 (Jan. 27, 1995); Priv. Ltr. Rul. 9414004 (Dec. 17, 1993).

[71] Footnote omitted.

b) Sharing of Losses. Loss sharing has also been cited as evidence that a partnership exists.[72] Although sharing of losses is not required to find a partnership,[73] the absence of loss sharing may override the other evidence of a partnership or joint venture.[74]

[72]*See Estate of Levine v. Commissioner*, 72 T.C. 780, 785 (1979) ("Nevertheless, the evidence in the record overwhelmingly supports a finding that decedent and Harvey intended to, and did, operate as a partnership. They engaged in an active business, performed various services, and shared the gains and losses. Such factors are more indicative of an intent to manage the properties as a partnership than as a mere passive investment."), *aff'd* 634 F.2d 12 (2nd Cir. 1980); *Luna*, 42 T.C. at 1079 (1964) (in finding no partnership, court mentions no sharing of losses); *James*, 16 T.C. at 940 ("The one-sidedness of the arrangement in the instant proceeding is evidenced by some of the following factors, none of which alone perhaps would be sufficient to find that petitioners were not partners, but all of which together requires us, we think, to find that petitioners were not partners. James was the controlling head of the business; he agreed to indemnify Gerdes and Wayman for all losses occasioned by the agreement. James as controlling stockholder of the corporation could have, without further responsibility to Gerdes and Wayman, cancelled the agreement between the corporation and Consolidated Venetian Blind Co. and thus terminated the 'partnership.'"); *Duley v. Commissioner*, 41 T.C.M. (CCH) 1521, 1529 (1981) ("Absent proof of a real intent to form a partnership, a profit sharing arrangement will not be considered a partnership for tax purposes . . .This is especially true where, as here, the record shows that Dean and Orville did not agree to share the losses.").

[73]*Sierra Club, Inc. v. Commissioner*, 103 T.C. at 324, *aff'd in part and rev'd in part on other grounds*, 86 F.3d 1526 (9th Cir. 1996); *see McDougal*, 62 T.C. at 725 ("While in the case at bar the risk of loss was to be borne by the McDougals alone, all the other elements of a joint venture were present once the transfer of October 4, 1968, had been effected. Accordingly, we hold that the aforesaid transfer constituted the formation of a joint venture to which the McDougals contributed capital in the form of the horse, Iron Card, and in which they granted McClanahan an interest equal to their own in capital and profits as compensation for his having trained Iron Card."); *Boca Investerings Partnership*, 167 F.Supp. 2d at 388 fn. 17 ("While the sharing of profits and losses has been recognized as a critical factor, the Tax Court has often pointed out that the disproportionate sharing of losses and expenses is not fatal to the existence of a partnership."); *70 Acre Recognition Equipment Partnership v. Commissioner*, 72 T.C.M. (CCH) 1508, 1510 (1996) ("Sharing of losses, however, is not required."); *Wheeler*, 37 T.C.M. (CCH) at 891 (1978) ("these restrictions on petitioner's authority were merely protection for Perrault's capital advances, and characteristics such as Perrault's holding title to the properties or bearing all the losses have been specifically recognized by respondent as insufficient to negate the existence of a joint venture. Rev. Rul. 54-84, 1954-1 C.B. 284."); *Halstead v. Commissioner*, 19 T.C.M. (CCH) 571, 574 (1960) (Petitioner's remaining argument is that no partnership was in fact created because the partnership agreement contained no provision for the sharing of losses. The absence of such a provision is one of the factors to be considered in determining whether a partnership was created. It does not conclusively establish, however, that a partnership was not created where, as here, there is an agreement which otherwise manifests the intention of the parties to associate themselves together as partners in the practice of the law.*"), aff'd per curiam*, 296 F.2d 61 (2d Cir. 1961)*; but cf. Acme Music*, 196 B.R. at 938 fn. 20 (stating that "case law seems to strongly suggest that a sharing of losses (i.e., a sharing of expenses even if such expenses exceed gross receipts) is also a necessary, but not sufficient, condition for a finding that a joint venture exists.").

[74]*See, e.g., Smith v. Commissioner*, 33 T.C. 465, 466 (1959), *aff'd in part and rev'd in part*, 313 F.2d 724 (8th Cir. 1963) (commodity trading funds governed by "partnership" agreements found to be associations taxable as corporations; fund manager had no economic interest in the funds despite an interest in a share of the profits which might be realized, and was obligated to cover losses only to the extent it had withdrawn its share of profits); *Koss*, 57 T.C.M. (CCH) at 891; *but see McDougal*, 62 T.C. at 720 (joint venture found where profits were to be shared equally by the parties, while losses were allocated to one partner).

v) Whether Business Was Conducted in the Joint Names of the Parties. Another factor that evidences a partnership is the parties conducting business under a joint name.[75]

vi) Whether the Parties Filed Federal Partnership Returns or Otherwise Represented to the Internal Revenue Service or to Persons with Whom They Dealt that They Were Joint Venturers. A factor that evidences the existence of a partnership is the parties' filing federal partnership returns or otherwise representing to the Internal Revenue Service or to persons with whom they dealt that they were joint venturers.[76] The failure to file partnership returns, however, does not prevent recognition of a partnership for federal tax purposes.[77]

vii) Whether Separate Books of Account Were Maintained for the Venture. Another factor indicative of the intent to form a partnership is the parties maintaining separate books of account for the venture. Such books of account would be necessary to, among other things, determine any net profit of the venture and a participant's share thereof.[78]

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[75] *Comtek Expositions, Inc.*, 85 T.C.M. (CCH) at 1292 ("The evidence with respect to this *Luna* factor is mixed. One trade catalogue listed both petitioner and Crocus as the producers and managers of the trade show; another catalogue listed petitioner as the producer and manager of the trade show and listed Crocus as the marketer of the trade show in the former Soviet Union."); *Mayhew*, 63 T.C.M. (CCH) at 1987 (no partnership; no evidence property held in joint venture's name).

[76] *Cf. Lattin v. Commissioner*, 69 T.C.M. (CCH) 2734, 2738 (1995) ("Petitioners have failed to produce any documentary proof that FFC #2 partnership was in existence during the years in issue. There is no partnership agreement nor have petitioners offered any evidence in the form of testimony from other purported partners that the partnership was in existence. Furthermore, petitioners have not produced books and records, and they have admitted that they cannot prove that Federal income tax returns were filed for FFC #2 for the years in issue."); *Mayhew*, 63 T.C.M. (CCH) at 1987 (no partnership; no evidence joint venture filed partnership tax returns, no evidence that there were books of account, bank accounts, stationery, or an office separate from what SMLA maintained for itself.); *Hunt*, 59 T.C.M. (CCH) at 645 (partnership; "Certificates of limited partnership were filed with the Secretaries of State in Texas and North Dakota. The partners held their arrangement out to third parties, such as the Banks, the Securities and Exchange Commission, the CFTC, the Internal Revenue Service, and various brokerage houses as a partnership.").

[77] *Ayrton Metal Co. v. Commissioner*, 299 F.2d 741, 742 (2d Cir. 1962) (in finding partnership, "[n]or is it of any significance tax-wise that no articles of partnership or tax returns were filed for the joint account."); *Strickland v. Commissioner*, 51 T.C.M. (CCH) 534 (1986) ("The failure to file partnership returns does not prevent recognition of a partnership for Federal tax purposes.").

[78] *Sierra Club, Inc.*, 103 T.C. at 327 (in finding no partnership, "None of the agreements calls for the keeping of any books of account from which could be determined any net profit attributable to Chase Lincoln's extension of credit to cardholders."), *aff'd in part and rev'd in part on other grounds*, 86 F.3d 1526 (9th Cir. 1996); c*f. Hunt*, 59 T.C.M. (CCH) at 645 (in finding a partnership; "PIL took physical possession and title to all the assets contributed to the partnership by N. B. and W. H. PIC, as general partner, then managed these assets. PIC, the general partner, actively maintained the books and records of the partnership, PIL, and filed Federal income tax returns on behalf of PIL as a partnership."); *Form Builders, Inc.*, 58 T.C.M. (CCH) at 1417 ("The facts that no partnership books were kept and no information return filed, evidencing both an internal and an external lack of contemporaneous manifestation of partnership intent, further support our finding that no partnership existed.").

viii) Whether the Parties Exercised Mutual Control Over and Assumed Mutual Responsibilities for the Enterprise. Another factor that is indicative of the intent to form a partnership is the parties exercising mutual control over and mutual responsibilities for the venture.[79] The Tax Court has stated that the term "mutual" is used in *Luna*[80] in the sense of common or shared control.[81]

Active participation is not required, however, to make a person a partner for federal income tax purposes.[82] Otherwise, no passive limited partner would ever be a partner for federal income tax purposes.[83] Moreover, the reservation to one partner of the function of managing the common enterprise and financing its affairs does not, of itself, preclude the existence of an otherwise valid partnership for federal income tax purposes.[84]

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[79] *Sierra Club, Inc.,* 103 T.C. at 327 (in finding no partnership; "Chase Lincoln's mutual responsibility for solicitation activities was limited in function and did not constitute a general delegation of authority to manage the affinity card program. Lacking any such delegation, the agreements do not otherwise establish the mutual control and responsibility indicative of a partnership for tax purposes."), *aff'd in part and rev'd in part on other grounds,* 86 F.3d 1526 (9th Cir. 1996); *Hunt*, 59 T.C.M. (CCH) at 635 (in finding a partnership; "PIL took physical possession and title to all the assets contributed to the partnership by N. B. and W. H. PIC, as general partner, then managed these assets. PIC, the general partner, actively maintained the books and records of the partnership, PIL, and filed Federal income tax returns on behalf of PIL as a partnership."); *Form Builders, Inc.,* 58 T.C.M. (CCH) at 1417 (in finding no partnership, "The facts that no partnership books were kept and no information return filed, evidencing both an internal and an external lack of contemporaneous manifestation of partnership intent, further support our finding that no partnership existed.").

[80] 42 T.C. 1067.

[81] *Sierra Club, Inc.*, 103 T.C. at 327, *aff'd in part and rev'd in part on other grounds,* 86 F.3d 1526 (9th Cir. 1996); s*ee Arthur Venneri Co. v. United States*, 169 Ct. Cl. 74, 340 F.2d 337, 343 (1965) (lack of "equal right of control" was factor used to determine that no joint venture was formed); *Estate of Briden v. Commissioner*, 11 T.C. 1095, 1126 (1948) (no partnership was found to have existed among decedent and other persons, in part because there was no evidence that any of those persons "exercised any authority as a partner or participated in the management" of the business), *affd. on other grounds sub nom., Kirk v. Commissioner*, 179 F.2d 619 (1st Cir. 1950).

[82] *Beck Chem. Equip. Corp.*, 27 T.C. at 853 ("But the *Culbertson* case does not require active participation to make a person a partner for tax purposes. On the contrary, it made it clear that no one element is essential.").

[83] *McKee*, ¶ 3.02[5][b][iii].

[84] *Beck Chem. Equip. Corp.*, 27 T.C. at 852 ("It is true that active management of the enterprise and the manufacture and sale of the flame thrower were handled entirely by Beattie, which was in accordance with petitioner's arrangement with Beattie (although petitioner, through Beck, made engineering services available). But it is likewise recognized under the law that partners may be inactive . . . Thus, the reservation, as here, to one partner of the function of managing the common enterprise and financing its affairs does not, of itself, vitiate the existence of an otherwise valid joint venture."); *J.A. Riggs Tractor Co. v. Commissioner*, 6 T.C. 889, 897-898 (1946) ("The fact that Riggs, Sr., was given a controlling vote in the event of a disagreement between the partners or a difference in opinion as to a policy to be adopted does not alter the case. It is not uncommon for a partnership to have a managing partner. *Cf. George Bros. & Co., supra.* Certainly, that part of the partnership agreement giving Riggs, Sr., this veto power is not so rare a provision in partnership agreements as to require our holding that this enterprise was more than an ordinary partnership. It is not an uncommon feature in partnership agreements. We are unable to discern any real distinction between the management and control of petitioner's business and the management and control of the business of ordinary partnerships. We are satisfied that the operations and business conduct of petitioner more closely resemble the operations of an ordinary partnership than the operations of a corporation.");

In the context of a joint venture, the Tax Court has held that one member may reserve the function of managing the common enterprise and financing its affairs.[85] The Court has also held that lack of day-to-day managerial control does not necessarily militate against the existence of a partnership when there is "control over . . . continued contributions of funds to the venture."[86] In *Podell v. Commissioner*,[87] the Tax Court found that the lack of managerial control over the day-to-day activities of a venture was not sufficient reason to find against the existence of a partnership. The Court determined that while one venturer had given discretion to the other venturer with respect to all aspects of a real estate project, the Court found that the first venturer

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Wilson v. Commissioner, 11 B.T.A. 963, 971 (1928) (Another argument advanced by the respondent against the contention that the three wives were members of the partnership is their unfamiliarity with the business in which they were supposed to participate. Conceding this to be true, it is only an evidentiary circumstance to be considered in connection with all the other testimony. They were not active partners. This fact should also be considered."); *cf. Estate of Kahn v. Commissioner*, 499 F.2d 1186, 1187 (2d Cir. 1974) (in finding no partnership, "[w]hile it is true that the agreement gave Grober a 25% interest in the venture's assets, that interest was expressly limited to the profits that would be derived from their operation and sale: Control of the assets—including the power to dispose of them—was vested solely in Kahn *** Kahn's dominant position and his contribution of 99% of the assets' purchase price was further reflected in the venture's operation. While there is some dispute as to Grober's day-to-day authority and his right to examine the venture's books, the fact remains that Kahn had sufficient legal and practical control to misappropriate some $400,000 over a three-year period without detection by his defrauded 'partner.' Similarly it is undisputed that when the Service uncovered Kahn's activities and the split occurred, it was Grober, and not Kahn, who was soon sent packing. Such facts are hardly consistent with taxpayer's portrayal of Grober as an equal partner; rather they suggest that Grober was merely an important, but by no means indispensable, employee."); *Fiore v. Commissioner*, 39 T.C.M. (CCH) 64, 72 (1979) ("There was no written agreement documenting the creation of the partnership nor was there any evidence of a contemporaneous understanding regarding the terms of the purported partnership. There was also no showing that Julia participated in the mining business or took part in the operation and decisions of the partnership. Petitioner alone managed the mining operations and reaped all the benefits therefrom. He retained complete control over the handling and disposition of the assets and income of the purported partnership. In fact, petitioner testified that his financial arrangement with his mother allowed him to hold the money and give her 'whatever she wanted.' The $91,050.39 check that petitioner wrote out and forwarded to the Internal Revenue Service for Julia's income tax liability for 1972 was the only amount paid on her behalf. No record was kept of any monies she was entitled to receive from the partnership. These practices are hardly consistent with her status as an 'equal partner.'") (Footnote omitted.)); *Halstead v. Commissioner*, 19 T.C.M. (CCH) 571, 574 (1960) ("Concentration of management in the hands of a single partner does not of itself destroy the existence of a partnership.").

[85]*Ayrton Metal Co.*, 34 T.C. at 472 ("One member of the joint venture may also reserve the function of managing the common enterprise and financing its affairs, as did Metal Traders, without destroying the existence of the otherwise valid joint venture."), *aff'd in part and rev'd in part on other grounds*, 288 F.2d 741 (2d Cir. 1962); *Hartman v. Commissioner*, 17 T.C.M. (CCH) 1020 (1958) ("It is well settled that a partner or joint adventurer may intrust performance to another.").

[86]*Podell*, 55 T.C. at 432 ("The fact that petitioner did not exercise as much managerial control over the day-to-day activities relating to the purchase, renovation, and sale of the real estate as Young is not sufficient reason for this Court to find against the existence of a joint venture. While petitioner gave Young discretion with respect to all aspects of the purchase, renovation, and sale of the real estate in question, petitioner retained the power to approve of the steps undertaken by Young to execute their agreement through his control over his continued contributions of funds to the venture."); *see S & M Plumbing Co.*, 55 T.C. at 708 (1971) (reiterating that "lack of day-to-day managerial control does not necessarily militate against the existence of a joint venture when there is 'control over *** continued contributions of funds to the venture.'"); *Fishback v. United States*, 215 F. Supp. 621, 625-626 (D.S.D. 1963) (stating that inequality in day-to-day control is not "fatal to the idea of a joint venture".).

[87]55 T.C. 429.

retained the power to approve of the steps undertaken by the second venturer to execute their agreement through this control over his continued contributions of funds to the venture.[88]

2. Step Two: If a Separate Entity Exists, Determine Whether the Entity Is a Trust or a Business Entity. The regulations provide that an organization that is recognized as a separate entity for federal tax purposes is either a trust or a "business entity" (unless a provision of the Code expressly provides for special treatment, such as the real estate mortgage investment conduit rules). Thus, the second step in the classification process is to determine whether a separate entity for federal tax purposes is a trust or a "business entity."[89] A "business entity" is defined in the regulations as "any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner . . .) that is not properly classified as a trust . . . or otherwise subject to special treatment under the Internal Revenue Code."[90] The classification of organizations as trusts is governed by Treas. Reg. § 301.7701-4. That section restates the distinction between trusts and business entities that existed prior to the issuance of the check-the-box regulations. The check-the-box regulations were not intended to change the pre-check-the-box rules for determining whether an organization is classified as a trust for federal tax purposes.[91]

3. Step Three: If an Entity Is a Business Entity, Determine Whether It Is Automatically Classified as a Corporation. If an entity is a business entity, the third step in the classification process is to determine whether it is automatically classified as a corporation.[92] Treas. Reg. § 301.7701-2 specifies eight types of business entities that are automatically classified as corporations for federal tax purposes and also prescribes certain special rules applicable to foreign entities. The eight types of entities that are automatically classified as corporations are as follows:

a. A business entity organized under a Federal or State statute (or under a statute of a federally recognized Indian tribe) describing or referring to the entity as incorporated or as a corporation, body corporate, or body politic;[93]

b. A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association;[94]

c. An insurance company;[95]

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[88] *Podell*, 55 T.C. at 429.

[89] *See, e.g.*, Rev. Rul. 2013-14, 2013-26 I.R.B. 1267 ("In all three situations described above, the [Mexican land trust] is not a trust within the meaning of § 301.7701-4(a).).

[90] Treas. Reg. § 301.7701-2(a).

[91] *See* T.D. 8697, 1997-2 I.R.B. 12; Reg. Notice, 1996-1 C.B. at 866.

[92] *See* Treas. Reg. § 301.7701-3(a); Reg. Notice, 1996-1 C.B. at 866.

[93] Treas. Reg. § 301.7701-2(b)(1); Reg. Notice, 1996-1 C.B. at 866-67.

[94] Treas. Reg.§ 301.7701-2(b)(3).

d. A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act, as amended,[96] or a similar federal statute;[97]

e. A business entity wholly owned by a State or any political subdivision thereof, or a business entity wholly owned by a foreign government or certain integral parts or controlled entities of a foreign sovereign;[98]

f. A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3),[99] including a business entity that is publicly traded within the meaning of section 7704 (and not within the exception in section 7704(c)) and a business entity that is a taxable mortgage pool under section 7701(i);[100]

g. Certain foreign entities listed in the regulations;[101] and

h. An entity created or organized under the laws of more than one jurisdiction if the check-the-box rules would treat it as a corporation as a result of its formation in any one of the jurisdictions in which it is created or organized.[102]

4. Step Four: If an Entity Is a Business Entity and Is Not Automatically Classified as a Corporation, Classify the Entity According to the Regulations. If an entity is a business entity and is not automatically classifiable as a corporation, such an entity (referred to as an "eligible entity" in the regulations) may elect its classification for federal tax purposes.[103]

a. General Classification Rules. An eligible entity with two or more members may elect to be classified as a corporation or a partnership.[104] An eligible entity with a single member may elect to be classified as a corporation or to be "disregarded" as an entity separate from its owner.[105] (Certain special rules apply to banks.[106]) A disregarded entity

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[95]Treas. Reg. § 301.7701-2(b)(4).

[96]12 U.S.C. § 1811.

[97]Treas. Reg. § 301.7701-2(b)(5).

[98]Treas. Reg. § 301.7701-2(b)(6); *see* Treas. Reg. § 1.892-2T.

[99]Treas. Reg. § 301.7701-2(b)(7).

[100]Reg. Notice, 1996-1 C.B. at 867.

[101]Treas. Reg. § 301.7701-2(b)(8).

[102]Temp. Treas. Reg. § 301.7701-2(b)(9).

[103]*See* Treas. Reg. § 301.7701-3.

[104]Treas. Reg. § 301.7701-3(a).

[105]Treas. Reg. §§ 301.7701-3(a), 301.7701-2(b)(2); *cf.* AM 2012-001 (Feb. 17, 2012) ("Issue: Whether a taxpayer (Owner) who owns one-hundred percent of the membership interest in an eligible entity, which is a disregarded entity for federal tax purposes, may split his eligible entity interest into separate classes of interests and

is treated in the same manner as a sole proprietorship, in the case of an entity owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation.[107] The Regulations provide a default classification for an eligible entity that does not make an election.[108] Thus, elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification.[109]

b. Default Classification Rules (For Eligible Entities That Do Not File an Election).

(1) Domestic Eligible Entities. For domestic eligible entities formed on or after January 1, 1997, the default rules are as follows: (1) a domestic entity with two or more members is classified as a partnership;[110] and (2) a domestic single-member eligible entity is disregarded as separate from its owner.[111] For domestic eligible entities in existence prior to January 1, 1997, the default classification is generally the classification claimed by the entity under the pre-check-the-box regulations[112] subject to a special rule for single-member entities. Single-member entities that claimed to be a partnership under the pre-check-the-box regulations are treated as disregarded entities.[113]

Revenue Procedure 2002-69 provides guidance on the classification of a "qualified entity" that is owned by a husband and wife as community property under the laws of a U.S. state, a foreign country or a possession of the United States.[114] A business entity is a qualified

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then allocate income, loss, deduction, credit, and basis among those classes. Conclusion: For federal tax purposes, unless Owner elects otherwise under § 301.7701-3, a wholly owned eligible entity is a disregarded entity, and Owner may not allocate tax items or basis among its different interests.").

[106]*See* Treas. Reg. § 301.7701-2(c)(2)(ii).

[107]Treas. Reg. § 301.7701-2(a).

[108]Treas. Reg. Sec. 301.7701-3(a).

[109]Treas. Reg. Sec. 301.7701-3(a).

[110]Treas. Reg. § 301.7701-3(b)(1)(i).

[111]Treas. Reg. § 301.7701-3(b)(1)(ii); *but cf.* Treas. Reg. § 301.7701-2(c)(2)(iii)(A)("An entity that is otherwise disregarded as separate from its owner is treated as an entity separate from its owner for purposes of (1) federal tax liabilities of the entity with respect to any taxable period for which the entity was not disregarded. (2) federal tax liabilities of any other entity for which the entity is liable. (3) refunds or credit of federal tax."); *see also* Notice of Proposed Rulemaking, 69 Fed. Reg. No. 63 at 17,117 (Apr. 1, 2004) ("[T]he [proposed] regulations clarify that if a disregarded entity is liable for Federal taxes, the disregarded entity will be treated as an entity separate from its owner for purposes of those liabilities, such that assessment may be made against the disregarded entity, the assets of the disregarded entity may be subject to lien and levy, and the disregarded entity may consent to extend the period of limitations on assessment.").

[112]Treas. Reg. § 301.7701-3(b)(3)(i).

[113]Treas. Reg. § 301.7701-3(b)(3)(i)).

[114]Rev. Proc. 2002-69, § 1, 2002-45 I.R.B. 831 (Oct. 9, 2002).

entity if: (1) the business entity is wholly owned by a husband and wife as community property under the laws of a U.S. state, a foreign country, or a U.S. possession;[115] (2) no person other than one or both spouses would be considered an owner for federal tax purposes; and (3) the business entity is not treated as a corporation under the check-the-box regulations.[116] The Revenue Procedure provides that: (1) if a qualified entity, and the husband and wife, as community property owners, treat the entity as a disregarded entity for federal tax purposes, the Internal Revenue Service will accept the position that the entity is a disregarded entity for federal tax purposes;[117] (2) if a qualified entity, and the husband and wife as community property owners, treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the Internal Revenue Service will accept the position that the entity is a partnership for federal tax purposes;[118] and (3) a change in reporting position will be treated for federal tax purposes as a conversion of the entity.[119]

(2) Foreign Eligible Entities. For foreign eligible entities formed on or after January 1, 1997, unless the entity elects otherwise, a foreign eligible entity is (1) a partnership if it has two or more members and at least one member does not have limited liability; (2) a corporation if all members have limited liability; (3) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.[120] For foreign eligible entities in existence prior to January 1, 1997, the default classification is generally the classification claimed by the entity under the pre-check-the-box regulations[121] subject to a special rule for single-member entities. Single-member entities that claimed to be a

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[115]*Cf.* IRSMISC rdpfaqs (Sept. 19, 2013) ("Q27: Does Rev. Proc. 2002-69, 2002-2 C.B. 831, apply to registered domestic partners? A27. No. Rev. Proc.2002-69 allows spouses to classify certain entities solely owned by the spouses as community property, as either a disregarded entity or a partnership for federal tax purposes. Rev. Proc.2002-69applies only to spouses. Because registered domestic partners are not spouses for federal tax purposes, Rev. Proc. 2002-69 does not apply to registered domestic partners.").

[116]Rev. Proc. 2002-69, § 3.02.

[117]Rev. Proc. 2002-69, § 4.01; *cf.* CCA 200851102 (Dec. 19, 2008) ("The LLC is owned by husband and wife as community property. Rev. Proc 2002-69 does not contain a default for treatment of the entity if no income tax return has been filed. If the entity has not filed an income tax return, how should the Service treat this entity for the purposes of collection of employment taxes? Since they did not "treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns"should we treat them as a disregarded entity? The election under Rev. Proc. 2002-69 is optional. If no election is made, then the classification of the LLC defaults to the "check the box" regulations, Treas. Reg. § 301.7701-3. Under these regulations, if there are two owners of the business, it is automatically by default a partnership. If there is one owner of the business, it is automatically by default a disregarded entity. * * * The election and default rules under Rev. Proc. 2002-69 supersede the governing documents. Therefore, while both husband and wife appear as responsible individuals on the governing documents, which would imply a partnership, they can elect to have their business considered a disregarded entity. Since no returns have been filed and the husband and wife have not made an election under Rev.Proc. 2002-69, the business would be considered a partnership because both husband and wife own the business.").

[118]Rev. Proc. 2002-69, § 4.02.

[119]Rev. Proc. 2002-69, § 4.03.

[120]Treas. Reg. § 301.7701-3(b)(2).

[121]Treas. Reg. § 301.7701-3(b)(3)(i).

partnership under the pre-check-the-box regulations are treated as disregarded entities.[122] A foreign eligible entity is treated as being in existence prior to January 1, 1997, only if the entity's classification was relevant at any time during the 60 months prior to January 1, 1997.[123] The regulations provide special rules for determining the relevancy of an entity's classification.[124]

c. Procedural Rules for Filing Election. The Treasury regulations prescribe the procedure for filing an election to classify an eligible entity.[125] An eligible entity makes a classification election by filing Form 8832 with the Internal Revenue Service.[126] The regulations provide that "[a]n election will not be accepted unless all of the information required by the form and instructions, including the taxpayer identifying number of the entity, is provided on Form 8832."[127] 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.[128] An election is effective on the date specified on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 cannot be more than 75 days prior to the date on which the election is filed and cannot be more than 12 months after the election is filed.[129]

On July 21, 2004, the Service issued Temp. Reg. § 301.7701-3(c)(l)(v)(C) to address certain untimely filings by a taxpayer that has a default classification of partnership or disregarded entity but is seeking to be classified as an S corporation. In that case, prior to the issuance of Temp. Reg. § 301.7701-3(c)(1)(v)(C), the taxpayer had to elect to be classified as an association by filing Form 8832 and had to elect to be an S corporation by filing Form 2553. The Revenue Service stated that, in some cases, an entity may timely file the Form 2553 but fail to file the Form 8832. The entity was then required to submit a letter ruling request for an extension of time under Sec. 301.9100 to file a late entity classification election. The temporary regulation provides relief for this situation. In other cases, the Form 2553 and the Form 8832 are filed late, and the entity must submit a ruling request under Sec. 301.9100 to file a late entity

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[122] Treas. Reg. § 301.7701-3(b)(3)(i).

[123] Treas. Reg. § 301.7701-3(b)(ii).

[124] Treas. Reg. § 301.7701-3(d)(1).

[125] Treas. Reg. § 301.7701-3(c).

[126] Treas. Reg. § 301.7701-3(c)(1)(i).

[127] Treas. Reg. § 301.7701-3(c)(1)(i).

[128] Treas. Reg. § 301.7701-3(c)(1)(iv).

[129] Treas. Reg. § 301.7701-3(c)(1)(iii). The Procedure and Administration regulations permit the Service to grant a reasonable extension of time for making certain elections, including the entity classification election on Form 8832. Treas. Reg. § 301.9100-1(c). Under these regulations, an extension of time to file certain elections will be granted if the taxpayer is able to establish that it acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government. Treas. Reg. § 301.9100-3. *See, e.g.*, Priv. Ltr. Rul. 200318061 (Jan. 27, 2003); Priv. Ltr. Rul. 200316029 (Jan. 9, 2003); Priv. Ltr. Rul. 200306006 (Oct. 29, 2002). Private letter rulings are not binding as "precedent," but they often represent a substantial indication of the position of the Revenue Service on an issue.

classification election and to file a late S corporation election. Rev. Proc. 2013-30,[130] provides certain relief for these entities.

The temporary regulation eliminates, in certain cases, the requirement that the entity elect to be classified as an association. Instead, an eligible entity that makes a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation. The temporary regulation amends Treas. Reg. § 301.7701-3(c)(l)(v) to provide that, if an eligible entity makes a timely and valid election to be an S corporation, it is treated as having made an election to be classified as an association under Treas. Reg. § 301.7701-3. If, however, the eligible entity's election is not timely and valid, the default classification rules will apply to the entity unless the Service provides late S corporation election relief or inadvertent invalid election relief. If the late or invalid election is not perfected, the default rules will maintain the passthrough taxation treatment by classifying the entity as a partnership or a disregarded entity.[131]

On May 23, 2005, the Revenue Service issued final regulations that adopt the procedure in the temporary regulation.[132]

On September 3, 2009, the Revenue Service issued Rev. Proc. 2009-41, 2009-39 I.R.B. 439, providing guidance for an eligible entity that requests relief for a late classification election filed with the applicable IRS service center within 3 years and 75 days of the requested effective date of the eligible entity's classification election. An entity is eligible for relief under Rev. Proc. 2009-41 for a late classification election if the following requirements are met:

1. (a) The entity failed to obtain its requested classification as of the date of its formation or upon the entity's classification becoming relevant within the meaning of § 301.7701-3(d) solely because Form 8832 was not filed timely under § 301.7701-3(c)(1)(iii); or (b) The entity failed to obtain its requested change in classification (subject to the limitations of § 301.7701-3(c)(1)(iv)) solely because Form 8832 was not filed timely under § 301.7701-3(c)(1)(iii); and

2. (a) The eligible entity seeking an extension of time to make an entity classification election has not filed a federal tax or information return for the first year in which the election was intended because the due date has not passed for that year's federal tax or information return; or (b) the eligible entity seeking an extension of time to make an entity classification election timely filed all required federal tax returns and information returns consistent with its requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed by or with respect to the entity during any of the taxable years. For changes in an eligible entity's classification election, consistent filing of returns includes filing returns consistent with the deemed treatment of elective changes under § 301.7701-3(g). If the eligible entity is not

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[130] 2013-36 I.R.B. 173.

[131] *See* Temp. Treas. Reg. § 301.7701-3(c)(1)(v)(C); Preamble, T.D. 9139.

[132] *See* T.D. 9203, *reprinted in* 2005 TNT 9203.

required to file a federal tax return or information return, each affected person, who is required to file a federal tax return or information return, must have timely filed all such returns consistent with the entity's requested classification for all of the years the entity intended the requested election to be effective and no inconsistent tax or information returns have been filed during any of the taxable years. Solely for this purpose, an entity and an affected person will be treated as having timely filed a required tax or information return if the return is filed within 6 months after its due date, excluding extensions. An indirect owner of an eligible entity (such as a partner in a partnership that holds an interest in the eligible entity) is not an affected person if an entity in which the indirect owner holds a direct or indirect interest would be required to attach a copy of the eligible entity's Form 8832 to its federal tax or information return in the circumstances described in (i) or (ii) below. An affected person is either:

> (i) with respect to the effective date of the eligible entity's classification election, a person who would have been required under § 301.7701-3(c)(1)(ii) to attach a copy of the Form 8832 for the eligible entity to its federal tax or information return for the taxable year of the person which includes that date; or
>
> (ii) with respect to any subsequent date after the entity's requested effective date of the classification election, a person who would have been required under § 301.7701-3(c)(1)(ii) to attach a copy of the Form 8832 for the eligible entity to its federal tax or information return for the person's taxable year that includes that subsequent date had the election first become effective on that subsequent date; and

3. The eligible entity has reasonable cause for its failure to timely make the entity classification election; and

4. 3 years and 75 days from the requested effective date of the eligible entity's classification election have not passed. [133]

Certain procedural requirements apply under Rev. Proc. 2009-41 for purposes of requesting relief. Within 3 years and 75 days from the requested effective date of the eligible entity's classification election, the eligible entity must file with the applicable IRS service center (determined in accordance with the instructions to Form 8832) a completed Form 8832, signed in accordance with § 301.7701-3(c)(2). The Form 8832 must indicate that it is being filed pursuant to Rev. Proc. 2009-41 in accordance with the Form 8832 and accompanying instructions. The Form 8832 must include both a declaration that the elements required for relief in Section 4.01 of Rev. Proc. 2009-41 have been satisfied and a statement explaining the reason for the failure to file a timely entity classification election (referred to as “the reasonable cause statement”). (Until Form 8832 is modified to include the declaration contained in this revenue procedure and space for a reasonable cause statement, the eligible entity should write “Filed Pursuant to Rev. Proc. 2009-41” at the top of Form 8832 and attach both the declaration and the reasonable cause statement to its Form 8832 that is filed with the applicable IRS service center. The declaration and reasonable cause statement must be accompanied by a dated declaration, signed by an authorized representative of the eligible entity and the affected person(s), if any, which states: “Under penalties of perjury, I (we) declare that I (we) have examined this election, including

[133] Rev. Proc. 2009-41, § 4.01, 2009-39 I.R.B. 439.

accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the election. The copy of the Form 8832 that is required under §301.7701-3(c)(1)(ii) to be attached to either the eligible entity's or the affected person's return does not need the writing at the top of the Form 8832 or the attachments.)[134]

Upon receipt of a completed Form 8832 requesting relief under Section 4.01 of Rev. Proc. 2009-41, the IRS service center will determine whether the requirements for granting the late entity classification election have been satisfied and will notify the entity of the result of its determination. An entity receiving relief Rev. Proc. 2009-41 is treated as having made a timely entity classification election as of the requested effective date of the election.[135]

C. Elective Changes in Classification. The Treasury regulations prescribe the deemed federal income tax consequences of the following elective changes in classification: (1)

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[134]Rev. Proc. 2009-41, § 4.02.

[135]Rev. Proc. 2009-41, § 4.03; see also CCA 201036019 (Sept. 10, 2010) stating as follows:

> You first asked how you should process a request for relief if the taxpayer submits a request under Rev Proc 2009-41, but the request is filed more than 3 years and 75 days after the requested effective date for the entity classification election?
>
> We would suggest that the Service Center simply grant relief for the date 3 years and 75 days prior to the filing date and that the Service Center send a generic letter indicating that the relief was limited to this date due to the late filing. (This would be consistent with 301.7701-3(c)(1)(iii)). The letter could also suggest that the taxpayer may still be able to receive the requested effective date by filing a private letter ruling request. The 60 month rule shouldn't be a problem if the PLR grants the relief because the taxpayer would just be receiving permission to have its intended classification effective earlier.
>
> For example, if I filed today May 26th under the Rev Proc to make m y intended entity classification election effective January 1, 2007 (date of formation), I would be past the 3 year 75 day limit. So the Service Center would make my election effective as of March 12, 2007. I could then request a PLR for January 1, 2007 through March 12, 2007 without being impacted by the 60 month rule, because once the Jan 1, 2007 effective date is granted via the PLR, the Service Center should treat the me as if I made an intial classification on January 1, 2007, so I would still have my one free change available. If my January 1, 2007 election was a change in classification, the 60 months would run from that January 1, 2007 date.

partnership to corporation;[136] (2) corporation to partnership;[137] (3) corporation to disregarded entity; and (4) disregarded entity to a corporation.[138]

D. Revenue Ruling 2004-77. In Revenue Ruling 2004-77, the Revenue Service considers the federal income tax classification of a limited partnership (LP) that consists of a limited liability company (L) as general partner and a corporation (X) as limited partner. X is the sole owner of L and L is disregarded as an entity separate from X and L's activities are treated in the same manner as a branch or division of X. The Ruling concludes that, for federal tax purposes, LP is disregarded as an entity separate from its owner, X. The Ruling states that because L is disregarded as an entity separate from X, X is treated as owning all of the interests in LP. LP is a domestic entity, with only one owner for federal tax purposes, that has not made an election to be classified as an association taxable as a corporation. Because LP has only one owner for federal tax purposes, LP cannot be classified as a partnership.

E. Administrative Dissolution. The Revenue Service has concluded in several relatively recent private letter rulings that if the affairs of a corporation continue after the expiration of its state charter, or the termination of its existence, it becomes an association and continues to be classified as a corporation.[139] In Private Letter Ruling 200539005 (June 17, 2005), the Revenue Service, citing *Ochs v. United States*,[140] stated that "[i]f the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association." The Service stated that a corporation is subject to federal corporate income tax liability as long as it continues to do business in a corporate manner,

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[136]*Cf.* Priv. Ltr. Rul. 201214014 (Apr. 6, 2012) (For Federal income tax purposes, the [conversion of a partnership to a corporation], will be treated as if (a) Pship 2 transferred all of its assets to Taxpayer solely in exchange for stock of Taxpayer and the assumption by Taxpayer of the liabilities of Pship 2 (the "Exchange") and (b) Pship 2 liquidated, distributing the Taxpayer stock to its partners (Sub 1, Sub 2, and Newco) (the "Distribution") (Treas. Reg. § 301.7701-3(g)(1)(i)).").

[137]*Cf.* AM 2011-003 (Aug. 26, 2011) ("This memorandum addresses the tax consequences when an insolvent foreign subsidiary of a domestic corporation makes a check-the-box election to be classified as a partnership under § 301.7701-3(c)(1)(i) of the Procedure and Administration Regulations.").

[138]Treas. Reg. § 301.7701-3(g); *see* Rev. Rul. 2004-59, 2004-24 I.R.B. 1050 ("If an unincorporated state law entity that is classified as a partnership for federal tax purposes converts into a state law corporation under a state law formless conversion statute, the following is deemed to occur: the partnership contributes all its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners."); *see also* Rev. Rul. 2009-15, 2009-21 I.R.B. 1035 (May 7, 2009) ("In Situations 1 and 2, when an unincorporated entity taxed as a partnership becomes a corporation for federal tax purposes, the corporation is eligible to elect to be taxed as an S corporation effective its first taxable year. Additionally, the corporation will not be deemed to have an intervening short taxable year in which it was a C corporation.").

[139]*See, e.g.*, Priv. Ltr. Rul. 201237001 (Sept. 14, 2012); Priv. Ltr. Rul. 200806006 (Feb. 8, 2008); Priv. Ltr. Rul. 200622019 (Feb. 8, 2006); Priv. Ltr. Rul. 200616002 (Dec. 16, 2005); Priv. Ltr. Rul. 200539005 (June 17, 2005); Priv. Ltr. Rul. 200535017 (May 26, 2005); Priv. Ltr. Rul. 200315020 (Jan. 6, 2003); Priv. Ltr. Rul. 200252033 (Dec. 26, 2002); Priv. Ltr. Rul. 200123058 (Mar. 13, 2001); Priv. Ltr. Rul. 200114029 (Apr. 4, 2001).

[140]305 F.2d 844, 847 (Ct.Cl. 1962), *cert. denied*. 372 U.S. 968 (1963).

despite the fact that its recognized legal status under state law is terminated.[141] In Private Letter Ruling 200114029, the Service held that the administrative dissolution of a corporation, the subsequent reincorporation that followed and the new corporation's succession to its assets and business (1) did not affect the corporation's S corporation election; (2) did not result in a distribution for purposes of Sections 301, 311, or 336, (3) the formation of the new corporation and its succession to the administratively dissolved corporation's business was not a transaction subject to Section 351 of the Code; (4) the dissolution and subsequent reincorporation of the corporation did not affect the bases or holding period of the shareholders' stock; and (5) the new corporation need not apply for a new employer identification number.[142]

F. Internal Revenue Service Issues Final Regulations on Employment and Excise Taxation of Disregarded Entities. On August 16, 2007, the Revenue Service issued final regulations under which qualified subchapter S subsidiaries and single-owner eligible entities that currently are disregarded as entities separate from their owners for federal tax purposes are treated as separate entities for employment tax and related reporting requirement purposes.[143] These regulations treat such disregarded entities as separate entities for purposes of certain excise taxes reported on Forms 720, 730, 2290, and 11-C; excise tax refunds or payments claimed on Form 8849; and excise tax registrations on Form 637. These regulations affect disregarded entities and the owners and employees of disregarded entities in the payment and reporting of federal employment taxes and the reporting of wage payments. These regulations also affect disregarded entities and their owners in the payment and reporting of certain Federal excise taxes and in registration and claims related to certain Federal excise taxes. The employment tax provisions of these regulations apply to wages paid on or after January 1, 2009. The excise tax provisions in these regulations apply to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.[144]

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[141] *See also* Priv. Ltr. Rul. 200123058 (June 11, 2001); Priv. Ltr. Rul. 200114029 (Apr. 4, 2001).

[142] Priv. Ltr. Rul. 200114029 (Apr. 6, 2001).

[143] Treas. Reg. Sec. 301.7701-2(c)(2)(iv)(B); T.D. 9356

[144] T.D. 9356, *reprinted in* 2007 TNT 159-4.

III: SOLE PROPRIETORSHIPS.

A. Taxation of Business Income of Sole Proprietorship. A sole proprietorship generally refers to an unincorporated business owned by an individual.[145] Generally, the income and expenses of a sole proprietorship are the income and expenses of the individual who owns the business.[146] Thus, the income of a sole proprietorship must be included in calculating the income and tax liabilities of the individual owning the business.[147] The net profit or loss of such an enterprise is generally computed by subtracting cost of goods sold and ordinary and necessary business expenses from the gross receipts of the venture.[148]

B. Taxable Sale of a Business by An Individual.

1. Rate Structure Applicable to Individuals. For 2014, the regular income tax rate schedules for individuals and estates and trusts are shown below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns.[149] A separate, compressed rate schedule applies to estates and trusts.[150]

Individual Regular Income Tax Rates for 2014[151]		
If taxable income is:	But not over:	Then regular income tax equals:
Unmarried individuals (other than Surviving Spouses and Heads of Households)		
$0	$9,075	10% of the taxable income
Over $9,075	$36,900	$907.50 plus 15% of the excess over $9,075
Over $36,900	$89,350	$5,081.25 plus 25% of the excess over $36,900
Over $89,350	$186,350	$18,193.75 plus 28% of the excess over $89,350
Over $186,350	$405,100	$45,353.75 plus 33% of the excess over $186,350
Over $405,100	$406,750	$117,541.25 plus 35% of the excess over $405,100

[145]For an in-depth analysis of structural issues relating to the individual income tax, see Joint Comm. on Taxation, 107th Cong., *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001.

[146]I.R.C. § 61(a)(2); *see Stewart v. Commissioner*, 84 T.C.M. (CCH) 175 (2002); *LeBouef v. Commissioner*, 82 T.C.M. (CCH) 685 (2001).

[147]I.R.C. § 61(a)(2).

[148]I.R.C. § 61(a)(2); Treas. Reg. § 1.61-3(a); *LeBouef v. Commissioner,* 82 T.C.M. (CCH) 685 (2001).

[149]*See* I.R.C. §§ 1(a), 1(d).

[150]I.R.C. § 1(e).

[151]I.R.C. § 1; *see* Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

Over $406,750		$118,118.75 plus 39.6% of the excess over $406,750
Heads of Household		
$0	$12,950	10% of taxable income
Over $12,950	$49,400	$1,295 plus 15% of the excess over $12,950
Over $49,400	$127,550	$6,762.50 plus 25% of the excess over $49,400
Over $127,550	$206,600	$26,300 plus 28% of the excess over $127,550
Over $206,600	$405,100	$48,434 plus 33% of the excess over $206,600
Over $405,100	$432,200	$113,939 plus 35% of the excess over $405,100
Over $432,200		$123,424 plus 39.6% of the excess over $432,200
Married Individuals Filing Joint Returns and Surviving Spouses		
$0	$18,150	10% of the taxable income
Over $18,150	$73,800	$1,815 plus 15% of the excess over $18,150
Over $73,800	$148,850	$10,162.50 plus 25% of the excess over $73,800
Over $148,850	$226,850	$28,925 plus 28% of the excess over $148,850
Over $226,850	$405,100	$50,765 plus 33% of the excess over $226,850
Over $405,100	$457,600	$109,587.50 plus 35% of the excess over $405,100
Over $457,600		$127,962.50 plus 39.6% of the excess over $457,600
Married individuals filing separate returns		
$0	$9,075	10% of the taxable income
Over $9,075	$36,900	$907.50 plus 15% of the excess over $9,075
Over $36,900	$74,425	$5,081.25 plus 25% of the excess over $36,900
Over $74,425	$113,425	$14,462.50 plus 28% of the excess over $74,425
Over $113,425	$202,550	$25,382.50 plus 33% of the excess over $113,425
Over $202,550	$228,800	$54,793.75 plus 35% of the excess over $202,550
Over $228,800		$63,981.25 plus 39.6% of the excess over $228,800
Estates and Trusts		
$0	$2,500	15% of the taxable income
Over $2,500	$5,800	$375 plus 25% of the excess over $2,500
Over $5,800	$8,900	$1,200 plus 28% of the excess over $5,800
Over $8,900	$12,150	$2,068 plus 33% of the excess over $8,900

Over $12,150		$3,140.50 plus 39.6% of the excess over $12,150

2. Taxation of Capital Gain Recognized by Individuals on Sales or Exchanges.

a. Net Capital Gain of an Individual. The net capital gain of an individual is subject to lower rates of tax than the rates applicable to ordinary income.[152]

(1) Net Capital Gain. Net capital gain is generally the excess of the net gain from the sale or exchange of capital assets held more than one year over the net loss from the sale or exchange of capital assets held not more than one year.[153]

(2) Gains from Sales or Exchanges of Depreciable Property or Real Property Used in a Taxpayer's Trade or Business. Generally, if there is net gain from the sale or exchange of depreciable business property or real property used in a taxpayer's trade or business and held for more than 1 year (other than inventory or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business), gains and losses are treated as capital gains and losses, but if there is a net loss, the gains and losses are treated as ordinary.[154] Certain exceptions to the characterization of net gains as capital in nature apply with respect to certain recapture of depreciation and amortization,[155] certain recapture of deductions claimed with respect to natural resource property[156] and recapture of certain prior losses.[157] Special rules also apply to timber, coal, iron ore, livestock, and unharvested crops.[158]

[152] *See* I.R.C. § 1(h).

[153] I.R.C. § 1222(11).

[154] I.R.C. §§ 1231(a), 1231(b).

[155] I.R.C. §§ 1245(d), 1250(h), 1252(b); Treas. Reg. § 1.1245-6(a); Treas. Reg. § 1.1250-1(c)(1); Treas. Reg. § 1.1252-1(d)(1).

[156] I.R.C. § 1254(a); *cf*. Priv. Ltr. Rul. 8642010 (June 17, 1986) ("Section 1231 of the Internal Revenue Code provides for capital gains treatment for the disposal of property used in a trade or business to the extent not otherwise recharacterized by section 1245 and 1254."); Priv. Ltr. Rul. 8234140 (May 28, 1982) ("Any gain recognized by the transferors will be taxed as a gain realized upon the sale or exchange of a capital asset or a section 1231 asset assuming the property transferred was held on the date of exchange as either a capital asset as defined in section 1221 or an asset used in a trade or business as defined in section 1231(b), except to the extent such gain is subject to the recapture provisions of sections 1245, 1250, and 1254."); Priv. Ltr. Rul. 8138096 (June 25, 1981) ("Any gain recognized will be taxed as a gain realized upon the sale or exchange of a capital asset or a section 1231 asset provided the properties were held on the date of the exchange as either a capital asset (as defined in section 1221) or an asset used in a trade or business (as defined in section 1231(b)), except to the extent such gain is subject to the recapture provisions of section 1245, 1250, and 1254 (or in the case of a transferor of a Partnership Interest such gain is attributable to such Transferor's share of Partnership items described in section 751(c) or (d) of the Code).").

[157] I.R.C. § 1231(c).

[158] I.R.C. §§ 1231(b)(2), 1231(b)(3), 1231(b)(4).

b. Applicable Rates.

(1) Maximum Tax Rate on Adjusted Net Capital Gain Is 20-Percent. For 2014, the maximum rate of tax on the adjusted net capital gain of an individual is 20-percent on any amount of gain that otherwise would be taxed at a 39.6% rate.[159] In addition, any adjusted net capital gain otherwise taxed at a 10-or 15-percent rate is taxed at a zero-percent rate.[160] Adjusted net capital gain otherwise taxed at rates greater than 15-percent but less than 39.6 percent is taxed at a 15 percent rate.[161] These rates apply for purposes of both the regular tax and the alternative minimum tax.[162] The "adjusted net capital gain" of an individual is the sum of (a) the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain; and (b) qualified dividend income.[163] The net capital gain is further reduced (but not below zero) by the amount of gain that an individual taxpayer treats as investment income for purposes of determining the investment interest limitation.[164]

(2) Maximum Tax Rate on "28-Percent Rate Gain" Is 28-Percent. "28-percent rate gain" generally means the sum of (i) the net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles, and (ii) an amount of gain equal to the amount of gain excluded from gross income on the sale of small business stock, reduced by the net short-term capital loss for the tax year, and any long-term capital loss carryover to the tax year.[165] The 28-percent rate gain is taxed at a maximum rate of 28-percent.[166]

(3) Maximum Tax Rate on Unrecaptured Section 1250 Gain Is 25-Percent. "Unrecaptured section 1250 gain" means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if Section 1250 recapture applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation), reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain.[167] The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of trade or business property

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[159] I.R.C. Sec. 1(h)(1)(D) (as amended by the American Taxpayer Relief Act of 2012).

[160] I.R.C. § 1(h)(1)(B) (as amended by the American Taxpayer Relief Act of 2012); *see* Jt. Comm. on Tax'n, *Overview of the Federal Tax System as in Effect for 2013*, JCX-2-13R (Jan. 8, 2013), *reprinted at* 2013 TNT 6-14 [hereinafter "JCT 2013 Overview"].

[161] I.R.C. § 1(h)(1)(C) (as amended by the American Taxpayer Relief Act of 2012); JCT 2013 Overview.

[162] *See* I.R.C. § 55(b)(3).

[163] I.R.C. § 1(h)(3).

[164] I.R.C. § 1(h)(2).

[165] I.R.C. § 1(h)(4).

[166] I.R.C. § 1(h)(1)(E).

[167] I.R.C. § 1(h)(6)(A).

(and certain other property) is subject to a limitation.[168] The unrecaptured section 1250 gain is taxed at a maximum rate of 25-percent.[169]

3. Taxable Stock Sales.

a. General Rule. If the stock of a corporation is sold in a taxable sale, the selling shareholder recognizes gain or loss from their sale of stock.[170] The gain or loss is measured by the difference between the amount realized by the shareholder from the sale and the taxpayer's adjusted basis in the stock.[171] The amount realized from the sale is the sum of any money plus the fair market value of property received.[172] The purchaser of the stock takes a basis in the stock equal to his cost.[173]

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[168]I.R.C. § 1(h)(6)(B).

[169]I.R.C. § 1(h)(1)(D).

[170]The Service has ruled that a subsidiary used to acquire the stock of a target corporation in a reverse subsidiary cash merger should be disregarded for federal income tax purposes if it was formed solely for the purpose of acquiring stock and did not conduct any activities other than those required for the merger. *See* Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 79-273, 1972-2 C.B. 125; Rev. Rul. 90-95, 1990-2 C.B. 67. The Service concluded that such a transaction is properly viewed as the acquiring corporation's direct acquisition of target stock.

In Rev. Rul. 73-427, 1973-2 C.B. 301, corporation P had purchased 97.9% of the outstanding stock of corporation Y for cash. In order to acquire the remaining 2.1% of the Y stock outstanding, P created S, a wholly owned subsidiary, by contributing P stock and a small amount of cash (sufficient to meet the capital requirements of state law) to S in exchange for all the S stock. S then merged into Y. By operation of state law, all S stock held by P was converted into Y stock. Y distributed all of the P stock to Y's minority shareholders in return for their Y stock. The small amount of cash transferred from S to Y in the merger was returned to Y. The ruling held that the transaction would be treated for federal income tax purposes as though P transferred its stock directly to the minority shareholders of Y in exchange for their Y stock.

The Service similarly concluded in Rev. Rul. 79-273, 1979-2 C.B. 125, that the cash acquisition of the target corporation's stock by means of a reverse subsidiary merger represents a sale of such stock by the target corporation's shareholders to the acquiring corporation. That Ruling involves two unrelated corporations, X and P. X desired to purchase the P stock for cash, but not the business of P's subsidiary, S. X formed Z. Z was merged into P. The shareholders of P received the cash contributed to Z by X and stock of S. The Ruling ignores the transitory existence of Z and treats the transaction as an integrated plan to directly acquire a portion of the P stock by X for cash, and a redemption of P's remaining stock with P property (i.e., the S stock.).

In Situation 1 of Rev. Rul. 90-95, 1990-2 C. B. 67, corporation P formed a wholly owned corporation, S, for the sole purpose of acquiring all of the stock of an unrelated target corporation, T, by means of a reverse subsidiary cash merger. The only activities that S conducted were those required by the merger. Pursuant to a plan of merger, S merged into T with T surviving. The shareholders of T exchanged all of their T stock for cash from S. Part of the cash used to carry out the acquisition was received by S from P, and the remaining cash was borrowed by S. Following the merger, P owned all of the stock of T. The Service held that because S had no significance apart from P's acquisition of the T stock, the step transaction doctrine should be applied to disregard the existence of S for federal income tax purposes. Accordingly, the Service held that the transaction should be treated as a qualified stock purchase of T stock by P.

[171]I.R.C. § 1001(a).

[172]I.R.C. § 1001(b).

[173]I.R.C. § 1012.

If all of the stock of a C corporation is acquired in a taxable sale, the basis of assets inside the acquired corporation does not change to reflect the stock purchase price. If a corporation acquires 80-percent or more of the stock of another corporation within a 12-month period in a taxable purchase, an election is available under certain circumstances to recognize corporate level gain and pay corporate level tax on such gain.[174]

b. Exclusion of Certain Gain for Certain Stock in Small Business. Current tax law also generally allows a noncorporate taxpayer who holds certain qualified small business stock for more than 5 years to exclude 50-percent of any gain on the sale or exchange of the stock.[175] The amount of gain eligible for the 50-percent exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million gain from stock in that corporation.[176] For qualified small business stock acquired from February 18, 2009, through December 31, 2010, and held for five years, the percentage exclusion is 75-percent.[177] Under the Small Business Jobs Act of 2010 (as amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[178]), the percentage exclusion for qualified small business stock acquired after the date of enactment of such Act and before January 1, 2012, is increased to 100 percent[179] and the minimum tax preference does not apply.[180] Thus, no regular tax or alternative minimum tax is imposed on the sale of this stock held at least five years.[181] The American Taxpayer Relief Act of 2012 extended the 100% exclusion and the exception from minimum tax preference for two years (for stock acquired before January 1, 2014).[182]

c. Section 1244 Stock. Generally, a loss incurred by an individual taxpayer on a sale or exchange of corporate stock is characterized and reported for federal income tax purposes as a capital loss.[183] Section 1244(a) provides a limited exception to this general rule in that it allows an individual taxpayer to treat a loss on "section 1244 stock" as an ordinary loss where it would otherwise be treated as a loss from the sale or exchange of a capital asset. The aggregate amount of the loss that may be treated as an ordinary loss under section 1244 cannot exceed $50,000 ($100,000 in the case of a husband and wife filing a joint return).[184]

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[174]*See* I.R.C. § 338.

[175]I.R.C. § 1202(a).

[176]I.R.C. § 1202(b)(1).

[177]I.R.C. § 1202(a)(3) (as added by the American Recovery and Reinvestment Tax Act of 2009).

[178]P.L. 111-312, § 360, (2010).

[179]I.R.C. § 1202(a)(4)(A).

[180]I.R.C. 1202(a)(4)(C).

[181]Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," JCX-55-10 (Dec. 10, 2010).

[182]I.R.C. Sec. 1202(a)(4) (as amended by the American Taxpayer Relief Act of 2012, P.L. 112-240, Sec. 324).

[183]*See* I.R.C. §§ 165(f) and (g).

[184]I.R.C. § 1244 (b)(2).

The term "section 1244 stock" generally means stock of a qualifying domestic small business corporation (as defined in the statute) that was issued for money or other property (other than stock or securities).[185] The corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, must have derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.[186]

C. Treatment of Capital Losses Recognized by Individuals. The deductibility of capital losses of both individuals and corporations are subject to limitations.[187] Capital losses generally are deductible in full against capital gains.[188] In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year.[189] Any remaining unused capital losses of individuals may be carried forward indefinitely to another taxable year.[190] Corporate taxpayers, but not individuals, may carryback unused capital losses to the 3 preceding years and carryforward such losses for 5 years.[191]

D. Qualified Dividend Income. Subject to certain limitations, a dividend paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation" is subject to tax at the reduced rates applicable to certain capital gains. For 2014, the maximum rate of tax on the adjusted net capital gain and qualified dividend income of an individual is 20-percent on any amount of such income that otherwise would be taxed at a 39.6% rate.[192] In addition, any adjusted net capital gain and qualified dividend income otherwise taxed at a 10-or 15-percent rate is taxed at a zero-percent rate.[193] Adjusted net capital gain and qualified dividend income otherwise taxed at rates greater than 15-percent but less than 39.6 percent is taxed at a 15 percent rate.[194] These rates apply for purposes of both the regular tax and the alternative minimum tax.[195] The "adjusted net capital gain" of an individual is the sum of (a) the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain; and (b) qualified dividend income.[196] The net capital gain is

[185] I.R.C. § 1244(c).

[186] I.R.C. § 1244(c)(1)(C).

[187] *See* I.R.C. §§ 1211(a), 1211(b).

[188] I.R.C. §§ 1211(a), 1211(b).

[189] I.R.C. § 1211(b).

[190] I.R.C. § 1212(b)(1)

[191] I.R.C. § 1212(a)(1)(B).

[192] I.R.C. Sec. 1(h)(1)(D) (as amended by the American Taxpayer Relief Act of 2012).

[193] I.R.C. § 1(h)(1)(B) (as amended by the American Taxpayer Relief Act of 2012); *see* Jt. Comm. on Tax'n, *Overview of the Federal Tax System as in Effect for 2013*, JCX-2-13R (Jan. 8, 2013), *reprinted at* 2013 TNT 6-14 [hereinafter "JCT 2013 Overview"].

[194] I.R.C. § 1(h)(1)(C) (as amended by the American Taxpayer Relief Act of 2012); JCT 2013 Overview.

[195] *See* I.R.C. § 55(b)(3).

further reduced (but not below zero) by the amount of gain that an individual taxpayer treats as investment income for purposes of determining the investment interest limitation.[197] Net capital gain means net capital gain increased by "qualified dividend income".[198]

Qualified dividend income means dividends received during the taxable year from domestic corporations and "qualified foreign corporations."[199] Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either (i) incorporated in a possession of the United States, or (ii) eligible for benefits of a comprehensive income tax treaty with the United States which Treasury determines is satisfactory for this purpose and which includes an exchange of information program.[200] Subject to the same exceptions, a foreign corporation that does not satisfy either of these two tests is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States.[201] A qualified foreign corporation does not include any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company.[202]

The Revenue Service has announced that, for taxable years beginning on or after January 1, 2003, common or ordinary stock, or an American depositary receipt in respect of such stock, is considered readily tradable on an established securities market in the United States if it is listed on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934[203] or on the Nasdaq Stock Market. Treasury and the IRS are continuing to consider, for future years, the treatment of dividends with respect to stock listed only in a

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[196] I.R.C. § 1(h)(3).

[197] I.R.C. § 1(h)(2).

[198] I.R.C. § 1(h)(11)(A).

[199] I.R.C. § 1(h)(11)(B)(i); *see* Notice 2011-64, 2011-37 I.R.B. 231 which contains the current list of the U.S. tax treaties that meet these requirements. For a recent article analyzing the definition of qualified dividend income in the international context, see Rubinger, “Converting Low-Taxed Income Into ‘Qualified Dividend Income’ for U.S. Taxpayers, 2004 WTD 130-19 (May 11, 2004); see also Notice 2006-3, 2006-3 I.R.B. 306 (“This notice provides guidance for persons required to make returns and provide statements under section 6042 of the Internal Revenue Code with respect to securities issued by a foreign corporation, and for individuals receiving such statements. This notice provides generally that the simplified procedures regarding information reporting of distributions with respect to securities issued by foreign corporations and other rules contained in Notice 2003-79 and Notice 2004-71 for tax years 2003 and 2004, respectively, are extended to apply for 2005 and future years.”).

[200] I.R.C. § 1(h)(11)(C)(i).

[201] I.R.C. § 1(h)(11)(C)(ii).

[202] I.R.C. § 1(h)(11)(C)(iii) (as amended by The Jobs Creation Act of 2004); *see also* Notice 2004-70; 2004-44 I.R.B. 1 (“This notice provides guidance regarding the extent to which distributions, inclusions and other amounts received by, or included in the income of, individual shareholders as ordinary income from foreign corporations subject to certain anti-deferral regimes may be treated as qualified dividend income . . . .”).

[203] 15 U.S.C.A. 78f (West 2004).

manner that does not meet this definition, such as on the OTC Bulletin Board or on the electronic pink sheets.[204]

E. Self-Employment Tax. Sole proprietors are subject to self-employment tax if they have $400 or more in net earnings from self-employment income.[205] In 2014, the tax rate for self-employment tax is 15.3%, of which 12.4% is social security (old age, survivors and disability insurance) plus 2.9% for Medicare (hospital insurance).[206] For 2014, the maximum earnings base for the social security tax is $117,000.[207] (If a self-employed individual also has wages subject to social security taxes, the wages are deducted from the maximum earnings base subject to self-employment tax.[208]) For tax years beginning in 2011 and 2012, a self-employed individual may deduct the sum of 59.6% of the old age, survivors and disability insurance tax paid, plus one-half of the amount of hospital insurance tax paid.[209] For tax years beginning in 2013, a self-employed individual may deduct one half of the old age, survivors and disability insurance tax paid, plus one-half of hospital insurance tax paid.[210] Such deduction is computed without regard to the additional .9% tax on certain wages applicable beginning in 2013 (discussed below).[211]

For the 2010 tax year only, the Small Business Jobs Act of 2010 amended the Code to provide that the deduction for income tax purposes allowed to self-employed individuals for the cost of health insurance for themselves, their spouses, dependents, and children who have not attained the age of 27 as of the end of the tax year is taken into account, and thus is allowed, in calculating net earnings from self employment income.[212]

For tax years beginning after December 31, 2012, the Code imposes on every taxpayer (other than a corporation, estate or trust) a tax equal to .9% of the self-employment income for such tax year which is in excess of (1) in the case of a joint return, $250,000; (2) in the case of a married taxpayer filing a separate return, ½ of the dollar amount determined under clause (i); and (3) in any other case, $200,000.[213]

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[204]Notice 2003-71; 2003-43 I.R.B. 1.

[205]I.R.C. § 1402(b)(2).

[206]I.R.C. § 1401(a); I.R.C. § 1401(b); P.L. 111-312, § 601(a)(1) (as amended by P.L. 112-96, § 1001(a)).

[207]IRS Notice 2013-72, 2013-48 I.R.B. 592.

[208]I.R.C. § 1402(b)(1); *see* Treas. Reg. § 1.1402(b)-1(b)(2)(iii).

[209]I.R.C. § 164(f)(1); P.L. 111-312, § 601(b)(2) (2010) (as amended by as amended by P.L. 112-96, § 1001(a)); Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," JCX-55-10 (Dec. 10, 2010).

[210]I.R.C. Sec. 164(f)(1).

[211]I.R.C. Sec. 164(f)(1)

[212]I.R.C. § 162(l)(4) (as amended by The Small Business Jobs Act of 2010).

[213]I.R.C. § 1401(b)(2)(A) (as added by the Patient Protection and Affordable Care Act and as amended by the Health Care and Education Reconciliation Act of 2010).

F. 3.8 Percent Medicare Contribution Tax on Unearned Income for Tax Years Beginning After December 31, 2012.

1. Overview of Statutory Provisions. Subject to certain limited exceptions, Section 1411(a) subjects certain individuals, estates and trusts to a 3.8% "unearned income Medicare contribution tax"[214] beginning in 2013.

a. Application to Individuals. In the case of an individual, Section 1411(a)(1) imposes a 3.8 percent tax for the tax year on the lesser of (1) "net investment income" for such year,[215] or (2) the excess of modified adjusted gross income ("*MAGI*") for such tax year[216] over the threshold amount.[217]

(1) Net Investment Income. Net investment income is certain statutorily-prescribed investment income reduced by the deductions properly allocable to such income.[218] The referenced statutorily-prescribed investment income is the sum of: (1) gross income from interest, dividends, annuities, royalties, and rents (other than such income which is derived in the ordinary course of business from any trade or business that is neither a passive activity (within the meaning of Section 469) with respect to the taxpayer[219] nor a trade or

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[214]Section 1411 was enacted as part of the Health Care and Education Reconciliation Act of 2010. *See* P.L. 111-152, § 1402(a)(1).

[215]I.R.C. § 1411(a)(1)(A).

[216]I.R.C. § 1411(a)(1)((B)(i).

[217]I.R.C. § 1411(a)(1)(B)(ii).

[218]*See* I.R.C. § 1411(c)(1); *see* "IRS Official Previews Scope of Coming Medicare Contribution Tax Guidance," *in* 2012 TNT 41-2 (Mar. 1, 2012), stating as follows:

> Proposed regulations providing rules for the section 1411 Medicare contribution tax will answer whether the government will grant taxpayers a fresh start on the passive activity grouping rules in reg. section 1.469-4, an IRS official said February 29.
>
> The regs will also address whether interest expense, current passive deductions, suspended passive deductions, and section 469(g) losses triggered by the disposition of an interest in a partnership or S corporation are "properly allocable" for purposes of determining net investment income, said Michala Irons, branch 1 attorney, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries).
>
> Irons, speaking at a Passthroughs and Real Estate Committee meeting of the District of Columbia Bar Taxation Section, said any practitioner who advises clients on section 469 issues should be paying attention to section 1411. "Section 469 matters because one of the trades or businesses that section 1411 applies to is any trade or business that is a passive activity with respect to the taxpayer -- passive activity being defined by reference to section 469," she said.
>
> "Prior to section 1411, taxpayers in most circumstances didn't really care if they were generating passive income, and in some cases they wanted to and tried to generate passive income," Irons said, adding that section 1411 "could represent a paradigm shift in the way people view passive income."

[219]I.R.C. § 1411(c)(2)(A).

business of trading financial instruments or commodities);[220] (2) other gross income derived from any passive activity of the taxpayer or a trade or business of trading in financial instruments or commodities;[221] and (3) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is neither a passive activity with respect to the taxpayer nor a trade or business of trading in financial instruments or commodities.[222]

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[220]I.R.C. § 1411(c)(1)(A)(i); I.R.C. § 1411(c)(2)(B).

[221]I.R.C. § 1411(c)(1)(A)(ii); *see also* Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act," (JCX-18-10), Mar. 21, 2010, *reprinted in* 2010 TNT 55-23 (hereinafter "JCT Healthcare Report"), at p. 70 ("The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.").

[222]I.R.C. § 1411(c)(1)(A)(iii); *see* "Medicare Contribution Tax Looming for S Corps," *in* 2012 TNT 12-4 (Jan. 19, 2012), stating as follows:

> The lack of adequate planning for the impending 3.8 percent Medicare contribution tax on unearned income is worrisome, especially if Congress fails to prevent a return to the pre-Bush tax cut income tax rates, practitioners said January 18.
>
> The section 1411 Medicare contribution tax, which was established as part of the Health Care and Education Reconciliation Act of 2010, imposes a 3.8 percent tax on the "net investment income" of individuals with adjusted gross incomes in excess of $200,000 (or $250,000 for joint filers) and is effective January 1, 2013. That investment income would typically include capital gains, dividends, annuities, royalties, interest, and rents.
>
> For S corporation shareholders, the tax would apply to passthrough investment income and passive activity income, as well as gain from selling property not held in a trade or business that is not passive activity, said Brian J. O'Connor, a partner with Venable LLP.
>
> Speaking at a District of Columbia Bar Taxation Section luncheon in Washington, O'Connor said many S corporation documents, including those for partnerships and limited liability companies, "are typically only going to be based off of income taxes, and they're not likely to take into account employment taxes."
>
> "There are a lot of documents out there that do not take [the Medicare tax] into account," O'Connor said, describing the tax as effectively an employment tax for investment income. Unless S corporations begin planning for the tax, shareholders "will be short" when it comes time to pay their taxes, especially those who have passive positions in those passthroughs, he said.
>
> Coupled with a potential increase of the income tax back to 39.6 percent for the highest bracket, the Medicare contribution tax could pose significant problems for S corporations, which must maintain a single class of stock requirement, O'Connor said. As a result, the S corporations must "distribute the same amount to everyone," he said, adding, "So that essentially means that more money is going to be coming out of the company."
>
> If the income tax rates do rise to pre-Bush era levels, the effect will be "dramatic," O'Connor said. Nonetheless, practitioners can mitigate those effects by making passive shareholders or members into active ones, he said.
>
> Linda E. Carlisle, a partner with White & Case LLP, added that the issue puts "tremendous pressure on the definition of passive activity."
>
> While guidance for the tax did not make the 2011-2012 priority guidance plan for projects affecting S corporations, the IRS has a guidance project open and is "definitely" working

(a) Items Excluded from Gross Income. The JCT Healthcare Report provides that "[g]ross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax."[223]

(b) Income, Gain or Loss on Working Capital. Income, gain, or loss on working capital is not treated as derived in the ordinary course of a trade or business.[224]

(c) Distributions from Retirement Plans. Investment income does not include distributions from a qualified retirement plan.[225] Specifically, Section 1411(c)(5) provides that "net investment income" does not include a distribution from any plan or arrangement described in:

i) Section 401(a) (stock bonus, pension or profit sharing plan);

ii) Section 403(a) (qualified annuity plans);

iii) Section 403(b) (annuities for employees of tax-exempt organizations or public schools);

iv) Section 408 (individual retirement accounts);

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on the matter, said Stacy Short, branch 3 attorney, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries). "We know it's an issue," she said.

In November IRS officials described the guidance as a "top priority," with every division within the Office of Chief Counsel being involved in the project. Section 1411 takes cues from reg. section 1.55-1, with the alternative minimum tax being a good starting point for drafting the section 1411 rules, one official said at the time.

O'Connor said that like the AMT, the Medicare contribution tax is not indexed for inflation, so over time it will affect more and more people. When it comes to drafting legislation, creating a threshold that is not indexed could raise a lot of revenue, he said.

[223]JCT Healthcare Report, 2010 TNT 55-23, at p. 70 fn 285.

[224]I.R.C. § 1411(c)(3); *see generally* "Treasury to Issue Medicare Contribution Tax Guidance Soon," in 2012 TNT 34-13 ("Also, for those taxpayers who materially participate in a business that is not a trading activity, section 1411 will not apply, albeit with some exceptions, [Cornelia Schnyder, attorney-adviser in Treasury's Office of Tax Legislative Counsel] said. One exception is for working capital. For example, 'if you have a business that puts the money it doesn't need aside, and it earns interest, that is subject to 1411,' she said."); *cf.* Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in the "American Jobs and Closing Tax Loopholes Act of 2010," for consideration on the floor of the House of Representatives*, (JCX-29-10), May 28, 2010, *reprinted in* 2010 TNT 104-64, p. 167 ("Net investment income does not include amounts subject to SECA tax. Thus, for example, in the case of a partner, the tax does not apply to any item taken into account in determining self-employment income for the taxable year on which tax is imposed under the self-employment tax rules.").

[225]See I.R.C. § 1411(c)(5).

v) Section 408A (Roth IRAs); or

vi) Section 457(b) (deferred compensation plans of state and local governments and tax-exempt organizations).

(d) Amounts Subject to SECA Tax. Investment income does not include amounts subject to SECA tax.[226]

(e) Treatment of Dispositions of Partnership Interests and Stock in S Corporations. In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition.[227] The JCT Healthcare Report states that "[t]hus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account."[228] The Report also states that "[f]or this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business."[229]

(2) Excess of MAGI Over the Threshold Amount.

(a) MAGI. MAGI is adjusted gross income increased by the amount excluded from income as foreign earned income under Section 911(a)(1) of the Code[230] (net of the deductions and exclusions disallowed with respect to the foreign earned income[231]).

[226]I.R.C. § 1411(c)(6); *see generally* "Treasury to Issue Medicare Contribution Tax Guidance Soon," in 2012 TNT 34-13 ([Cornelia Schnyder, attorney-adviser in Treasury's office of Tax Legislative Counsel] said it is a common misconception that a taxpayer could fall under the section 1411 tax and also self-employment taxes. But '1411 itself has a carveout: If you're already subject to [self-employment taxes], you're not subject to 1411,' she said.").

[227]I.R.C. § 1411(c)(4)(A).

[228]JCT Healthcare Report, . 2010 TNT 55-23, at p. 70.

[229]JCT Healthcare Report, 2010 TNT 55-23, at p. 70 fn 286; *see* "Partners May Be Unaware of How Medicare Contribution Tax Applies to Sale," in 2012 TNT 34-9 (Feb. 21, 2012) ("When partners dispose of their interests in a partnership, the new section 1411 Medicare contribution tax of 3.8 percent on net investment income applies a deemed sale concept, requiring partners to know the tax basis and fair market value of the partnership's assets in order to calculate the gain on the portion that flows to them, an IRS official said February 17. 'Section 1411(c)(4) treats the net gain from a disposition of an interest in a partnership or S corp in the same manner as if the partnership itself had sold the property,' said Curtis Wilson, IRS associate chief counsel (passthroughs and special industries), speaking at a Partnerships & LLCs session of the American Bar Association Section of Taxation meeting in San Diego.").

[230]I.R.C. § 1411(d)(1).

[231]I.R.C. § 1411(d)(2).

(b) Threshold Amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse,[232] $125,000 in the case of a married individual filing a separate return,[233] and $200,000 in any other case.[234]

b. Application to Estates and Trusts. In the case of an estate or trust, Section 1411(a)(2) imposes a 3.8 percent tax for the tax year on the lesser of (a) undistributed net investment income for such tax year;[235] or (b) the excess of adjusted gross income (as defined in Section 67(e) of the Code) for such tax year,[236] over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.[237] Section 1411 does not define "undistributed net investment income."[238]

c. Persons Excluded from Tax. The 3.8 percent tax does not apply to the following persons:

(1) A nonresident alien;[239] or

(2) A trust all the unexpired interests in which are devoted to charitable purposes.[240] The JCT Healthcare Report states that "[t]he tax also does not apply to a

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[232]I.R.C. § 1411(b)(1).

[233]I.R.C. § 1411(b)(2).

[234]I.R.C. § 1411(b)(3).

[235]I.R.C. § 1411(a)(2)(A).

[236]I.R.C. § 1411(a)(2)(B)(i).

[237]I.R.C. § 1411(a)(2)(B)(ii).

[238]*See* "ABA Meeting: Trusts and Estates to be Covered Under Medicare Contribution Tax Regs," in 2012 TNT 93-27 (May 14, 2012) ("Proposed regs for the new section 1411 Medicare contribution tax will address trusts and estates, and practitioners working in those areas should pay close attention when they are released, a Treasury Department official said May 11. Catherine Hughes, an attorney-adviser in Treasury's Office of Tax Policy who spoke at the Estate and Gift Taxes session of the American Bar Association Section of Taxation's annual meeting in Washington, said section 1411 will become effective at the beginning of 2013 but Treasury is working on the regulations now. She explained that the tax was intended to pay for some Medicare costs and that trusts and estates are subject to the tax when they have income in the top bracket. 'There are a lot of rules in there,' Hughes said. 'Please pay attention.'"); "New York State Bar Request Clarification on Medicare Contribution Tax," in 2010 TNT 190-36 (Sept. 29, 2010) ("Under Section 1411(a)(2), an estate or non-grantor trust that is subject to the rules of subparts A through D of part I of subchapter J of chapter one of the Code will be required to pay the unearned income Medicare contribution tax on the lesser of (1) its 'undistributed net investment income' for the taxable year and (2) an amount calculated by reference to its AGI (as defined in Section 67(e)) for the taxable year. Section 1411, however, contains no definition of 'undistributed net investment income,' and there is ambiguity about what the term means, raising potential issues discussed below as to the appropriate treatment of payments in excess of an estate or trust's 'distributable net income' and items of income paid or set aside for charitable purposes. We also request guidance with respect to the application of Section 1411 to foreign estates and trusts.").

[239]I.R.C. § 1411(e)(1).

[240]I.R.C. § 1411(e)(2).

trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under Section 664."[241]

d. Medicare Contribution Tax Subject to Individual Estimated Tax Provisions. The Medicare contribution tax is subject to the individual estimated tax provisions.[242]

(1) Nondeductible Tax. The JCT Healthcare Report states that "[t]he tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes)."[243]

e. Effective Date. Section 1411 applies to taxable years beginning after December 31, 2012.[244]

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[241] JCT Healthcare Report, 2010 TNT 55-23, at p. 69.

[242] I.R.C. § 6654(a) (as amended by the Health Care and Education Reconciliation Act, P.L. 111-152).

[243] JCT Healthcare Report, 2010 TNT 55-23, at p. 69.

[244] P.L. 111-152, § 1402(a)(3); *see generally* "Net Investment Income Tax Guidance to be Comprehensive," *in* 2012 TNT 61-2 (Mar. 2, 2012), stating as follows:

> The government is confident that many questions regarding the section 1411 net investment income tax will be answered in proposed regulations, which are expected to be released soon, an IRS official said March 28.
>
> Several terms that are undefined in the section 1411 statute will be addressed in the coming proposed regulations, including the meaning of "undistributed" net investment income for trusts and estates, the meaning of "taken into account" for purposes of the self-employment income exception under section 1411(c)(6), as well as the meaning of "financial instruments" under section 1411(c)(2)(B), said Michala Irons, branch 1 attorney, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries).
>
> Largely reiterating comments she made several weeks ago, Irons said the proposed regs will address whether interest expenses, current passive deductions, suspended passive deductions, and section 469(g) losses triggered by disposition of an interest in a partnership or S corporation are "properly allocable" for purposes of determining net investment income.
>
> The guidance also will address whether taxpayers should receive a "fresh start" regarding the passive activity grouping rules under reg. section 1.469-4, Irons said, speaking on her own behalf at a District of Columbia Bar Taxation Section luncheon.
>
> **Passive Income 'Paradigm Shift'**
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> Robert Schachat of Ernst & Young LLP said that taxpayers have used the activity grouping rules under section 469, to the extent possible, to structure their income to be passive and their losses to be non-passive. Those activity groupings must remain consistent under reg. section 1.469-4(e), and the tax on net investment income will target those taxpayers.
>
> "It seems to me that this would be a pretty fair opportunity for the government to grant taxpayers a fresh start in activity grouping for section 469, given the change in the statute," Schachat said. He said he's under the impression that the government gave similar relief to taxpayers during the promulgation of regulations under section 704(b) by allowing them to book up their capital accounts.

2. IRS Issues Proposed Regulations Under Section 1411. In late 2012, the IRS issued proposed regulations that provide guidance under section 1411 of the Code.[245] The proposed regulations are generally effective for tax years beginning after December 31, 2013.[246] The Preamble to the Proposed Regulations (hereinafter, ***"1411 Preamble"***) provides that "[t]axpayers may rely on these proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations."[247]

3. IRS Issues Final Regulations. On December 2, 2013, the IRS issued final regulations under Section 1411.[248] The final regulations are effective on December 2, 2013.[249]

> "Section 1411 represents a paradigm shift" for those taxpayers who were in the habit of creating passive income, Irons said. Taxpayers may now rethink how they previously grouped their activities, she said. Nonetheless, the IRS is aware of the interest among taxpayers for a fresh start, and "hopefully we'll be able to say something about that," she said.

See also "Details Emerge on Medicare Contribution Tax Guidance Project," *in* 2011 TNT 218-3 (Nov. 10, 2011), stating as follows:

> A primary drafter of proposed regulations on the new section 1411 Medicare contribution tax of 3.8 percent on net investment income said November 9 that the IRS is focused on making the rules work administratively and from an enforcement standpoint.
>
> "I know that there's going to be some poor tax puppy in a practice office somewhere that's going to be having to do a reconciliation or a schedule of what net investment income is and compare it to whatever the front page of the [Form] 1040 or 1041 is showing," said David Kirk, branch 2 attorney-adviser, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), who spoke on his own behalf at the American Institute of Certified Public Accountants' fall Tax Division meeting in Washington.
>
> Kirk said every division in the IRS Office of Chief Counsel is involved in the project. He added that there are currently 24 forms, publications, and instructions that are scheduled to change as a result of the project and that forms 1120S and 1065 are not currently among that 24. If the project does affect those forms, "it might be an 'other information' box on a [Schedule] K1 that you're going to have to code," he said, adding that practitioners should let the IRS know if its proposal won't work.
>
> Kirk said that in drafting the section 1411 rules, he has taken his cues from reg. section 1.55-1, which says that unless provided otherwise, the general rules of chapter 1 apply to alternative minimum tax. "So if you have a sale or exchange for regular tax, you also have it for AMT -- that's kind of a good starting point for what we're dealing with," he said. "This is a parallel system. This has a lot of nuances like AMT. But it is not AMT." He added that the government doesn't want to create another AMT.
>
> Curtis Wilson, IRS associate chief counsel (passthroughs and special industries), speaking on his own behalf, said the government hopes to have something out soon. "It's one of our top priorities. We're working it quickly," he said.

[245] See Notice of Proposed Rulemaking, REG-130507-11; 77 F.R. 72612-72652, *reprinted in* 2012 TNT 232-15.

[246] Preamble, Notice of Proposed Rulemakeing, REG-130507-11; 77 F.R. at 72632.

[247] 1411 Preamble, 77 F.R. at 72632.

[248] T.D. 9644, 2013-51 I.R.B. 676.

a. Scope of Final Regulations. The Final Regulations provide (1) general operating rules applicable to section 1411;[250] (2) specific rules applicable to individuals;[251] (3) specific rules applicable to estates and trusts;[252] (4) rules for defining net investment income;[253] (5) rules for net investment income derived from trades or businesses that are passive activities or trading in financial instruments or commodities;[254] (6) rules for gross income and net gain on the investment of working capital;[255] (7) rules for distributions from certain qualified plans;[256] (9) rules for items taken into account in determining self-employment income;[257] and (10) rules with respect to controlled foreign corporations and passive foreign investment companies.[258] Finally, the IRS issued final regulations amending the passive activity regulations to provide a regrouping "fresh start" for certain taxpayers.[259]

b. Overview of Selected Provisions of the Final Regulations.

(1) General Operating Rules. The final regulations provide that, except as otherwise provided, all Internal Revenue Code provisions that apply for chapter 1 purposes in determining taxable income of a taxpayer also apply in determining the tax imposed by section 1411.[260] The 1411 Preamble to the Proposed Regulations expanded on this concept by providing that, except as otherwise provided, chapter 1 principles and rules apply in determining the tax under section 1411.[261] Consistent with this general approach, the 1411 Preamble states that, except as otherwise provided, gain that is not recognized under chapter 1 for a taxable year is not recognized for that year for purposes of section 1411.[262] By way of example, the 1411 Preamble cites the following examples: gain deferred or excluded under the

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[249]T.D. 9644, 2013-51 I.R.B. 676.

[250]*See* Treas. Reg. § 1.1411-1.

[251]*See* Treas. Reg. § 1.1411-2.

[252]*See* Treas. Reg. § 1.1411-3.

[253]*See* Treas. Reg. § 1.1411-4.

[254]*See* Treas. Reg. § 1.1411-5.

[255]*See* Treas. Reg. § 1.1411-6.

[256]*See* Treas. Reg. § 1.1411-8.

[257]*See* Treas. Reg. § 1.1411-9.

[258]*See* Treas. Reg. § 1.1411-10.

[259]*See* Treas. Reg. § 1.469-11(b)(3)(iv).

[260]Treas. Reg. § 1.1411-1(a).

[261]1411 Preamble, 2012 TNT 232-15 at p. 77 F.R. at 72613.

[262]1411 Preamble, 2012 TNT 232-15 at p. 77 F.R. at 72613.

installment sale rules, the like-kind exchange rules, the involuntary conversion rules and the rules applicable to the sale of a principal residence.[263]

(2) Specific Rules Applicable to Individuals.

(a) Definition of Individual. The final regulations provide that, for purposes of section 1411 and the regulations thereunder, an individual is any natural person.[264] Section 1411, however, does not apply to nonresident alien individuals.[265] Therefore, in the case of individual, for purposes of section 1411 and the regulations thereunder, the 3.8% tax applies to any citizen or resident of the United States.[266] The final regulations also clarify the treatment of (1) grantor trusts,[267] (2) certain bankruptcy estates,[268]), and (3) bona fide residents of the U.S. territories.[269]

(b) Calculation of Tax. The amount of the tax on individuals is equal to 3.8 percent of the lesser of two amounts: (A) an individual's net investment income for such taxable year, or (B) the excess (if any) of (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount.[270] For example, if an unmarried U.S. citizen has modified adjusted gross income of $190,000, which includes $50,000 of net investment income, there is no tax imposed under section 1411 because the threshold amount for a single individual is $200,000. On the other hand, if that individual has modified adjusted gross income of $220,000, which includes net investment income of $50,000, the individual has a section 1411 tax of $760 (3.8 percent times $20,000, the lesser of $50,000 net investment income or $20,000 excess of modified adjusted gross income over the threshold amount).[271]

(3) Specific Rules Applicable to Estates and Trusts.

(a) General Rule. As a general rule, the final regulations provide that Section 1411 and the regulations thereunder apply to "all estates and trusts that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code, unless specifically exempted by [the regulations]."[272] This rule excludes

[263] 1411 Preamble, 2012 TNT 232-15 at p. 77 F.R. at 72613.

[264] Treas. Reg. § 1.1411-1(d)(5).

[265] Treas. Reg. § 1.1411-2(a)(1).

[266] Treas. Reg. § 1.1411-2(a)(1).

[267] *See* Treas. Reg. §§ 1.1411-2(a)(2)(iv), 1.1411-3(b)(1)(v).

[268] *See* Treas. Reg. §§ 1.1411-2(a)(2)(v), 1.1411-2(d)(1)(ii).

[269] *See* Treas. Reg. § 1.1411-2(a)(2)(vi); 1411 Preamble, 77 F.R. at 72614.

[270] Treas. Reg. § 1.1411-2(b)(1).

[271] Treas. Reg. § 1.1411-2(b)(2).

[272] Treas. Reg. § 1.1411-3(a)(1)(i).

from the application of section 1411 certain business trusts which are treated as business entities and as eligible entities for purposes of entity classification. Accordingly, such trusts are not subject to section 1411 at the entity level.[273]

(b) Exceptions. The final regulations state that the following trusts are excluded from the application of section 1411: (1) a trust all of the unexpired interests in which are devoted to one or more of the following purposes: religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;[274] (2) certain tax-exempt trusts;[275] (3) certain charitable remainder trusts;[276] (5) a trust, or a portion thereof, that is treated as a grantor trust (however, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 shall be treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income);[277] (6) Electing Alaska Native Settlement Trusts;[278] (7) Cemetery Perpetual Care Funds;[279] and (6) certain foreign trusts.[280] The final regulations provide specific guidance relating to electing small business trusts,[281] charitable remainder trusts,[282] foreign estates and trusts,[283] and bankruptcy estates.[284] The final regulations also provide detailed guidance on the calculation of undistributed net investment income.[285]

(4) Other Selected Provisions. The final regulations provide detailed guidance on the determination of net investment income, including guidance on the scope of the ordinary trade or business exception.[286] The final regulations also provide rules for determining whether gross income is derived in a trade or business that qualifies for the

[273]1411 Preamble, 77 F.R. at 72615.

[274]Treas. Reg. § 1.1411-3(b)(1)(i).

[275]Treas. Reg. §. 1.1411-3(b)(1)(ii), 1.1411-3(b)(1)(iv).

[276]Treas. Reg. § 1.1411-3(b)(1)(iii); *see also* Treas. Reg. Sec. 1.1411-3(d).

[277]Treas. Reg. § 1.1411-3(b)(1)(v).

[278]Treas. Reg. Sec. 1.1411-3(b)(1)(vi).

[279]Treas. Reg. Sec. 1.1411-3(b)(1)(vii).

[280]Treas. Reg. § 1.1411-3(b)(1)(viii).

[281]Treas. Reg. Sec. 1.1411-3(c).

[282]Treas. Reg. Sec. 1.1411-3(d).

[283]Treas. Reg. Sec. 1.1411-3(e).

[284]*See* Treas. Reg. §§ 1.1411-3(b)(2)(ii).

[285]Treas.. Reg. § 1.1411-3(e).

[286]Treas. Reg. § 1.1411-4.

exclusion from the tax levied under section 1411 (i.e., rules to determine whether that the trade or business is neither a passive activity to the taxpayer nor the business of trading in financial instruments or commodities),[287] rules for determining whether there has been a disposition of property under section 1411[288] and rules for determining the treatment of properly allocable deductions for purposes of reducing items of gross income and net gain.[289]

G. Alternative Minimum Tax. An individual taxpayer is subject to an alternative minimum tax to the extent the individual's tentative minimum tax liability exceeds his regular tax liability.[290] The alternative minimum tax is applicable to nonresident aliens engaged in a trade or business in the United States.[291]

1. Tentative Minimum Tax Liability. The tentative minimum tax liability is computed for individuals at rates of (1) 26-percent on the first $175,000 of alternative minimum taxable income in excess of a phased-out exemption amount[292] and (2) 28-percent on the amount in excess of $175,000.[293] The excess taxable income above which the 28% rate applies is adjusted for inflation for tax taxable year beginning in a calendar year after 2012.[294] For tax years beginning in 2013, the excess taxable income above which the 28% rate applies is: (1) $89,750 in the case of married individuals filing separate returns; and (2) $179,500 in the case of joint returns, unmarried individuals (other than surviving spouses) and estates and trusts.[295] For tax years beginning 2014, the excess taxable income above which the 28% rate applies is: (1) $91,250 in the case of married individuals filing separate returns; and (2) $182,500 in the case of joint returns, unmarried individuals (other than surviving spouses) and estates and trusts.[296]

The exemption amounts are $78,750[297] in the case of tax years beginning in 2012 ($58,000 in the case of tax years beginning in 2003, 2004 and 2005,[298] $62,550 in the case of tax

[287]Treas. Reg. Sec. 1.1411-5.

[288]Treas. Reg. Sec. 1.1411-4(d).

[289]Treas. Reg. Sec. 1.1441-4(f).

[290]I.R.C. § 55(a).

[291]I.R.C. § 871(b)(1); *Hofstetter v. Commissioner*, 98 T.C. 695, 701 (1992) ("Section 55, imposing the AMT, is expressly made applicable to nonresident alien individuals engaged in a trade or business within the United States. Sec. 871(b)(1).").

[292]I.R.C. §§ 55(b)(1)(A)(i)(I), 55(b)(1)(A)(ii), 55(d).

[293]I.R.C. §§ 55(b)(1)(A)(i)(II), 55(b)(1)(A)(ii), 55(d).

[294]I.R.C. § 55(d)(4).

[295]Rev. Proc. 2013-15, 2013-5 I.R.B. 444.

[296]Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

[297]I.R.C. Sec. 55(d)(1)(A) (as amended by the American Taxpayer Relief Act of 2012).

[298]I.R.C. § 55(d)(1)(A) (as amended by The Working Families Tax Relief Act of 2004).

years beginning in 2006,[299] $66,250 in the case of tax years beginning in 2007,[300] $69,950 in the case of tax years beginning in 2008,[301] $70,950 in the case of tax years beginning in 2009,[302] $72,450 in the case of tax years beginning in 2010,[303] and $74,450 in the case of tax years beginning in 2011[304]) in the case of married individuals filing a joint return and surviving spouses; $50,600 in the case of tax years beginning in 2012[305] ($40,250 in the case of tax years beginning in 2003, 2004 and 2005,[306] $42,500 in the case of tax years beginning in 2006,[307] $44,350 in the case of tax years beginning in 2007,[308] $46,200 in the case of tax years beginning in 2008,[309] $46,700 in the case of tax years beginning in 2009,[310] $47,450 in the case of tax years beginning in 2010,[311] and $48,450 in the case of tax years beginning in 2011[312]) in the case of other unmarried individuals; and $22,500 for in the case of estates and trusts.[313] In the case of any taxable year beginning in a calendar year after 2012, the exemption amounts are adjusted for inflation.[314] For tax years beginning in 2013, the exemption amounts are: (1) $80,800 for joint returns and surviving spouses; (2) $51,900 for unmarried individuals (other than surviving spouses); (3) $40,400 for married individuals filing separate returns; and (4) $23,100 for estates and trusts.[315] For tax years beginning in 2014, the exemption amounts are: (1) $82,100 for joint returns or surviving spouses; (2) $52,800 for unmarried individuals (other than surviving

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[299] I.R.C. § 55(d)(1)(A) (as amended by the Tax Increase Prevention and Reconciliation Act of 2005).

[300] I.R.C. § 55(d)(1)(A) (as amended by the Tax Increase Prevention Act of 2007).

[301] I.R.C. § 55(d)(1)(A) (as amended by the Emergency Economic Stabilization Act of 2008).

[302] I.R.C. § 55(d)(1)(A) (as amended by the American Recovery and Reinvestment Tax Act of 2009).

[303] I.R.C. § 55(d)(1)(A) (as amended by Section 201(a)(1) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010).

[304] I.R.C. § 55(d)(1)(A) (as amended by Section 201(a)(1) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010).

[305] I.R.C. Sec. 55(d)(1)(B) (as amended by the American Taxpayer Relief Act of 2012).

[306] I.R.C. § 55(d)(1)(B) (as amended by The Working Families Tax Relief Act of 2004).

[307] I.R.C. § 55(d)(1)(B) (as amended by the Tax Increase Prevention and Reconciliation Act of 2005).

[308] I.R.C. § 55(d)(1)(B) (as amended by the Tax Increase Prevention Act of 2007).

[309] I.R.C. § 55(d)(1)(B) (as amended by the Emergency Economic Stabilization Act of 2008).

[310] I.R.C. § 55(d)(1)(B) (as amended by the American Recovery and Reinvestment Tax Act of 2009).

[311] I.R.C. § 55(d)(1)(B) (as amended by Section 201(a)(2) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010).

[312] I.R.C. § 55(d)(1)(B) (as amended by Section 201(a)(2) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010).

[313] I.R.C. § 55(d)(1)(D) (as amended by The Working Families Tax Relief Act of 2004).

[314] I.R.C. § 55(d)(4).

[315] Rev. Proc. 2013-15, 2013-5 I.R.B. 444.

spouses); (3) $41,050 for married individuals filing separate returns; and (4) $23,500 for estates and trusts.[316]

The foregoing exemption amounts are phased out by an amount equal to 25-percent of the amount that the individual's alternative minimum taxable income exceeds a threshold amount ($150,000 for married individuals filing a joint return and surviving spouses; $112,500 for unmarried individuals; and $75,000 for married individuals filing a separate return, estates, and trusts).[317] The foregoing amounts are adjusted for inflation for tax taxable year beginning in a calendar year after 2012.[318] For tax years beginning in 2013, the amounts used to determine the phaseout of the exemption amounts are: (1) $153,900 for joint returns and surviving spouses; (2) $115,400 for unmarried individuals (other than surviving spouses); and (3) $76,950 for married individuals filing separate returns and estates and trusts.[319] For tax years beginning in 2014, the amounts used to determine the phaseout of the exemption amounts are: (1) $156,500 for joint returns and surviving spouses; (2) $117,300 for unmarried individuals (other than surviving spouses; and (3) $78,250 for married individuals filing separate returns and estates and trusts.[320]

2. Lower Capital Gains Rates Apply for Purposes of Alternative Minimum Tax. The lower capital gains rates applicable to the regular tax also apply for purposes of the alternative minimum tax.[321]

3. Alternative Minimum Taxable Income. Alternative minimum taxable income is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.[322] Certain other rules on allowance of losses and credits also apply.[323]

a. Preference Items. Minimum tax preference items for individuals include:

(1) The excess of the percentage depletion deduction over the adjusted basis of mineral property at the end of the tax year.[324] The percentage depletion

[316] Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

[317] I.R.C. § 55(d)(3).

[318] I.R.C. § 55(d)(4).

[319] Rev. Proc. 2013-15, 2013-5 I.R.B. 444.

[320] Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

[321] I.R.C. § 55(b)(3).

[322] I.R.C. § 55(b)(2).

[323] *See*, *e.g.*, I.R.C. § 58, 56(d), 53, 59.

[324] I.R.C. § 57(a)(1); *see* Treas. Reg. § 1.57-1(h).

deduction claimed by certain independent oil and gas producers and royalty owners is not a tax preference item.[325]

(2) Generally, for integrated oil companies only,[326] the amount by which excess intangible drilling costs arising in the tax year exceed 65-percent of the net income from oil, gas, and geothermal properties.[327]

(3) Certain tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds) issued after August 7, 1986.[328]

(4) Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.[329]

(5) A prescribed percentage of the amount excluded from income as a gain on the sale of certain small business stock.[330]

b. Adjustments in Computing Alternative Minimum Taxable Income. The adjustments that individuals must make to compute alternative minimum taxable income include:

(1) Depreciation on certain property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property.[331] Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the alternative minimum tax methods described in the previous sentence.[332] Depreciation on certain property placed in service after September 10, 2001, and before January 1, 2005, which is allowed an additional allowance under Section 168(k) of the Code for regular tax purposes is computed without regard to any AMT adjustments.[333]

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[325] I.R.C. § 57(a)(1).

[326] I.R.C. § 57(a)(2)(E).

[327] I.R.C. § 57(a)(2).

[328] I.R.C. § 57(a)(5).

[329] I.R.C. § 57(a)(6).

[330] I.R.C. § 57(a)(7).

[331] I.R.C. § 56(a)(1)(A)(i).

[332] I.R.C. § 56(a)(1)(A)(ii).

[333] I.R.C. § 168(k)(2)(G).

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.[334]

(3) Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.[335]

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method).[336] The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.[337]

(5) The alternative tax net operating loss deduction is allowed in lieu of the net operating loss deduction.[338]

(6) Miscellaneous itemized deductions are not allowed.[339]

(7) Itemized deductions for State, local, and foreign real property taxes; State and local personal property taxes; and State, local, and foreign income, war profits, and excess profits taxes are not allowed.[340]

(8) Medical expenses are allowed only to the extent they exceed 10-percent of the taxpayer's adjusted gross income.[341]

(9) Standard deductions and personal exemptions are not allowed.[342]

(10) The amount allowable as a deduction for circulation expenditures must be capitalized and amortized over a 3-year period.[343]

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[334] I.R.C. § 56(a)(2).

[335] I.R.C. § 56(a)(3).

[336] I.R.C. § 56(a)(5)

[337] I.R.C. § 56(a)(5).

[338] I.R.C. § 56(a)(4).

[339] I.R.C. § 56(b)(1)(A)(i).

[340] I.R.C. § 56(b)(1)(A)(ii).

[341] I.R.C. § 56(b)(1)(B).

[342] I.R.C. § 56(b)(1)(E).

(11) The amount allowable as a deduction for research and experimentation expenditures must be capitalized and amortized over a 10-year period.[344]

(12) The special regular tax rules relating to incentive stock options do not apply.[345]

4. Credit for Prior Year Minimum Tax Liability. If an individual is subject to alternative minimum tax in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year.[346] For individuals, the credit is allowed only to the extent that the taxpayer's alternative minimum tax liability is the result of adjustments that are timing in nature.[347]

H. Employer Identification Numbers.

1. Sole Proprietorships. An individual, whether U.S. or foreign, who is an employer or is engaged in a trade or business as a sole proprietor should use an employer identification number (sometimes referred to herein as "EIN") as required by Internal Revenue Service returns, statements, or other documents and their related instructions.[348]

2. Special Rules Regarding Disregarded Entities.

a. General Rule. As a general rule, a single owner entity that is disregarded as an entity separate from its owner must use its owner's taxpayer identification number (sometimes referred to herein as "TIN") for federal tax purposes.[349] For purposes of employment taxes and related reporting requirements applicable to wages paid on or after January 1, 2009, the Treasury Regulations provide that a disregarded entity is treated as a separate entity.[350] The regulations clarify that the separate entity is treated as a corporation for purposes of employment taxes and related reporting requirements.[351] The regulations also clarify that an owner of a disregarded entity treated as a sole proprietorship is subject to self-employment tax on self-employment income arising from the disregarded entities activities.[352]

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[343]I.R.C. § 56(b)(2)(A)(i).

[344]I.R.C. § 56(b)(2)(A)(ii).

[345]I.R.C. § 56(b)(3).

[346]I.R.C. § 53(a), 53(b), 53(c).

[347]I.R.C. § 53(d)(1)(B).

[348]Treas. Reg. § 301.6109-1(a)(1)(ii)(D).

[349]Treas. Reg. § 301.6109-1(h)(2)(i).

[350]Treas. Reg. §§ 301.7701-2(c)(2)(iv)(A), 301.7701-2(c)(2)(iv)(B).

[351]Treas. Reg. § 301.7701-2(c)(2)(iv)(B).

[352]Treas. Reg. § 301.7701-2(c)(2)(iv)(A).

The regulations contain an example illustrating than an individual owner of a disregarded entity continues to be treated as self-employed for purposes of the self-employment tax, and not as an employee of a disregarded entity for employment tax purposes.[353]

b. Classification Changes. Any entity that has an EIN will retain that EIN if its federal tax classification changes.[354] If a single owner entity's classification changes so that it is recognized as a separate entity for federal tax purposes, and that entity had an EIN, then the entity must use that EIN and not the TIN of the single owner. If the entity did not already have its own EIN, then the entity must acquire an EIN and not use the TIN of the single owner.[355] The Revenue Service provided additional guidance regarding these rules in Revenue Ruling 2001-61.[356]

IV: C CORPORATIONS.

A. Corporate Income Tax Rates. The taxable income of a C corporation is subject to federal income tax at graduated rates ranging from 15-percent to 35-percent.[357]

1. Corporate Tax Rate Schedule. The tax rate schedule for a C corporation is as follows:[358]

If taxable income is:			
Over--	But not over--	Tax is:	Of the amount over--
$0	$50,000	15%	-0-
$50,000	$75,000	$7,500 + 25%	$50,000
$75,000	$100,000	$13,750 + 34%	$75,000
$100,000	$335,000	$22,250 + 39%[359]	$100,000
$335,000	$10,000,000	$113,900 + 34%	$335,000
$10,000,000	$15,000,000	$3,400,000 + 35%	$10,000,000
$15,000,000	$18,333,333	$5,150,000 + 38%[360]	$15,000,000
$18,333,333	--	35%	-0-

[353] Treas. Reg. § 301.7701-2(c)(2)(iv)(C), Example (iii).

[354] Treas. Reg. § 301.6109-1(h)(1).

[355] Treas. Reg. § 301.6109-1(h)(2)(ii).

[356] 2001-2 C.B. 573.

[357] I.R.C. §§ 11(a), 11(b).

[358] I.R.C. § 11(a).

[359] The tax rate for a C corporation with taxable income in excess of $100,000 is increased by the lesser of (i) 5 percent of such excess, or (ii) $11,750. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 5 percent of tax is imposed on taxable income between $100,000 and $335,000.

[360] The tax rate for corporations with taxable income in excess of $15,000,000 is increased by the lesser of (i) 3 percent of such excess, or (ii) $100,000. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 3 percent of tax is imposed on taxable income between $15,000,000 and $18,333,333.

Under current law, the capital gains of a corporation are taxed at the same rates as ordinary income.[361]

2. Tax Rate Applicable to Qualified Personal Service Corporation. A qualified personal service corporation is taxed at a flat rate of 35-percent on taxable income.[362] Generally, a personal service corporation is one substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and substantially all of the stock of which is held by employees or retired employees or by their estates or by certain persons who acquired the stock from a deceased employee and who have held the stock for 2 years or less.[363]

B. Tax Treatment of Contributions to a Corporations.

1. General Rule of Nonrecognition. Generally, no gain or loss is recognized to the corporation or to the contributing shareholder, in the case of contributions of property to a corporation solely in exchange for stock of the corporation, by one or more persons who have control of the corporation immediately after the exchange.[364] Transferors are in control of a transferee corporation if, immediately after the transfer, they own stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80-percent of the total number of share of all other classes of stock of such corporation.[365] (The control requirement for tax-free contributions by shareholders differs from the treatment under the partnership rules, which do not require that the partner control the partnership for his contribution to be tax-free.)

In addition to the statutory requirements of section 351, the Internal Revenue Service takes the position that a transaction meeting the statutory elements of section 351 does not qualify for nonrecognition if it lacks a non-tax, business purpose.[366] One court has expressly

[361]*See* I.R.C. § 1201(a).

[362]I.R.C. § 11(b)(2).

[363]I.R.C. § 448(d)(2); s*ee* Treas. Reg. § 1.448-1T(e).

[364]I.R.C. § 351(a); Treas. Reg. § 1.351-1(a)(1).

[365]I.R.C. §§ 351(a), 368(c); Treas. Reg. § 1.351-1(a)(1).

[366]*See, e.g.,* ILM 200242006 (Jun. 27, 2002) ("Courts have held that a transaction meeting the statutory elements of §351 does not qualify for nonrecognition if it lacks a non-tax business purpose . . . You have indicated that the facts as currently developed do not suggest a plausible business purpose for the putative §351 transactions. If the Taxpayer does provide a purported business purpose for this transaction you should attempt to get as many details as possible and address any defects in that explanation."); ILM 200235005 (May 15, 2002) ("Generally, section 351 will apply to a transaction if the taxpayer has a valid business purpose for the transaction other than tax savings."); FSA 200224011 (Mar. 5, 2002) ("In addition to satisfying the technical requirements of § 351, a transfer must have a bona fide business purpose in order to qualify as a § 351 exchange."); FSA 200135001 (Jul. 16, 1999) ("If the transfers to Sub2 lack a business purpose, the transfers would be treated as taxable sales under I.R.C. section 1001.").

held that the transfer of property to a controlled corporation must have a business purpose to qualify under Section 351.[367]

Stock issued for services is not considered as being issued in return for property.[368] In addition, stock issued for the following is not considered as being issued in return for property: (1) indebtedness of the transferee corporation which is not evidenced by a security; and (2) interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt.[369]

2. Receipt of Boot.

a. Transferor Recognizes Gain upon Receipt of Boot. If the transferor in a transaction subject to section 351(a) receives not only the transferee corporation's stock but also other property or money ("boot"), the transferor is required to recognize gain.[370] The amount of gain recognized, however, is limited to the amount of money received plus the fair market value of other property received. Any loss to the transferor is not recognized.[371]

b. Certain Preferred Stock Treated as Boot. Certain preferred stock is treated as boot for purposes of Section 351.[372] (For this purpose, the term "preferred stock" means stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent. Stock is not treated as participating in corporate growth to any significant extent unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.[373]) Preferred stock treated as boot is referred to as "nonqualified preferred stock." Nonqualified preferred stock ("NQPS") is defined as preferred stock if (1) the holder has the right to require the issuer or a related person to redeem or purchase the stock, (2) the issuer or a related person is required to redeem or purchase the stock, (3) the issuer or a related person has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part (directly or indirectly)

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[367] *See Caruth v. U.S.*, 688 F. Supp. 1129, 1138-1141 (N.D. Tex. 1987) , *aff'd on other issues*, 865 F.2d 644 (5th Cir. 1989); *cf. Stewart v. Commissioner*, 714 F.2d 977, 989 (9th Cir. 1983) ("Both section 482 and the substance-over-form doctrine have been held to limit the extent to which a taxpayer may obtain nonrecognition treatment under section 351 for a transaction that appears formally to fall within the bounds of the provision."); *Estate of Kluener v. Commissioner*, 154 F.3d 630, 634 (6th Cir. 1998) ("Therefore, a shareholder may use §351 so long as some valid, non-tax business purpose partially motivated the transfer, even if tax concerns also played a major role. Stewart, 714 F.2d at 987."), *aff'g in part and rev'g in part* 72 T.C.M. (CCH) 1326 (1996).

[368] I.R.C. § 351(d)(1); Treas. Reg. § 1.351-1(a)(1)(i).

[369] I.R.C. §§ 351(d)(2), 351(d)(3).

[370] I.R.C. § 351(b)(1).

[371] I.R.C. § 351(b)(2).

[372] I.R.C. § 351(g)(1).

[373] I.R.C. § 351(g)(3)(A) (as amended by The American Jobs Creation Act of 2004).

with reference to interest rates, commodity prices, or other similar indices.[374] Factors (1), (2), and (3) above will cause an instrument to be NQPS only if the right or obligation may be exercised within 20 years of the date the instrument is issued and such right or obligation is not subject to a contingency which, as of the issue date, makes remote the likelihood of the redemption or purchase.[375]

The foregoing rights or obligations do not cause preferred stock to be NQPS in certain prescribed circumstances.[376] In one exception, if neither the stock surrendered nor the stock received in the exchange is stock of a publicly-traded corporation, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetency of the holder.[377] In another exception, a redemption or purchase right does not cause stock to be NQPS if the stock containing the right is transferred in connection with the performance of services for the issuer or a related person (and represents reasonable compensation), and the right may be exercised only upon the holder's separation from service.[378]

3. Treatment of Liabilities. A transferor in a section 351 exchange is generally not treated as receiving boot where the acquiring corporation assumes a liability of the transferor.[379] One exception to this general rule provides that if, in connection with the transfer of property to a controlled corporation, the transferor's principal purpose for having the controlled corporation assume a liability of the transferor or take the property subject to a liability: (1) is to avoid federal income tax on the exchange or (2) is not a bona fide business purpose, then the total amount of liability assumed will be treated as money received by the taxpayer on the exchange.[380] If this exception applies and the transferor has realized gain on the section 351 exchange, the transferor will recognize that gain to the extent of the boot deemed received under this provision.[381]

Another exception to the general rule provides that if total liabilities assumed exceed the adjusted basis of all the property transferred, the excess is considered gain from the sale or exchange of the property transferred. This exception does not treat the assumption of excess liabilities as money received by the transferor. Instead it provides that the excess must be considered as gain.[382] Certain liabilities are excluded from the provisions of this exception.[383]

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[374]I.R.C. § 351(g)(2)(A).

[375]I.R.C. § 351(g)(2)(B).

[376]*See* I.R.C. § 351(g)(2)(C).

[377]I.R.C. § 351(g)(2)(c)(i)(I), 351(g)(2)(c)(ii).

[378]I.R.C. § 351(g)(2)(C)(i)(II).

[379]I.R.C. § 357(a); Treas. Reg. § 1.357-1(a).

[380]I.R.C. § 357(b); Treas. Reg. § 1.357-1(c).

[381]I.R.C. § 357(b); Treas. Reg. § 1.357-1(c).

[382]I.R.C. § 357(c)(1); Treas. Reg. 1.357-2(a).

4. Transfers to an Investment Company. The nonrecognition rule of Section 351(a) does not apply to "a transfer of property to an investment company." A transfer of property will be considered to be "a transfer to an investment company" if: (i) the transfer results in diversification of the transferor's interests;[384] and (ii) the transferee is a regulated investment company, a real estate investment trust, or a corporation more than 80-percent of the value of whose assets are:

a. Held for investment; and

b. Consist of money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in real estate investment trusts, regulated investment companies, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the assets listed in the statute.[385] Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are listed assets,[386] and to the extent provided in regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to listed assets.[387]

A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets in the exchange.[388]

5. Basis.

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[383]*See* I.R.C. § 357(c)(3).

[384]*See* Staff of the Joint Committee on Taxation, 105th Cong., *General Explanation of Tax Legislation Enacted in 1997*, 184 (1997) ("The bill is intended to change only the types of assets considered in the definition of an investment company in the present Treasury regulations (Treas. reg. sec. 1.351-1(c)(1)(ii)) and not to override the other provisions of those regulations. For example, the bill does not override (1) the requirement that only assets held for investment are considered for purposes of the definition (Treas. reg. sec. 1.351-1(c)(3)), (2) the rule treating the assets of a subsidiary as owned proportionately by a parent owning 50 percent or more of its stock (Treas. reg. sec. 1.351-1(c)(4)), (3) the requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer (Treas. reg. sec. 1.351-1(c)(2)), and (4) the requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized (Treas. reg. sec. 1.351-1(c)(1)(i)." [footnote omitted]); *cf*. Priv. Ltr. Rul. 200211017 (Dec. 12, 2001) ("The legislative history to the Taxpayer Relief Act of 1997 amendment to section 351(e)(1) makes clear that the 1997 amendments to section 351(e) do not override § 1.351-1(c)(4)."); Priv. Ltr. Rul. 199901028 (Oct. 13, 1998) ("[T]he Act is not intended to alter the requirement of section 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under section 351(e) only if the transfer results, directly or indirectly, in the diversification of the transferors' interests.").

[385]I.R.C. § 351(e)(1)(B).

[386]I.R.C. § 351(e)(1)(vi).

[387]I.R.C. § 351(e)(1)(vii).

[388]Treas. Reg. § 1.351-1(c)(5).

a. Basis of Property Received by the Transferee Corporation. A corporation's basis in property acquired in a transaction to which § 351(a) of the Code applies is generally the same as it would be in the hands of the transferor, increased by the amount of gain recognized by the transferor on the transfer.[389] Section 362(e), enacted by the American Jobs Creation Act of 2004, provides that if the aggregate adjusted bases of property contributed by a transferor to a corporation exceed the aggregate fair market value of the property transferred in a transaction subject to Section 351(a), the transferee's aggregate bases of the property is limited to the aggregate fair market value of the transferred property.[390] Under the provision, any required basis reduction is allocated among the transferred properties in proportion to their respective built-in-loss immediately before the transaction.[391] The new provision permits the transferor and transferee to make an irrevocable election to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred.[392] Such election is required to be included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs.[393]

b. Basis of Stock Received by Transferor. In the case of an exchange to which section 351 applies, the basis of the stock received by the transferor without the recognition of gain or loss is generally the same as the basis of the property exchanged, decreased by the fair market value of any boot received by the taxpayer and increased by the amount of any gain to the taxpayer recognized on the exchange.[394] If the transferee corporation assumes a liability of the transferor or takes property subject to a liability, such assumption or acquisition (in the amount of the liability) is treated (for purposes of determining basis) as money received by the taxpayer on the exchange.[395]

C. Taxation of Corporate Distributions.

1. Tax Consequences to Corporation. No gain or loss is generally recognized by a corporation on a distribution of its stock (or rights to acquire its stock).[396] A corporation, however, must generally recognize gain if appreciated property (other than an obligation of the corporation) is distributed to shareholders, regardless of whether the

[389] I.R.C. § 362(a); Treas. Reg. § 1.362-1(a).

[390] I.R.C. § 362(e)(2)(A).

[391] I.R.C. § 362(e)(2)(B).

[392] I.R.C. § 362(e)(2)(C)(i).

[393] I.R.C. § 362(e)(2)(C)(ii).

[394] I.R.C. § 358(a)(1); Treas. Reg. § 1.358-1(a).

[395] I.R.C. § 358(d).

[396] I.R.C. § 311(a)(1).

distribution is characterized as an "operating" or "liquidating" distribution.[397] The gain is recognized as if such property were sold to the distributee at its fair market value.[398]

2. Tax Consequences to Shareholder.

a. Taxation of Operating Distributions. Corporate earnings that are distributed to individual shareholders as dividends are taxed at individual ordinary income tax rates.[399] Dividends are generally those amounts representing distributions from the corporation's earnings and profits.[400] Distributions of the corporation's stock, however, are generally not treated as taxable dividends to the shareholders.[401] Distributions to shareholders with respect to the corporation's stock, in excess of the amount constituting a dividend, are treated as tax-free return of basis to the extent of the shareholder's basis in the stock, and as gain thereafter.[402]

b. Distributions in Redemption of Stock. Generally, corporate earnings that are not distributed to shareholders in the form of dividends, but rather are distributed in exchange for all of a shareholder's stock, can be treated as amounts paid for a sale or exchange of a shareholder's stock at capital gains rates which are significantly below the ordinary income rates.[403]

c. Taxation of Liquidating Distributions. Shareholders are also subject to tax in the case of liquidating distributions by the corporation. The amount received by a shareholder as a liquidating distribution is treated as received in exchange for his stock.[404] Thus, the shareholder includes in income the excess of the amount received in liquidation over his adjusted basis in his stock.[405]

3. Liquidations of Subsidiaries.

a. Tax Treatment of Distributee Corporation. Under the general rule for the treatment of distributions in liquidation of a corporation, amounts received by one

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[397] I.R.C. § 311(b)(1)(A); I.R.C. § 336(a).

[398] I.R.C. § 311(b); I.R.C. § 336(a).

[399] I.R.C. § 301(c)(1).

[400] I.R.C. §§ 301(c)(1), 316(a).

[401] I.R.C. § 305.

[402] I.R.C. § 301(c).

[403] I.R.C. § 302(a).

[404] I.R.C. § 331(a); Treas. Reg. § 1.331-1(a).

[405] *See* Treas. Reg. § 1.331-1(b); *but cf.* PLR 200613027 (Dec. 16, 2005) ("[T]he conversion of the Taxpayer from a corporation into a limited liability company taxable as a partnership pursuant to the Rescission Transaction will not be treated as a liquidation of Corporation for purposes of determining the taxable income of the Taxpayer, Owner 1, or Owner 2.").

corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation and gain or loss is recognized.[406] One exception to this general rule provides for nonrecognition of gain or loss with respect to property received by one corporation in complete liquidation of the stock of another corporation if certain requirements are met.[407] One of the principal requirements is that the corporation which is the actual owner of stock (in the liquidating distribution) owns (1) stock possessing at least 80-percent of the total combined voting power of all classes of stock entitled to vote and (2) at least 80-percent of the total combined value of the stock of such corporation (excluding certain nonvoting preferred stock for purposes of these tests).[408]

b. Tax Treatment of Distributing Corporation. No gain or loss is recognized to the liquidating corporation on the distribution to a distributee corporation meeting the 80-percent vote and value requirements discussed above.[409]

D. Taxable Stock and Asset Acquisitions.

1. Stock Sales. If the stock of a corporation is sold in a taxable sale, the selling shareholder recognizes gain or loss from their sale of stock. The gain or loss is measured by the difference between the amount realized by the shareholder from the sale and the taxpayer's adjusted basis in the stock.[410] The amount realized from the sale is the sum of any money plus the fair market value of property received.[411] The purchaser of the stock takes a basis in the stock equal to his cost.[412]

If all of the stock of a C corporation is acquired in a taxable sale, the basis of assets inside the acquired corporation does not change to reflect the stock purchase price. If a corporation acquires 80-percent or more of the stock of another corporation within a 12-month period in a taxable purchase, an election is available under certain circumstances to recognize corporate level gain and pay corporate level tax on such gain.[413]

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[406] I.R.C. § 331; *see* Treas. Reg § 1.332-1.

[407] *See* I.R.C. § 332(b); Treas. Reg. § 1.332-1.

[408] I.R.C. § 332(b)(1); I.R.C. § 1504(a)(2); *see generally* Bittker & Eustice, 1 Federal Income Taxation of Corporations and Shareholders, ¶ 10.21[3][a], n. 286, (7th ed. 2002) ("Because § 332(b)(1) incorporates the control test of § 1504(a)(2), it necessarily incorporates the definition of 'stock' in § 1504(a)(4), which excludes so-called pure preferred stock.").

[409] I.R.C. § 337(a).

[410] I.R.C. § 1001(a).

[411] I.R.C. § 1001(b).

[412] I.R.C. § 1012.

[413] *See* I.R.C. § 338.

2. **Asset Sales.** If the assets of a corporation are sold in a taxable sale, the selling corporation recognizes gain or loss and the buyer obtains a cost basis for the assets.[414] If the proceeds of the sale are then distributed to the individual shareholders of the selling corporation, the distribution (to the extent it exceeds the shareholder's basis in his stock) is subject to taxation again in the hands of the shareholders.[415]

E. **Section 338.** Section 338 allows certain purchasers of stock to treat the purchases as purchases of assets. A purchasing corporation can elect to treat a stock acquisition as an asset acquisition if it acquires 80 percent of the total voting power and 80 percent of the total value of the stock of a target corporation[416] (not taking into account certain preferred stock) by purchase within a 12-month period.[417] If a purchasing corporation makes a Section 338 election, the target is treated as if it (as old target) sold all of its assets at the close of the acquisition date at fair market value in a single transaction and (as new target) purchased all of the assets as of the beginning of the date after the acquisition date.[418] The following is a summary of the elections available under Sections 338(g) and 338(h)(10).[419]

1. **Election Under Section 338(g).** If a purchasing corporation acquires the stock of a target corporation in a qualified stock purchase and makes a Section 338(g) election (i.e., makes a general Section 338 election, not a Section 338(h)(10) election), old target's gain or loss from the deemed asset sale is included in old target's final return[420] unless old target is a member of a consolidated group or is an S corporation. In the consolidated and S corporation cases, old target files a special final return.[421] In the consolidated case, that return is not consolidated with either the selling corporation's or the purchasing corporation's consolidated group.[422] In the S corporation case, old target must file the special final return as a C corporation.[423] The Section 338(g) election (as opposed to a Section 338(h)(10) election) generally does not change the tax treatment of the selling shareholders -- that is, they are still taxed on their stock sale, notwithstanding the purchasing corporation's Section 338(g) election. The benefit of an election under Section 338(g) is economically valuable to a purchasing corporation only in limited situations because the present value of the future tax savings resulting

[414] I.R.C. § 1001(a).

[415] *See, e.g.,* I.R.C. §§ 301(c)(1), 301(c)(3), 331.

[416] I.R.C. § 338(d)(3).

[417] I.R.C. § 338(a).

[418] I.R.C. § 338(a).

[419] Treas. Reg. § 1.338-1(a).

[420] Treas. Reg. § 1.338-10(a)(1).

[421] Treas. Reg. § 1.338-10(a)(2); Treas. Reg. § 1.338-10(a)(3).

[422] Treas. Reg. § 1.338-10(a)(2).

[423] Treas. Reg. § 1.338-10(a)(3).

from the increase in the basis of the target's assets will rarely exceed the current tax cost of the Section 338(g) election.[424]

2. Election Under Section 338(h)(10). In certain cases, the selling shareholders may join with the purchasing corporation in making a Section 338(h)(10) election. Until 1994, a Section 338(h)(10) election could be made only for target corporations that were members of a consolidated group. The 1994 revisions to the Section 338 regulations expanded the eligibility for Section 338(h)(10) elections to target corporations that are members of an affiliated group and S corporations.[425] The Section 338(h)(10) election changes the tax treatment of old target and the selling shareholders. Old target is deemed to sell all its assets in a single transaction while a member of the selling consolidated group (or while a non-consolidated affiliate, or while an S corporation owned by the selling shareholders). Old target is then deemed immediately thereafter to distribute its assets in complete liquidation to the members of the selling consolidated group who sold the target stock (or to the selling affiliate or to all the S corporation shareholders).[426] Thus, under Section 338(h)(10), the selling shareholders are not treated as selling stock but instead realize gain or loss, if any, on the stock in the deemed liquidation.[427] Generally, a selling consolidated group or selling affiliate will recognize no stock gain or loss on the deemed liquidation under Section 332.[428] S corporation shareholders should include their share of items of income, gain, loss, or deduction on the deemed asset sale passed through to them under Section 1366, increase or decrease their basis accordingly under Section 1367, and then recognize any remaining gain or loss in their stock under Section 331.[429]

F. Corporate Reorganizations.

1. General Purpose of Reorganization Provisions. The corporate reorganization rules of the Internal Revenue Code provide an exception to the general rule of gain or loss recognition applicable to property exchanges.[430] The reorganization rules provide for tax-free treatment in certain corporate readjustment transactions, provided the proper amount and type of stock consideration is given to the shareholders, and provided that a sufficient amount of stock or assets of the target corporation are acquired.[431]

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[424] Mark J. Silverman, *Section 338*, *in* 3 PLI CORPORATE TAX PRACTICE SERIES: STRATEGIES FOR ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 7, 19-20 (Louis S. Freeman ed., 2009).

[425] Notice of Proposed Rulemaking, REG -107069-97; 64 F.R. 43462-43503, *reprinted in* 1999 TNT 158-8.

[426] Treas. Reg. § 1.338(h)(10)-1(d)(3); Treas. Reg. § 1.338(h)(10)-1(d)(4).

[427] Treas. Reg. § 1.338(h)(10)-1(d)(5)(iii).

[428] See Treas. Reg. § 1.338(h)(10)-1(d)(5)(i); Notice of Proposed Rulemaking, REG -107069-97; 64 F.R. 43462-43503, *reprinted in* 1999 TNT 158-8.

[429] Treas. Reg. § 1.338(h)(10)-1(d)(5).

[430] *See* Treas. Reg. § 1.368-1(b).

[431] *See* Treas. Reg. § 1.368-1(b).

2. Types of Reorganizations. The Code confers tax-free treatment on certain types of corporate reorganizations.

a. Type A Reorganization: A Type A reorganization is a statutory merger or consolidation.[432] For purposes of section 368(a)(1)(A), a statutory merger or consolidation is a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation, in which transaction, as a result of the operation of such statute or statutes, the following events occur simultaneously at the effective time of the transaction—(1) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (2) The combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of (1) above.[433] A combining unit is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal income tax purposes.[434] A combining entity is a business entity that is a corporation that is not a disregarded entity.[435]

b. Type B Reorganization: A Type B reorganization involves the acquisition by one corporation of stock of another corporation, solely for voting stock either of the acquiring corporation or of its direct parent (but not both).[436] Immediately after the acquisition, the acquiring corporation must own at least 80-percent of total combined voting power of all classes of stock and at least 80-percent of the total number of shares of all other classes of the stock of the acquired corporation.[437] The presence of any consideration that is not voting stock can prevent a transaction from qualifying under this provision.[438]

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[432] I.R.C. § 368(a)(1)(A).

[433] Treas. Reg. § 1.368-2(b)(1)(ii).

[434] Treas. Reg. § 1.368-2(b)(1)(i)(C).

[435] Treas. Reg. § 1.368-2(b)(1)(i)(B).

[436] I.R.C. § 368(a)(1)(B); Treas. Reg. § 1.368-2(c).

[437] I.R.C. §§ 368(a)(1)(B), 368(c).

[438] *See Helvering v. Southwest Consol. Corp.,* 315 U. S. 194 (1942); *Mills v. Commissioner,* 331 F.2d 321 (5th Cir. 1964), *rev'g* 39 T.C. 393 (1962); Rev. Rul. 75-123, 1975-1 C.B. 115 ("To qualify under section

c. Type C Reorganization: A Type C reorganization involves the acquisition by one corporation of substantially all of the properties of another corporation in exchange solely for all or a part of the voting stock of the acquiring corporation (or the voting stock of a corporation which is in control of the acquiring corporation).[439] In determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the acquired corporation is disregarded.[440] The acquired corporation must generally distribute all of the stock, securities and properties it receives from the acquiring corporation, as well as the acquired corporation's other properties, pursuant to the plan of reorganization.[441]

d. Type D Reorganization: An Type D reorganization is a transaction in which all or a part of a corporation's assets are transferred to another corporation, if immediately after the transfer the transferor, or one or more of its shareholders, is in control of the transferee corporation, and if the transferor corporation distributes stock or securities of the transferee corporation in a distribution meeting certain requirements.[442]

e. Type E Reorganization: A Type E reorganization involves a recapitalization of a corporation.[443] The Supreme Court has defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."[444] The Treasury regulation provide five examples of a recapitalization.[445]

f. Type F Reorganization: A Type F reorganization is a "mere change in identity, form, or place of organization of one corporation, however effected."[446]

g. Type G Reorganization: A Type G reorganization consists of a transfer by a corporation of all or part of its assets to another corporation in a bankruptcy or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which meets certain qualification requirements.[447]

368(a)(1)(B) of the Code as a reorganization, the consideration for whatever stock is acquired by the acquiring corporation must be solely its voting stock and nothing else.").

[439] I.R.C. § 368(a)(1)(C).

[440] I.R.C. § 368(a)(1)(C).

[441] I.R.C. § 368(a)(2)(G)(i).

[442] I.R.C. § 368(a)(1)(D).

[443] I.R.C. § 368(a)(1)(E).

[444] *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202 (1942).

[445] *See* Treas. Reg. § 1.368-2(e).

[446] I.R.C. § 368(a)(1)(F).

[447] I.R.C. § 368(a)(1)(G).

3. Other Requirements. Generally, the Treasury regulations impose three additional requirements for a reorganization to be accorded tax-free treatment: (a) the continuity of shareholder interest requirement (except in E and F reorganizations[448] and in certain D reorganizations); (b) the continuity of business enterprise requirement (except in E and F reorganizations[449]); and (c) the business purpose requirement.[450] Continuity of shareholder interest requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.[451] Continuity of business enterprise requires that the acquiring corporation either continue the acquired corporation's historic business or use a significant portion of the acquired corporation's historic business assets in a business.[452] The business purpose requirement requires that the reorganization transaction have a business purpose.[453]

G. Penalty Taxes: Personal Holding Company Tax and Accumulated Earnings Tax. In addition to the regular corporate income tax, a corporate-level penalty tax is imposed at a 20 percent rate on certain corporate earnings that are not distributed to shareholders. There are two types of corporate-level penalty taxes: the personal holding company tax and the accumulated earnings tax.[454] If a corporation is a personal holding company for the tax year, the accumulated earnings tax does not apply.[455]

1. Personal Holding Company Tax. The Code imposes a 20% penalty tax on the "undistributed personal holding company income" of a "personal holding company."[456] The purpose of the personal holding company tax is to force corporations to distribute personal holding company income through the imposition of a tax in addition to the ordinary income tax imposed upon the corporation.[457]

[448]Treas. Reg. § 1.368-1(b) (as amended by T.D. 9182 (Feb. 25, 2005)).

[449]Treas. Reg. § 1.368-1(b) (as amended by T.D. 9182 (Feb. 25, 2005)).

[450]*See* Treas. Reg. § 1.368-1(b).

[451]Treas. Reg. § 1.368-1(e)(1)(i).

[452]Treas. Reg. § 1.368-1(d)(1).

[453]Treas. Reg. § 1.368-1(b); *see Honbarrier, Inc. v. Commissioner*, 115 T.C. 300 (2000).

[454]*See* I.R.C. §§ 541, 531.

[455]I.R.C. § 532(b)(1).

[456]I.R.C. § 541.

[457]*See Fulman v. United States*, 434 U.S. 528, 531 (1978) ("The object of the personal holding company tax is to force corporations which are "personal holding companies" to pay in each tax year dividends at least equal to the corporation's undistributed personal holding company income--*i. e.*, its adjusted taxable income *less* dividends, paid to shareholders of the corporation, see §545--thus ensuring that taxpayers cannot escape personal taxes by accumulating income at the corporate level.") (footnote omitted).

a. Personal Holding Company. A corporation is a personal holding company if two requirements are satisfied.[458] Those two requirements have been described as the "stock ownership" and "tainted income" tests.[459] The "stock ownership" test is satisfied if at any time during the last half of the taxable year more than 50-percent in value of the corporation's outstanding stock is owned (directly or indirectly) by or for not more than 5 individuals.[460] The "tainted income" test is satisfied where at least 60-percent of the corporation's "adjusted ordinary gross income" (generally gross income reduced by capital gains and certain other items) for the taxable year is personal holding company income"[461] (i.e., dividends, interest, certain rents, royalties and certain other passive-type income).[462]

b. Tax Applies to Undistributed Personal Holding Company Income. The personal holding company tax applies to undistributed personal holding company income.[463] Undistributed personal holding company income is generally equal to taxable income of the corporation with certain adjustments and less a dividends paid deduction.[464]

2. Accumulated Earnings Tax. The Code imposes a 20% penalty tax on the accumulated taxable income of a corporation that is availed of for the purpose of avoiding tax with respect to its shareholders by permitting earnings and profits (earnings) to accumulate instead of being distributed.[465] The purpose of the penalty tax is to compel the corporation to distribute any earnings not needed for its business so that its shareholders will pay income taxes on the dividends received.[466] The accumulated earnings tax can be imposed on a corporation without regard to the number of shareholders.[467]

a. Evidence of Purpose to Avoid Income Tax. The fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of a business is determinative of a tax avoidance purpose unless the corporation, by a preponderance of the evidence, establishes to the contrary.[468] The reasonable needs of the

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[458] *See* I.R.C. § 542(a).

[459] *See Kenyatta Corp. v. Commissioner*, 86 T.C. 171 (1986), *aff'd*. 812 F.2d 577 (9th Cir. 1987); *Calypso Music Inc. v. Commissioner*, 80 T.C.M. (CCH) 388 (2000).

[460] I.R.C. § 542(a)(2).

[461] I.R.C. §§ 542(a)(1), 543(b)(2); *Calypso Music Inc. v. Commissioner*, 80 T.C.M. (CCH) 388 (2000).

[462] I.R.C. § 543(a).

[463] I.R.C. § 541.

[464] I.R.C. § 545(a).

[465] I.R.C. §§ 531 and 532(a); Treas. Reg. § 1.532-1(a).

[466] *See Ivan Allen Co. v. U.S.*, 422 U.S. 617, 626 (1975); *U.S. v. Donruss Co*., 393 U.S. 297, 303 (1969); *Helvering v. Chicago Stock Yards Co*., 318 U.S. 693, 699 (1943); *Haffner's Service Stations, Inc. v. Commissioner*, 83 T.C.M. (CCH) 1211 (2002), *aff'd*, 326 F.3d. 1 (1st Cir. 2003).

[467] I.R.C. § 532(c).

[468] I.R.C. § 533(a).

business include reasonably anticipated future needs.[469] In order to meet this reasonable-needs-of-the-business test, a need to retain earnings must be directly connected with the needs of the corporation itself and must be for bona fide business purposes.[470] The regulations provide a "prudent businessman" test to determine whether earnings have been accumulated beyond the business's present and reasonably anticipated future needs. Under this test, an accumulation of the earnings and profits is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonable anticipated future needs of the business.[471]

b. Tax Base. The accumulated earnings tax rate is generally imposed on "accumulated taxable income."[472] In computing the tax base, however, a credit (of no less than $250,000) is generally allowed for earnings retained for the reasonable needs of the business.[473] In the case of certain business principally engaged in the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, the minimum credit amount is reduced $150,000.[474]

H. Alternative Minimum Tax. Generally, a C corporation is subject to an alternative minimum tax to the extent the corporation's tentative minimum tax liability exceeds its regular tax liability.[475] A C corporation, however, with average annual gross receipts of less than $7.5 million for the prior three taxable years is exempt from the corporate alternative minimum tax.[476] The $7.5 million threshold is reduced to $5 million for the corporation's first taxable three-year period.[477]

1. Tentative Minimum Tax Liability. Generally, the tentative minimum tax of a corporation is 20-percent of alternative minimum taxable income in excess of a $40,000 phased-out exemption amount, reduced by the alternative minimum tax foreign tax credit for the

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[469] I.R.C. § 537(a)(1); Treas. Reg. § 1.537-1(a); *see Haffner's Service Stations, Inc. v. Commissioner,* 83 T.C.M. (CCH) 1211 (2002), *aff'd*, 326 F.3d. 1 (1st Cir. 2003).

[470] Treas. Reg. § 1.537-1(a); *see Haffner's Service Stations, Inc. v. Commissioner,* 83 T.C.M. (CCH) 1211 (2002), *aff'd*, 326 F.3d. 1 (1st Cir. 2003).

[471] Treas. Reg. § 1.537-1(a); *Haffner's Service Stations, Inc. v. Commissioner,* 83 T.C.M. (CCH) 1211 (2002), *aff'd*, 326 F.3d. 1 (1st Cir. 2003).

[472] I.R.C. § 531.

[473] I.R.C. §§ 535(c)(1), 535(c)(2)(A).

[474] I.R.C. § 535(c)(2)(B).

[475] I.R.C. § 55(a).

[476] I.R.C. § 55(e)(1)(A).

[477] I.R.C. § 55(e)(1)(B).

year.[478] The exemption amount is phased-out by an amount equal to 25-percent of the amount that the corporation's alternative minimum taxable income exceeds $150,000.[479]

2. Alternative Minimum Taxable Income. Alternative minimum taxable income is the corporation's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.[480] Certain other rules on allowance of losses and credits also apply.[481]

a. Preference Items. The minimum tax preference items for corporations generally are the same as for individuals (discussed above).

b. Adjustments in Computing Alternative Minimum Taxable Income. The adjustments that corporations must make to compute alternative minimum taxable income include:

(1) Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property.[482] Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the alternative minimum tax method described in the previous sentence.[483] Depreciation on certain property placed in service after September 10, 2001, and before January 1, 2005, which is allowed an additional allowance under Section 168(k) of the Code for regular tax purposes is computed without regard to any AMT adjustments.[484]

(2) Mining exploration and development costs must be capitalized and amortized over a 10-year period.[485]

(3) Taxable income from a long-term contract must be computed using the percentage of completion method of accounting.[486]

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[478] I.R.C. §§ 55(b)(1)(B), 55(d)(2).

[479] I.R.C. § 55(d)(3).

[480] I.R.C. § 55(b)(2).

[481] *See, e.g.*, I.R.C. §§ 58, 56(d), 53, 59.

[482] I.R.C. § 56(a)(1)(A)(i).

[483] I.R.C. § 56(a)(1)(A)(ii).

[484] I.R.C. § 168(k)(2)(G).

[485] I.R.C. § 56(a)(2).

[486] I.R.C. § 56(a)(3).

(4) The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999 (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method).[487] The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.[488]

(5) The alternative tax net operating loss deduction is allowed in lieu of the net operating loss deduction.[489]

(6) The adjustment for adjusted current earnings of a corporation[490] (other than an S corporation, regulated investment company, real estate investment trust, REMIC and FASIT[491]). Under this adjustment, alternative minimum taxable income is increased by 75-percent of the amount by which the adjusted current earnings of a corporation exceed alternative minimum taxable income (determined without the ACE adjustment or the alternative minimum tax net operating loss deduction).[492] If, however, alternative minimum taxable income (before this adjustment) exceeds the amount of adjusted current earnings, then alternative minimum taxable income is reduced by 75-percent of such difference.[493] However, such reduction cannot exceed the excess of the aggregate amount by which alternative minimum taxable income has been increased as a result of this provision in prior taxable years, less the aggregate amount of reductions taken in prior years.[494] In determining adjusted current earnings, the following rules apply:

(a) For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.[495] For property placed in service after 1993, the depreciation rules used for computing alternative minimum taxable income apply for purposes of computing adjusted current earnings.[496]

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[487]I.R.C. § 56(a)(5)

[488]I.R.C. § 56(a)(5).

[489]I.R.C. § 56(a)(4).

[490]I.R.C. § 56(c)(1).

[491]I.R.C. § 56(g)(6); Treas. Reg. § 1.56(g)-1(a)(4).

[492]I.R.C. §§ 56(g)(1), 56(g)(3); Treas. Reg. § 1.56(g)-1(a)(1).

[493]I.R.C. § 56(g)(2)(A); Treas. Reg. § 1.56(g)-1(a)(2)(i).

[494]I.R.C. § 56(g)(2)(B); Treas. Reg. § 1.56(g)-1(a)(2)(ii).

[495]I.R.C. § 56(g)(4)(A)(i).

[496]I.R.C. § 56(g)(4)(A)(i).

(b) Any amount that is excluded from gross income under the regular tax but is included for purposes of determining earnings and profits is generally included in determining adjusted current earnings.[497]

(c) The inside build-up of a life insurance contract is included in adjusted current earnings (and the related premiums are deductible).[498]

(d) Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.[499]

(e) The regular tax rules of section 173 (relating to deduction for circulation expenditures) and section 248 (allowing organizational expenses to be amortized) do not apply.[500]

(f) Adjusted current earnings must be increased or decreased by the taxpayer's last-in first out (LIFO) inventory recapture amount of the taxpayer.[501] This amount is the excess, if any, of the taxpayer's inventory amount using a first-in first out (FIFO) method over the taxpayer's inventory amount using a LIFO method.[502]

(g) The installment sales method generally may not be used.[503]

(h) No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.[504]

(i) For properties placed in service after 1989, depletion (other than depletion claimed by certain independent oil and gas producers and royalty owners) must be calculated using the cost method, rather than the percentage method.[505]

(j) In certain cases, the basis of assets of a corporation that has undergone an ownership change must be reduced to their fair market values.[506]

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[497] I.R.C. § 56(g)(4)(B)(i); Treas. Reg. § 1.56(g)-1(c)(1).

[498] I.R.C. § 56(g)(4)(B)(ii); Treas. Reg. § 1.56(g)-1(c)(5)(ii); Treas. Reg. § 1.56(g)-1(c)(5)(vi)(A).

[499] I.R.C. § 56(g)(4)(D)(i); I.R.C. § 312(n)(2)(A).

[500] I.R.C. § 56(g)(4)(D)(ii); Treas. Reg. § 1.56(g)-1(f)(2).

[501] I.R.C. § 56(g)(4)(D)(iii).

[502] Treas. Reg. § 1.56(g)-1(f)(3)(iii).

[503] I.R.C. § 56(g)(4)(D)(iv); *see* Treas. Reg. § 1.56(g)-1(f)(4)(iii)(A).

[504] I.R.C. § 56(g)(4)(E).

[505] I.R.C. §§ 56(g)(4)(F)(i), 56(g)(4)(F)(ii).

3. Allowance of Credit. If a corporation is subject to alternative minimum tax in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in such subsequent year.[507]

I. Stock as Compensation. Section 83 of the Code generally governs the timing and characterization of income when stock is transferred to a service provider in connection with the performance of services.[508] Under Section 83(a), if an interest in property is transferred to any person, by reason of the performance of services, the service provider[509] recognizes compensation income at the time the property becomes substantially vested.[510] Once property has been transferred and becomes substantially vested, the employee (or independent contractor) includes in gross income the excess of the fair market value of the property (determined without regard to any lapse restriction) at the time that the property becomes substantially vested, over the amount (if any) paid for such property.[511] The amount is includible in gross income for the tax year in which the property becomes substantially vested.[512] Property is substantially vested when it is either transferable by the service provider or not subject to a substantial risk of forfeiture.[513]

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[506] I.R.C. § 56(g)(4)(G).

[507] *See* I.R.C. § 53(a), 53(b), 53(c).

[508] Treas. Reg. § 1.83-1(a)(1); *see also* Treas. Reg. § 1.61-2(d)(6)(rules of Treas. Reg. § 1.61-2(d) relating to compensation paid other than in cash, apply to transfers of property "to the extent such rules are not inconsistent with section 83").

[509] *See Pagel, Inc. v. Commissioner*, 91 T.C. 200, 205 (1988) ("Section 83 does not apply only to employees of the transferor of the property; rather, it is applicable to any person other than the one for whom the services were performed, including independent contractors of the transferor."), *aff'd*, 905 F.2d 1190 (8th Cir. 1990).

[510] I.R.C. § 83(a); Treas. Reg. § 1.83-1(a)(1); T.D. 7554, 1978-2 C.B. 71, 72; *see Alves v. Commissioner*, 734 F.2d 478, 481 (9th Cir. 1984) ("By its terms, [Section 83] applies when property is: (1) transferred in connection with the performance of services; (2) subject to a substantial risk of forfeiture; and (3) not disposed of in an arm's length transaction before the property becomes transferable or the risk of forfeiture is removed.").

[511] I.R.C. § 83(a); Treas. Reg. § 1.83-1(a)(1).

[512] Treas. Reg. § 1.83-1(a)(1).

[513] Treas. Reg. § 1.83-3(b); *cf.* Tech. Adv. Mem. 94-43-006 (April 29, 1994)("Because Taxpayer's employees were not required to perform substantial future services in order to retain their beneficial interests in its secured promise to pay their vacation benefits, those interests were 'substantially vested' in the employees upon transfer. Accordingly, we have concluded that, under the rules of section 83(a) of the Code, the fair market value of those interests was includible in the employees' gross income for 1992 as of the date that those interests were transferred."); *see also* Rev. Proc. 80-11, 1980-1 C.B. 616 ("The purpose of this revenue procedure is to provide individual taxpayers guidance on reporting dividends on restricted stock that is not substantially vested within the meaning of section 83 of the Internal Revenue Code."); Rev. Proc. 83-38, 1983-1 C.B. 773 ("The purpose of this revenue procedure is to provide guidance to individual taxpayers concerning the reporting of dividends on restricted stock that is not substantially vested within the meaning of section 83 of the Internal Revenue Code, when the taxpayer has made the election under section 83(b) of the Code.").

Taxpayers may elect, under Section 83(b) and the regulations thereunder, to treat property as if it were substantially vested at the time of transfer, even though the property is not transferable and is subject to a substantial risk of forfeiture.[514] The Treasury regulations specify the time and manner for making the election.[515]

The Code and the Treasury regulations also provide rules with respect to the taxation of stock options. Stock options can be separated into qualified (or "statutory") and nonqualified options. A nonqualified option generally refers to an option that is not subject to the incentive stock option rules of Section 421 of the Code.

[514]I.R.C. § 83(b)(1); Treas. Reg. § 1.83-2(a); T.D. 7554, 1978-2 C.B. at 72; *see Morton v. Commissioner*, 73 T.C.M. (CCH) 2520, 2528 (1997) ("Section 83(b) allows a taxpayer to elect to include in gross income in the year of receipt the value of the property transferred in exchange for services regardless of whether his or her rights in the property are transferable or subject to a substantial risk of forfeiture.").

[515]*See* Treas. Reg. § 1.83-2(b); Treas. Reg. § 1.83-2(c).

V: PARTNERSHIPS.

A. Partners Include Distributive Share of Partnership's Income, Gains, Losses, Deductions and Credits. The partners in a partnership, and not the partnership, are liable for income tax.[516] In determining the partner's income tax, each partner is required to take into account separately the partner's distributive share of (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year; (2) gains and losses from sales or exchanges of capital assets held for more than 1 year; (3) gains and losses from sales or exchanges of Section 1231 property; (4) charitable contributions; (5) certain dividends; (6) foreign income taxes; (7) other items of income, gain, loss, deduction or credit, to the extent provided by regulations; and (8) taxable income or loss, exclusive of the foregoing 7 items requiring separate computation.[517]

Generally, a partner's distributive share of income, gain, loss, deduction, or credit is determined by the partnership agreement.[518] One limitation on this rule is that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.[519]

The Code contains a rule to prevent the shifting of federal income tax consequences among partners with respect to precontribution gain or loss.[520] Income, gain, loss, and deduction with respect to property contributed to a partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (the built-in gain or loss).[521]

Under new Section 704(c)(1)(C), enacted by The American Jobs Creation Act of 2004, a built-in loss in property at the time of contribution may be taken into account only by the contributing partner and not by other partners.[522] Except as provided in regulations, in determining the amount of items allocated to partners other than the contributing partner, the basis of the contributed property is treated as the fair market value at the time of contribution.[523] Thus, if the contributing partner's partnership interest is transferred or liquidated, the

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[516] I.R.C. § 701.

[517] I.R.C. §§ 702(a)(1), 702(a)(2).

[518] I.R.C. § 704(a); *but see* Treas. Reg. § 1.707-1(c) ("For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income.").

[519] I.R.C. § 704(b).

[520] I.R.C. § 704(c)(1)(A).

[521] I.R.C. § 704(c)(1)(A).

[522] I.R.C. § 704(c)(1)(C)(i).

[523] I.R.C. § 704(c)(1)(C)(ii).

partnership's adjusted basis in the property in the property is based on its fair market value at the time of contribution, and the built-in loss is eliminated.[524]

A partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which the loss occurred.[525] A partner's share of loss in excess of his adjusted basis at the end of the partnership tax year is not allowed for that year. Any loss so disallowed, however, may be carried forward and allowed as a deduction in a succeeding year to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).[526]

The at-risk rules[527] and the passive activity rules[528] may also limit the deductibility of losses from a partnership for certain taxpayers.

B. Contributions of Property to a Partnership.

1. Transfer of Unencumbered Property to a Partnership in Exchange for a Partnership Interest.

a. General Rules.

(1) Nonrecognition. Generally, no gain or loss is recognized by a partnership or any of its partners upon the contribution of property to the partnership in exchange for a partnership interest.[529] This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating.[530]

(2) Partnership's Tax Basis in Contributed Property. The partnership's tax basis in the contributed property is the adjusted basis of the property to the partner at the time of contribution.[531]

[524] H.R. Conf. Rep. No. 108-755.

[525] I.R.C. § 704(d).

[526] Treas. Reg. § 1.704-1(d).

[527] I.R.C. § 465.

[528] I.R.C. § 469.

[529] I.R.C. § 721(a); cf. PLR 200606009 (Oct. 17, 2005) (merger of multiple corporations into LLC taxable as a partnership is treated as (i) a transfer by the corporations of all their respective assets to the LLC in exchange for interests in the LLC and the assumption by the LLC of the liabilities of the corporations, followed by (ii) the distributions of the interests of the LLC in complete liquidation of the corporations).

[530] Treas. Reg. § 1.721-1(a).

[531] I.R.C. § 723.

(3) Partnership's Holding Period in Contributed Property. The partnership's holding period in the assets contributed by a partner includes the period such assets were held by the contributing partner.[532]

(4) Contributing Partner's Tax Basis in His Partnership Interest. The contributing partner's initial tax basis in his partnership interest will be the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution.[533]

(5) Contributing Partner's Holding Period in His Partnership Interest. In determining the holding period of a taxpayer who receives property in an exchange, there is included the period for which the taxpayer held the property exchanged if the property has the same basis in whole or in part in the taxpayer's hands as the property exchanged, and the property exchanged at the time of the exchange was a capital asset or property described in § 1231(b) (depreciable property and real property used in a trade or business and held for more than 1 year).[534] Thus, the holding period of a partnership interest received in exchange for a partner contributing to the partnership capital assets or property described in Section 1231(b) should include such partner's holding period for the property transferred to the partnership.[535] If, however, a partnership interest is received in exchange for assets that are neither capital assets nor section 1231(b) assets, the partner's holding period in the contributed assets should not "tack" onto the holding period of the partner's partnership interest.[536]

In the past, there has been some lack of clarity concerning the holding period of a partnership interest where a partner transfers both (1) capital assets or Section 1231(b) property, and (2) cash or property other than capital assets or Section 1231(b) property. There has also been some question concerning a partner's holding period in a partnership where a partner acquires interests in the partnership at different times.[537]

On September 21, 2000, the Internal Revenue Service issued final regulations relating to dividing the holding period of a partnership interest.[538] An overview of these regulations is presented below.

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[532] I.R.C. § 1223(2); Treas. Reg. § 1.723-1.

[533] I.R.C. § 722.

[534] I.R.C. § 1223(1).

[535] I.R.C. § 1223(1).

[536] *See* Treas. Reg. § 1.1223-1(a); *see generally* Banoff, "Partnership Interest Transfers Under the Holding Period Final Regs.: Opportunities and Traps Remain," 94 J. Tax'n 211 (April 2001).

[537] *See* Notice of Proposed Rulemaking, REG-106527-98, 64 F.R. 43117-43123 (Aug. 9, 1999).

[538] *See* T.D. 8902, 65 F.R. 57092-57101; Treas. Reg. § 1.741-1(f).

(a) General Rule. The final regulations provide that a partner will not have a divided holding period in a partnership unless (1) the partner acquired portions of a partnership interest at different times; or (2) the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods.[539]

(b) Accounting for Holding Periods of a Partnership Interest. The portion of a partnership interest to which a holding period relates is determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).[540] Special rules apply to contributions and distributions of cash by partners and to contributions of Section 751 property to the partnership.[541]

(c) Sale or Exchanges of All or a Portion of a Partnership Interest.

i) Sale or Exchange of Entire Interest in the Partnership. If a partner sells or exchanges the partner's entire interest in a partnership, any capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the partnership interest is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.[542]

To illustrate, assume that A contributes $5,000 of cash and a nondepreciable capital asset A has held for two years to the PRS Partnership in exchange for a 50-percent interest in PRS. A's basis in the capital asset is $5,000, and the fair market value of the asset is $10,000. After the exchange, A's basis in A's interest in PRS is $10,000, and the fair market value of the interest is $15,000. A received one-third of the interest in PRS for a cash payment of $5,000 ($5,000/$15,000). Therefore, A's holding period in one-third of the interest received (attributable to the contribution of money to the partnership) begins on the day after the contribution. A received two-thirds of the interest in PRS in exchange for the capital asset ($10,000/$15,000). Accordingly, A has a two-year holding period in two-thirds of the interest received in PRS.

Suppose that six months later, when A's basis in PRS is $12,000 (due to a $2,000 allocation of partnership income to A), A sells the interest in PRS for $17,000. Assuming PRS holds no inventory or unrealized receivables and no collectibles or Section 1250 property, A will realize $5,000 of capital gain. As determined above, one-third of A's interest in PRS has a

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[539] Treas. Reg. § 1.1223-3(a).

[540] Treas. Reg. § 1.1223-3(b)(1).

[541] *See* Treas. Reg. §§ 1.1223-3(b)(2)-(4).

[542] Treas. Reg. § 1.1223-3(c)(1).

holding period of one year or less, and two-thirds of A's interest in PRS has a holding period equal to two years and six months. Therefore, one-third of the capital gain will be short-term capital gain, and two-thirds of the capital gain will be long-term capital gain.[543]

ii) Sale or Exchange of a Portion of a Partnership Interest. If a partner has a divided holding period in a partnership interest, then the holding period of the transferred interest is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer.[544] A special rule applies to sales of interests in publicly-traded partnerships.[545]

(d) Distributions. Generally, under the final regulations, a partner's holding period in a partnership interest is not affected by distributions from the partnership.[546] If a partner is required to recognize capital gain or loss as a result of a distribution from a partnership, then the capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the distributee partner would realize if such partner's entire interest in the partnership were transferred in a fully taxable transaction immediately before the distribution.[547]

To illustrate, assume that in 1997, A and B each contribute cash of $50,000 to form and become equal partners in the PRS Partnership. More than one year later, A receives a distribution worth $22,000 from PRS, which reduces A's interest in PRS to 36-percent. After the distribution, B owns 64-percent of PRS. The holding periods of A and B in their interests in PRS are not affected by the distribution.

b. Exceptions to the General Rule. The general rule of nonrecognition applicable to transfers of unencumbered property to a partnership does not apply (a) on a transfer of property to a partnership which would be treated as an "investment company" (if the partnership were incorporated);[548] (b) a partnership capital interest received in exchange for services;[549] and (c) transactions between a partnership and a partner not acting in his capacity as a partner.[550]

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[543] Treas. Reg. § 1.1223-3(f), Example 1.

[544] Treas. Reg. § 1.1223-3(c)(2)(ii).

[545] Treas. Reg. § 1.1223-3(c)(2)(i).

[546] Treas. Reg. § 1.1223-3(d)(1).

[547] Treas. Reg. § 1.1223-3(d)(2).

[548] I.R.C. § 721(b).

[549] Treas. Reg. § 1.721-1(b)(1).

[550] Treas. Reg. § 1.721-1(a); *see generally* I.R.C. 707(a).

(1) Transfer of Property to a Partnership (that Would Be Treated as an Investment Company if the Partnership Were Incorporated). The general nonrecognition rule applicable to transfers of property to a partnership will not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (if the partnership were incorporated).[551] In the case of a transfer of property to a partnership that is classified as an investment company, the partner's basis in his partnership interest is the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized by the contributing partner at the time of contribution.[552] The partnership's basis in the contributed property is the adjusted basis of the property to the partner at the time of contribution increased by the amount (if any) of gain recognized by the contributing partner.[553]

(a) When Is a Transfer Considered a "Transfer to an Investment Company?" A transfer of property to a partnership will be considered to be "a transfer to an investment company" if: (i) the transfer results in diversification of the transferor's interests;[554] and (ii) more than 80-percent of the value of the partnerships assets are:

i) Held for investment; and

ii) Consist of money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in real estate investment trusts, regulated investment companies, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the assets listed in the statute.[555] Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are listed

[551] I.R.C. § 721(b).

[552] I.R.C. § 722.

[553] I.R.C. § 723.

[554] *See* Staff of the Joint Committee on Taxation, 105th Cong., *General Explanation of Tax Legislation Enacted in 1997*, 184 (1997) ("The bill is intended to change only the types of assets considered in the definition of an investment company in the present Treasury regulations (Treas. reg. sec. 1.351-1(c)(1)(ii)) and not to override the other provisions of those regulations. For example, the bill does not override (1) the requirement that only assets held for investment are considered for purposes of the definition (Treas. reg. sec. 1.351-1(c)(3)), (2) the rule treating the assets of a subsidiary as owned proportionately by a parent owning 50 percent or more of its stock (Treas. reg. sec. 1.351-1(c)(4)), (3) the requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer (Treas. reg. sec. 1.351-1(c)(2)), and (4) the requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized (Treas. reg. sec. 1.351-1(c)(1)(i)." [footnote omitted]); *cf*. Priv. Ltr. Rul. 200211017 (Dec. 12, 2001) ("The legislative history to the Taxpayer Relief Act of 1997 amendment to section 351(e)(1) makes clear that the 1997 amendments to section 351(e) do not override § 1.351-1(c)(4)."); Priv. Ltr. Rul. 199901028 (Oct. 13, 1998) ("[T]he Act is not intended to alter the requirement of section 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under section 351(e) only if the transfer results, directly or indirectly, in the diversification of the transferors' interests.").

[555] I.R.C. § 351(e)(1)(B).

assets,[556] and to the extent provided in regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to listed assets.[557]

(b) When Does a Transfer Result in Diversification of the Transferor's Interests? A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets in the exchange.[558] For this purpose, if any transaction involves the transfer of one or more transfers of nonidentical assets, which taken in the aggregate, constitutes "an insignificant portion"[559] of the total value of assets transferred, then such transfers are disregarded for purposes of determining whether diversification has occurred.[560] If a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.[561]

(c) When Is Investment Company Status Determined? The determination of whether a partnership is an investment company is ordinarily made immediately after the transfer.[562] If, however, the circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination is made by reference to the later circumstances.[563]

(2) Partnership Capital Interest Received in Exchange for Services. The receipt of a partnership capital interest by a service partner for services provided to or for the benefit of the partnership is taxable as compensation.[564] The Internal Revenue

[556]I.R.C. § 351(e)(1)(vi).

[557]I.R.C. § 351(e)(1)(vii).

[558]Treas. Reg. § 1.351-1(c)(5).

[559]The determination of what constitutes an "insignificant portion" of the total value of transferred assets is a factual issue. In Revenue Ruling 87-9, 1987-1 C.B. 133, the Revenue Service held that the transfer of a nonidentical asset (cash) constituting 11 percent of the total value of the transferred assets in a section 351 exchange was not an "insignificant portion." The regulations contain an example illustrating that in a situation where two percent of the total assets transferred are nonidentical, the two percent transfer is "insignificant" and therefore disregarded for purposes of determining whether diversification has occurred. Treas. Reg. § 1.351-1(c)(7), Example 1; *cf*. Priv. Ltr. Rul. 199901028 (Oct. 13, 1998).

[560]Treas. Reg. § 1.351-1(c)(5).

[561]Treas. Reg. § 1.351-1(c)(5).

[562]Treas. Reg. § 1.351-1(c)(2).

[563]Treas. Reg. § 1.351-1(c)(2).

[564]*Campbell v. Commissioner*, 943 F.2d 815, 820 (8th Cir. 1991) **(**"When a service partner receives an interest in partnership capital, the cases clearly hold that a taxable event has occurred. The receipt of the capital interest must be included in the service partner's income. *See, e.g. U.S.*, 335 F.2d 487, 489 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965) . . . As an interest in intangible personal property, the receipt of a capital interest appears to be taxable under the authority of Section 83 of the Internal Revenue Code. [Footnote omitted.] There is

Service defines a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest."[565]

(3) Transactions Between a Partnership and a Partner Not Acting in His Capacity as a Partner.[566] The general rule of nonrecognition applicable to transfers of property to a partnership does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner.[567] For example, a partner may sell property to a partnership rather than contributing the property. As to sales between a partner and his partnership, if a partner engages in a transaction with a partnership, other than in his capacity as a partner, the transaction will be treated as occurring between the partnership and one who is not a partner.[568] Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, the transaction will be treated as a taxable sale or exchange in which gain is recognized[569] rather than as a tax-free contribution.[570]

2. Transfer of Encumbered Property to a Partnership. The Code and regulations provide rules with respect to the transfer of encumbered property to a partnership.

a. Treatment of Decrease in Partner's Share of Liabilities. In the case of a transfer of property encumbered by debt to a partnership, any decrease in a partner's share of the partnership's liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of such individual liabilities, is considered a distribution of money to the partner by the partnership.[571]

b. Treatment of Increase in Partner's Share of Liabilities. Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual

little, if any, dispute that such a transaction involves the recognition of income."); *Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15 (2013) ("Section 83 applies to the transfer of a partnership capital interest in exchange for the performance of services."); *Larson v. Commissioner*, 55 T.C.M. (CCH) 1637, 1638 (1988) ("Under Section 83, a compensatory transfer of a partnership capital interest results in taxable income to the transferee to the extent that the fair market value of the interest exceeds the amount paid for the interest, in the year that the rights to the interest are transferable or not subject to a substantial risk of forfeiture."); Rev. Proc. 93-27, 1993-2 C.B 343, 343 ("Under Section 1.721-1(b)(1) of the Income Tax Regulations, the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation.").

[565]Rev. Proc. 93-27, § 2.01, 1993-2 C.B. 343.

[566]Treas. Reg. § 1.721-1(a); *see generally* I.R.C. 707(a).

[567]Treas. Reg. § 1.721-1(a); *see* I.R.C. § 707.

[568]I.R.C. § 707(a).

[569]*See* I.R.C. § 707(a); I.R.C. § 1001(c).

[570]Treas. Reg. § 1.721-1(a); Treas. Reg. § 1.707-1(a); Treas. Reg. § 1.731-1(c)(3).

[571]I.R.C. § 752(b); Treas. Reg. § 1.752-1(c).

liabilities by reason of the partner's assumption of partnership liabilities, is considered a contribution of money by that partner to the partnership.[572]

c. Property Subject to a Liability. If property is contributed by a partner to the partnership and the property is subject to a liability of the contributing partner, the partnership is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution.[573]

d. Netting of Increases and Decreases in Liabilities Resulting from Single Transaction. If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.[574] Generally, the contribution to a partnership of property subject to a liability will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction.[575]

e. Example. Assume that Baker contributes property (adjusted basis: $1,000) to a general partnership in exchange for a 33.33-percent interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of $150 and has a fair market value in excess of $150. After the contribution, Baker remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under the Code and regulations, the partnership is treated as having assumed the $150 liability. As a result, Baker's individual liabilities decrease by $150. At the same time, however, Baker's share of liabilities of the partnership increases by $150. Only the net increase or decrease in Baker's share of the liabilities of the partnership and Baker's individual liabilities is taken into account. Since there is no net change, Baker is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership. Baker will take a basis in his partnership interest equal to $1,000 (which is Baker's tax basis in the property contributed to the partnership).[576]

C. Federal Income Tax Treatment of Partnership Distributions – An Overview.

1. Treatment of Partners. In the case of a distribution by a partnership to a partner, generally gain is not recognized to the partner except to the extent that any money

[572] I.R.C. § 752(a).

[573] Treas. Reg. § 1.752-1(e); *see* I.R.C. § 752(c).

[574] I.R.C. § 1.752-1(f).

[575] Treas. Reg. § 1.752-1(f).

[576] Treas. Reg. § 1.752-1(g), Example 1.

(which is defined to include marketable securities)[577] distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.[578] Generally, no loss is recognized by a partner on a distribution by a partnership to the partner.[579] In the case, however, of a distribution by a partnership in liquidation of a partner's interest in a partnership where no property other than money, unrealized receivables and inventory is distributed to the partner, loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of (A) any money distributed, and (B) the basis to the distributee of any unrealized receivables and inventory.[580] Gain or loss recognized pursuant to these rules is considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.[581]

The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partnership interest is generally its adjusted basis to the partnership immediately before such distribution.[582] The basis to the distributee partner of property, however, is limited to the partner's adjusted basis in his partnership interest immediately before such distribution.[583]

The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is an amount equal to the partner's adjusted basis in his partnership interest, reduced by any money distributed in the same transaction.[584]

In determining the period for which a partner has held property (other than certain inventory items) received in a distribution from a partnership, there is included the holding period of the partnership with respect to the property.[585]

2. Treatment of Partnership. No gain or loss is recognized by a partnership on a distribution to a partner of property, including money.[586] If the partnership has

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[577]I.R.C. § 731(c)(1)(A).

[578]I.R.C. § 731(a)(1); *but see* I.R.C. § 704(c)(1)(B) (triggers gain or loss to property of contributing partner on certain distributions); I.R.C. § 737 (recognition of precontribution gain in case of certain distributions to contributing partner). I.R.C. §§ 736 and 751(b) also provide special rules applicable to certain distributions.

[579]I.R.C. § 731(a)(2).

[580]I.R.C. § 731(a)(2).

[581]I.R.C. § 731(a).

[582]I.R.C. § 732(a)(1).

[583]I.R.C. § 732(a)(2).

[584]I.R.C. § 732(b).

[585]I.R.C. § 735(b).

[586]I.R.C. § 731(b); *but see* I.R.C. § 751(b).

a Section 754 election in effect, or makes an election for the year of the distribution, the partnership is required to make certain adjustments to the basis of its undistributed property.[587]

D. Taxable Sale of Assets by a Partnership.

1. Tax Consequences to Partnership. Generally, a partnership is required to recognize gain or loss on the sale of property.[588] The Treasury regulations provide that "[t]he general rule with respect to gain or loss realized upon the sale or exchange of property . . . is that the entire amount of gain or loss is recognized except in cases where specific provisions . . . provide otherwise." The gain or loss is measured by the difference between the amount realized from the sale or other disposition of property and the partnership's adjusted basis in the property.[589]

For federal income tax purposes, the sale by a partnership of an interest in an entity that is disregarded should be treated as a sale of the assets of the disregarded entity.[590] If an entity is

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[587]I.R.C. § 734.

[588]I.R.C. § 1001(c); *see* Treas. Reg. § 1.1002-1(a); *see also* I.R.C. § 1060(a) (requiring allocation of purchase price in the case of certain transfers involving a group of assets constituting a trade or business).

[589]I.R.C. § 1001(a).

[590]*See* Treas. Reg. §§ 301.7701-2, 301.7701-3; Rev. Rul. 99-5, 1999-1 C.B. 434 ("In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, *B*, purchases an interest in the disregarded entity from the owner, *A*. *B*'s purchase of 50% of *A*'s ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by *A* for federal tax purposes. Immediately thereafter, *A* and *B* are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership."). The Service has held in Rev. Rul. 2004-77 and in several private letter rulings that a partnership with a single owner for federal income tax purposes is disregarded under the check-the-box regulations. *cf.* Priv. Ltr. Rul. 200201005 (Sept. 27, 2001) ("[Qualified subchapter S subsidiary X's] merger into Y, a state law limited partnership that is owned 1% by W, [a limited liability company] wholly owned by Z and 99% by Z will be disregarded for federal income tax purposes if no election is made under 301.7701-3(c) to treat W as an association because, at the end of the series of transactions, the assets of X continue to be held by Z for federal tax purposes."); Priv. Ltr. Rul. 200107025 (Nov. 17, 2000) ("[E]ach of the individual shareholders of X will be the sole owner of the limited partnership that the individual shareholder formed, owning m% through the respective individual's limited liability company, a disregarded entity, and n% directly. Because each of the limited partnerships are treated as owned by a single owner, they will be disregarded for federal tax purposes and each individual shareholder will be treated as directly owning the X stock held by their respective limited partnership."); Priv. Ltr. Rul. 199947001 (Dec. 7, 1998) ("If Company A [taxed as a partnership] makes an election under section 754, Company A's basis in its assets, including the assets of the Partnerships that are disregarded entities for federal income tax purposes, will be adjusted under section 743(b) as a result of the transaction."); Priv. Ltr. Rul. 199915030 (Jan. 12, 1999) ("Corporation B and Disregarded LLC1 organized a limited partnership, Disregarded Partnership. Corporation B owns the limited partnership interest and Disregarded LLC1 owns the general partnership interest. Corporation B and Disregarded LLC1 will not elect to treat Disregarded Partnership as a separate entity for federal income tax purposes * * * Disregarded LLC1, Disregarded Partnership . . . will not be treated for federal income tax purposes as entities separate from Corporation B . . . ."); Priv. Ltr. Rul. 9807013 (Feb. 13, 1998) ("Because each Replacement Entity will be disregarded as an entity separate from its owner for federal tax purposes, the assets of each Replacement Entity will be treated as assets of the Taxpayer."). While there does not appear to be any ruling directly on point, the same reasoning that applies to the sale of an interest in a disregarded limited liability company should apply to the sale of an interest in a disregarded partnership.

disregarded, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner.[591]

2. **Tax Consequences to Purchaser.** The purchaser of assets in a taxable sale by a partnership generally will take a cost basis in the assets.[592]

E. Sale of Partnership Interests.

1. Character of Gain or Loss on Sale of Partnership Interest.

a. General Rule. In the case of a sale or exchange of a partnership interest, gain or loss is recognized by the transferor partner and, subject to certain exceptions, is considered as a gain or loss from the sale or exchange of a capital asset (and therefore capital gain or loss).[593] The gain or loss is measured by the difference between the amount realized and the adjusted basis of the partnership interest.[594] This treatment applies regardless of whether the interest is sold to other members of the partnership or to persons who are not members of the partnership.[595] This rule also applies even though the sale of the partnership interest results in a termination of the partnership.[596]

b. Exception for Section 751 Property. Section 751 of the Code was enacted to prevent the conversion of certain potential ordinary income into capital gain upon the sale or exchange of a partnership interest.[597] Under this section, money or property received by a selling partner in exchange for all or any part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership.[598] These items include (1) certain unrealized receivables of the partnership,[599] and (2) inventory items of the partnership.[600]

(1) Definition of "Unrealized Receivables." "Unrealized receivables" of a partnership include rights to payment for (1) goods delivered, or to be

[591]Treas. Reg. § 301.7701-2(a).

[592]I.R.C. § 1012.

[593]I.R.C. § 741.

[594]Treas. Reg. § 1.741-1.

[595]Treas. Reg. § 1.741-1(b).

[596]Treas. Reg. § 1.741-1(b).

[597]H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70, 71 (1954) [hereinafter "H.R. Rep. No. 1337"]; S. Rep. No. 1622, 83d Cong., 2d Sess. 99 (1954) [hereinafter "S. Rep. No. 1622"].

[598]I.R.C. § 751(a).

[599]I.R.C. § 751(a)(1).

[600]I.R.C. § 751(a)(2).

delivered, to the extent the proceeds therefrom would be treated as ordinary income,[601] or (2) services rendered or to be rendered.[602] Both types of rights are unrealized receivables only to the extent not previously includible in income under the partnership's method of accounting.[603] "Unrealized receivables" of a partnership also include a variety of recapture amounts with respect to partnership property.[604]

(2) Definition of "Inventory Items." The term "inventory items" means:

(a) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the tax year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business.[605]

(b) Any other property that, on sale or exchange by the partnership, would be considered property other than a capital asset and other than Section 1231 property. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items, as do any unrealized receivables.[606]

(c) Any other property of the partnership that, if sold or exchanged by the partnership, would result in gain taxable under Section 1246(a) (relating to gain on foreign investment company stock).[607]

(d) Any other property held by the partnership that, if held by the selling or distributee partner, would be considered property of the type described above.[608]

c. Exception for Sales of Partnership Interests in Partnership Holding Appreciated Collectibles or Section 1250 Property. On September 21, 2000, the Internal Revenue Service issued final regulations containing special rules applicable to capital gain or loss recognized when a partner sells or exchanges an interest in a partnership that holds appreciated collectibles or Section 1250 property with Section 1250 capital gain.[609] These

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[601] I.R.C. § 751(a)(1).

[602] I.R.C. § 751(a)(2).

[603] I.R.C. § 751(c).

[604] I.R.C. § 751(c).

[605] I.R.C. § 751(d)(1); Treas. Reg. § 1.751-1(d)(2)(i).

[606] I.R.C. § 751(d)(2); Treas. Reg. § 1.751-1(d)(2)(ii).

[607] I.R.C. § 751(d)(3).

[608] I.R.C. § 751(d)(4).

[609] Treas. Reg. § 1.741-1(e).

regulations provide that when a partner sells or exchanges a partnership interest held for more than one year, the partner may recognize ordinary income (e.g., under Section 751(a)), collectibles gain, Section 1250 capital gain and residual long-term capital gain or loss.[610] The regulations address to what extent a partner recognizes collectibles gain or Section 1250 gain when a partnership interest is sold or exchanged.[611]

2. Purchasing Partner's Basis in His Partnership Interest.

a. General Rule. A purchasing partner's basis in his partnership interest is generally his cost.[612] Generally, the basis of partnership property is not adjusted as the result of a transfer of a partnership interest by sale or exchange unless a "Section 754 election" is in effect with respect to such partnership or unless the partnership has a substantial built in loss (as defined in Section 743(d)) immediately after such transfer.[613]

b. Section 754 Election.

(1) Adjustments to Basis of Partnership Property if Section 754 Election in Effect. If a partnership files a Section 754 election, the partnership adjusts the basis of partnership property in the case of a transfer of a partnership interest,[614] as follows:

(a) The partnership increases the adjusted basis of partnership property by the excess of the transferee partner's basis in his partnership interest over the partner's proportionate share of the adjusted basis to the partnership of partnership property;[615] or

(b) The partnership decreases the adjusted basis of partnership property by the excess of the transferee partner's proportionate share of the adjusted basis to the partnership of partnership property over the partner's basis in his partnership interest.[616]

The increase or decrease is an adjustment to the basis of partnership property with respect to the transferee partner only.[617] The Treasury regulations provide special rules for determining

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[610] *See* Treas. Reg. §1.1(h)-1(a); T.D. 8902, 65 F.R. 57092-57101.

[611] *See* Treas. Reg. §1.1(h)-1(a); T.D. 8902, 65 F.R. 57092-57101.

[612] I.R.C. §§ 742, 1012; Treas. Reg. § 1.742-1.

[613] I.R.C. § 743(a).

[614] I.R.C. § 754.

[615] I.R.C. § 743(b)(1).

[616] I.R.C. § 743(b)(2).

[617] I.R.C. § 743(b).

a transferee partner's proportionate share of the adjusted basis to the partnership of partnership property.[618]

(2) Allocation of Basis Adjustment. The amount of the basis adjustment made pursuant to an election under Section 754 is required to be allocated among partnership assets in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of those assets, or in any other manner permitted by the regulations.[619] In applying the allocation rules, the basis adjustment is first allocated between (1) capital assets and property described in Section 1231(b) and (2) any other property of the partnership.[620] The portion of the basis adjustment allocated to each class is then allocated among the items within the class.[621]

(3) Section 754 Election. A Section 754 election applies with respect to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent years.[622] An election may be revoked only with the consent of the Service.[623]

3. Sale of Interest in Partnership with Liabilities. In determining the amount realized on a sale or exchange of a partnership interest, liabilities are treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.[624] Thus, if a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized.[625] For example, if a partner sells an interest in a partnership for $750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of $250, the sellers realizes $1,000 on the transaction.[626]

4. Installment Sales of Partnership Interests. Gain recognized on the sale of a partnership interest is generally reportable under the installment method.[627] The Service has concluded, however, that the portion of the gain that is attributable to Section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the Section 751 property would be reportable under such method. Thus, in Revenue Ruling 89-

[618] Treas. Reg. § 1.743-1(d).

[619] I.R.C. § 755(a).

[620] I.R.C. § 755(b); Treas. Reg. § 1.755-1(a).

[621] Treas. Reg. § 1.755-1(a).

[622] I.R.C. § 754.

[623] I.R.C. § 754; Treas. Reg. §§ 1.754-1(a), 1.754-1(c).

[624] I.R.C. § 752(d).

[625] Treas. Reg. § 1.752-1(h).

[626] Treas. Reg. § 1.752-1(h).

[627] Rev. Rul. 76-483, 1976-2 C.B. 131; *see* Rev. Rul. 89-108, 1989-2 C.B. 100.

108, the Service determined that the installment method was not available on a sale of a partnership interest to the extent the income was attributable to the partnership's inventory. The Service reasoned that a direct sale of personal property constituting inventory in the hands of the partner would not be eligible for the installment method.[628]

5. Sale of 50-Percent or More of the Total Interest in Partnership Capital and Profits. A partnership terminates for federal income tax purposes when 50-percent or more of the total interests in partnership capital and profits is sold or exchanged within a period of 12 consecutive months.[629] The federal income tax consequences of this technical termination are discussed below.

a. Sale or Exchange Requirement. For purposes of the partnership termination rules, a sale or exchange includes a sale or exchange to another member of the partnership.[630] A disposition, however, of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange.[631] Moreover, the contribution of property to a partnership does not constitute a sale or exchange for purposes of these rules.[632] If the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership.[633]

b. Taxable Year. A partnership taxable year closes with respect to all partners on the date on which the partnership terminates.[634]

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[628]Rev. Rul. 89-108; s*ee* I.R.C. § 453(b)(2)(B); *cf.* 1995 FSA LEXIS 124 (Sept. 11, 1995) ("With regard to the sale of a partnership interest, gain recognized is generally reportable under the installment sale provisions. The sale is treated, however, as a sale of proportionate shares of the partnership's assets. Section 453A(e)(2). Accordingly, installment sale treatment is not available to the extent the partnership assets represent unrealized receivables or inventory items. Sections 453(b)(2)(B) and 751(a); Rev. Rul. 89-108."). For an in-depth discussion of the various federal income tax issues associated with selling a partnership interest on the installment basis, *see* Jackel, "Installment Sales of Partnership Interests: Aggregate or Entity," 95 TNT 202-75 (Oct. 16, 1995).

[629]I.R.C. § 708(b)(1)(B); Treas. Reg. § 1.708-1(b)(2).

[630]Treas. Reg. § 1.708-1(b)(2).

[631]Treas. Reg. § 1.708-1(b)(2).

[632]Treas. Reg. § 1.708-1(b)(2).

[633]Treas. Reg. § 1.708-1(b)(2).

[634]I.R.C. § 706(c)(1); Treas. Reg. § 1.708-1(b)(3); *see also* Notice 2001-5, 2001-1 I.R.B. 327 ("Accordingly, a partnership that terminates under section 708(b)(1)(B) is required to file a short-year final return for the taxable year ending with the date of its termination. The new partnership is required to file a return for its taxable year beginning after the date of termination of the terminated partnership.")

c. Form of Termination if a Partnership Is Terminated by a Sale or Exchange. If a partnership is terminated by a sale or exchange of a partnership interest, the following is deemed to occur:

(1) The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter,

(2) The terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up.[635]

d. Capital Accounts. The deemed contribution of assets to a new partnership and the distribution of the new partnership interests to the partners of the terminated partnership are disregarded for purposes of maintaining capital accounts.[636] As a result, the termination of a partnership does not change the capital accounts of the partners or the books of the partnership. The capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership.[637]

e. Section 704(c) Property. The deemed contribution of assets to a new partnership does not create additional Section 704(c) property.[638] The new partnership is not bound by the Section 704(c) method used by the terminated partnership.[639]

f. Employer Identification Number. The new partnership retains the Employer Identification Number of the terminated partnership.[640]

g. Section 754 Election. If a partnership is terminated by a sale or exchange of an interest in the partnership, a Section 754 election (including a Section 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming

[635] Treas. Reg. § 1.708-1(b)(4); *see generally* Grace, "Interaction of the Final Regs. on Partnership Technical Terminations with TRA '97," 14 J. Partnership Tax'n, 275 (Winter 1998) (detailed analysis of technical termination of a partnership).

[636] *See* Treas. Reg. § 1.704- 1(b)(2)(iv)(l).

[637] Treas. Reg. § 1.704-1(b)(2)(iv)(l).

[638] Treas. Reg. § 1.704-3(a)(2).

[639] Treas. Reg. § 1.704-3(a)(3)(i).

[640] Treas. Reg. § 301.6109-1(d)(2)(iii).

partner. Therefore, the bases of partnership assets are adjusted prior to their deemed contribution to the new partnership.[641]

h. Example. Suppose that A and B each contribute $10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time A sells its entire 50-percent interest to C for $15,000 in a transfer that terminates the partnership. At the time of the sale, Property X had an adjusted tax basis of $16,000 and a book value of $16,000 (original $20,000 tax basis and book value reduced by $4,000 of depreciation). In addition, A and B each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).

Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted tax basis of Property X in the hands of new AB is $16,000. The book value of Property X in the hands of new partnership AB is also $16,000 (the book value of Property X immediately before the termination) and B and C each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB prior to the termination). The deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership. New AB retains the taxpayer identification number of the terminated AB partnership.

Property X was not Section 704(c) property in the hands of terminated AB and is therefore not treated as Section 704(c) property in the hands of new AB, even though Property X is deemed contributed to new AB at a time when the fair market value of Property X ($30,000) was different from its adjusted tax basis ($16,000).[642]

6. Special Issues Relating to 2-Member Limited Liability Companies. The Revenue Service has recently issued guidance with respect to sales of interests in 2-member limited liability companies ("LLCs").

a. Existing Member in 2-Member LLC Purchases All Ownership Interests Held by Other Member. In Revenue Ruling 99-6, the Revenue Service addressed the federal income tax consequences if an existing member of a 2-member domestic LLC (classified as a partnership) purchases all of the ownership interests in the LLC from the other member and thereby causes the LLC's status as a partnership to terminate.[643] Under the Ruling, the partnership terminates and the Ruling concludes that the selling partner should treat the transaction as the sale of a partnership interest and report the gain or loss, if any, resulting from

[641]Treas. Reg. § 1.708-1(b)(5).

[642]*See* Treas. Reg. § 1.708-1(b)(4), Example.

[643]Rev. Rul. 99-6, 1991-1 C.B. 432; *but see generally* "NYSBA Tax Section Submits Report on Partnership Guidance," *reprinted in* 2011 TNT 114-19 (June 13, 2011) (addressing the Federal income tax issues that arise when all of the equity interests of a partnership are sold in a taxable transaction to a person who then owns all of the partnership equity).

the sale of its partnership interest in accordance with the general rules applicable to a sale of a partnership interest.[644] With respect to the purchasing partner, the Ruling holds that, for purposes of determining the tax treatment of the purchasing partner, the partnership is deemed to make a liquidating distribution of all of its assets to the purchasing partner and the selling partner, and following this distribution, the purchasing partner is treated as acquiring the assets deemed to have been distributed to the selling partner in liquidation of the selling partner's partnership interest.

To illustrate, assume that A and B are equal partners in TexLLC, a Texas limited liability company classified as a partnership for federal income tax purposes. TexLLC does not hold any unrealized receivables or inventory items. Suppose further that TexLLC is not liable for any indebtedness and none of its assets are subject to any indebtedness. Suppose that A sells A's entire interest in TexLLC to B for $10,000. After the sale, the business is continued by the LLC, which is owned solely by B.

Under Revenue Ruling 99-6, the AB partnership terminates when B purchases A's entire interest in AB. A must treat the transaction as the sale of a partnership interest[645] and report gain or loss, if any, resulting from the sale of A's partnership interest.

For purposes of determining the tax treatment of B, the AB partnership is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest.[646] B's basis in the assets attributable to A's one-half interest in the partnership is $10,000, the purchase price for A's partnership interest.[647] B's holding period for these assets begins on the day immediately following the date of the sale.

Upon the termination of AB, B is considered to receive a distribution of those assets attributable to B's former interest in AB. B must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by the partnership distribution provisions of the Code.[648] B's basis in the assets received in the deemed liquidation of B's partnership interest is equal to B's basis in his partnership interest reduced by any money distributed in the same transaction.[649] B's holding period for the assets attributable to B's one-half interest in AB includes the partnership's holding period for such assets.[650]

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[644]Rev. Rul. 99-6.

[645]Treas. Reg. § 1.741-1(b).

[646]Rev. Rul. 99-6.

[647]I.R.C. § 1012.

[648]*See* I.R.C. § 731(a).

[649]I.R.C. § 732(b).

[650]I.R.C. § 735(b).

b. Third Party Purchases All Ownership Interests in 2-Person LLC. In Revenue Ruling 99-6, the Revenue Service also addresses the federal income tax consequences if the two members in a 2-member LLC classified as a partnership for federal income tax purposes sell all of their LLC interests to a third party and thereby cause the LLC's status as a partnership to terminate. The Ruling holds that the selling partners should treat the transaction as the sale of a partnership interest[651] and should report gain or loss, if any, resulting from the sale of their partnership interest in accordance with the general rules applicable to a sale of a partnership interest.[652] The Ruling also concludes that, for purposes of classifying the acquisition by the third party, the partnership is deemed to make a liquidating distribution of its assets to the pre-sale partners. Immediately following this distribution, the third party purchaser is deemed to acquire, by purchase, all of the former partnership's assets.

To illustrate, assume that C and D are equal partners in CD, an LLC classified as a partnership for federal income tax purposes. C and D sell their entire interests in CD to E, an unrelated person, in exchange for $10,000 each. After the sale, the business is continued by the LLC, which is owned solely by E. Under the Ruling, CD's status as a partnership terminates when E purchases the entire interests of C and D in CD. C and D must report gain or loss, if any, resulting from the sale of partnership interests for federal income tax purposes. For purposes of classifying the acquisition by E, the CD partnership is deemed to make a liquidating distribution of its assets to C and D. Immediately following this distribution, E is deemed to acquire, by purchase, all of the former partnership's assets. E's basis in the assets is $20,000. E's holding period for the assets begins on the day immediately following the date of sale.[653]

c. Third Party Purchases Interest in LLC. In Revenue Ruling 99-5,[654] the Service analyzed the federal income tax treatment of a sale of an interest in an LLC by the existing sole member of the entity.[655] In that Ruling, the LLC has a single owner, A, and is disregarded as an entity separate from its owner for federal tax purposes. The Ruling states that the LLC would not be treated as an investment company (within the meaning of section 351) if it were incorporated. All of the assets held by each LLC are capital assets or property described in section 1231. For the sake of simplicity, the Ruling assumes that the LLC is not liable for any indebtedness and that the assets of the LLCs are not subject to any indebtedness. In Situation 1 of the Ruling, B, who is not related to A, purchases 50% of A's ownership interest in the LLC for $5,000. A does not contribute any portion of the $5,000 to the LLC. A and B continue to operate the business of the LLC as co-owners of the LLC. The Ruling holds that, In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is

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[651]Treas. Reg. § 1.741-1(b); Rev. Rul. 99-6.

[652]Rev. Rul. 99-6.

[653]Rev. Rul. 99-6.

[654]1999-1 C.B. 434.

[655]*See also* Rev. Rul. 2001-61, 2001-2 C.B. 573 ("If an entity classified as a disregarded entity for federal tax purposes calculates, reports, and pays its employment tax obligations under its own name and EIN pursuant to Notice 99-6 and if the federal tax classification of that entity changes to a partnership, the partnership must retain the same EIN it used as a disregarded entity.").

converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

In Situation 2 of Rev. Rul. 99-5, B, who is not related to A, contributes $10,000 to the LLC in exchange for a 50% ownership interest in the LLC. The LLC uses all of the contributed cash in its business. A and B continue to operate the business of the LLC as co-owners of the LLC. In this situation, the Ruling holds that the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.[656]

[656]*See* Priv. Ltr. Rul. 200934013 (Aug. 21, 2009) ("The admission of Shareholder A to LLC caused LLC to convert to a partnership for U.S. federal income tax purposes. Pursuant to Rev. Rul. 99-5, CORP, as the sole owner of LLC prior to the admission of Shareholder A, is deemed to contribute the existing assets of LLC to the newly-formed LLC partnership in exchange for a membership interest in LLC. This deemed transaction is treated as a contribution of property to LLC by CORP within the meaning of § 721(a). Additionally, because the assets of LLC are represented to be a diversified portfolio of assets within the meaning of § 1.351-1(c)(6)(i), CORP's contribution of these assets, when combined with Shareholder A's contribution of cash, does not cause LLC to be treated as an investment company within the meaning of § 351(e) if LLC were incorporated. Therefore, § 721(b) does not apply to Shareholder A's contribution of cash and to CORP's deemed contribution of property to LLC."); Priv. Ltr. Rul. 200910030 (Mar. 6, 2009) ("Upon the distribution of the LLC interests pro rata to the shareholders of Taxpayer on Date 5, a distribution of property to which section 311(b) applies, gain on the deemed sale of the Stock shall be recognized to Taxpayer in its taxable year ending at that time."); Priv. Ltr. Rul. 200825008 (June 20, 2008) ("The distribution of membership interests in LLC will be taxed under the principles set forth in Rev. Rul. 99-5, 1999-1 C.B. 434. For federal income tax purposes, the distribution of the membership interests in LLC will be treated as a distribution to the Partners of LLC's assets and liabilities, immediately followed by a deemed contribution of those assets to a new LLC. Pursuant to § 731(a) gain shall not be recognized by the Partners on the distribution of the LLC assets, except to the extent any money distributed exceeds a Partner's basis in the Partner's partnership interest."); Priv. Ltr. Rul. 200812012 (Mar. 21, 2008) ("On Date I, pursuant to the Termination Plan, the Trust distributed all of its shares in Successor Entity, which then held almost all of the Trust's real estate and other investment operation assets, including its interests in LLC, to the remainder beneficiaries. Under Rev. Rul. 99-5, 1999-1 C.B. 434, the distribution of the shares to the remainder beneficiaries is treated as a distribution of Trust's assets followed by a recontribution of those assets by the remainder beneficiaries to Successor Entity. Because assets held by Successor Entity include a greater than 50 percent interest in LLC, this distribution and deemed recontribution of the shares resulted in a § 708(b)(1)((B) termination of LLC."); Priv. Ltr. Rul. 200701032 (Jan. 5, 2007) ("Because the contractual arrangement is treated as a business entity, the transfer of the interest to the second owner should be analyzed in accordance with the holding of Situation One of Rev. Rul. 99-5."); Priv. Ltr. Rul. 200613025 (Mar. 31, 2006) ("P was created as a limited liability company with a single owner, and, thus, disregarded as an entity separate from its owner, T, for federal tax purposes. When T distributes interests in P to the Bs, P will convert from a disregarded entity to a partnership. In addition, each B that receives an interest in P will be treated as receiving a proportionate share of the P's Assets, subject to a proportionate share of P's liabilities, and immediately thereafter, each B will be treated as contributing those Assets subject to the liabilities to a partnership in exchange for ownership interests in the partnership. See Rev. Rul. 99-5, 1991-1 C.B. 434. Because P will thus received property subject to the Debt, and receive no cash Debt proceeds, P effectively will be treated as borrowing the balance of the Debt and investing the proceeds in the property so received.); Priv. Ltr. Rul. 200512020 (Mar. 25,

F. Application of Self-Employment Tax to Partners. For purposes of the self-employment tax, a limited partner's distributive share of partnership income (other than guaranteed payments for services actually rendered) is not treated as "net earnings from self-employment."[657] A general partner's distributive share of partnership is subject to self-employment tax.[658]

Members of a limited liability company ("LLC") may be either passive, active, or have other characteristics and the applicability of the self employment tax rules to members of an LLC is not entirely clear. In Private Letter Ruling 9452024, the Revenue Service held that the members of an LLC who engaged in the daily activities of the LLC and performed substantial services for the LLC were required to include their distributive shares of income in determining their "net earnings from self-employment." (Private letter rulings are not binding as "precedent.")

On December 28, 1994, the Treasury issued proposed regulations[659] (which were subsequently withdrawn) that attempted to address when an LLC member's distributive share of income constituted net earnings from self-employment. Under the 1994 proposed regulations, net earnings from self-employment generally included an individual's distributive share of income or loss from any trade or business carried on by an LLC of which the individual is a member.[660] An LLC member, however, was treated as a limited partner, and thus not subject to self-employment tax, if (1) the member was not a manager of the LLC; (2) the LLC could have been formed as a limited partnership rather than an LLC in the same jurisdiction; and (3) the member could have qualified as a limited partner in that limited partnership under applicable law.[661]

2005) ("Because the Primary Trust is treated as a business entity, the transfer of the interest to the second owner should be analyzed in accordance with the holding of Situation One of Rev. Rul. 99-5.").

[657] I.R.C. § 1402(a)(13).

[658] I.R.C. § 1402(a); *see Cokes v. Commissioner*, 91 T.C. 222, 229-230 (1988) ("[I]f petitioner's interest in the Rogers Unit in 1980, 1981, and 1982 was a partnership interest, then her distributive share of the partnership's trade or business income, will, subject to the limitation of section 1402(b) , be subject to the taxes imposed by section 1401 on self-employment income. (footnote omitted.)); *Anderson v. Commissioner*, 63 T.C.M. (CCH) 2278, 2282 (1992) ("It is undisputed that Mrs. Anderson's interest in Carlisle's Potpourri was a general partnership interest. Accordingly, her distributive share of the partnership's trade or business income is, in addition to the $2,000 guaranteed payment in each year, subject to the limitations of section 1402(b) , subject to the taxes imposed by section 1401 on self-employment income."); *Norwood v. Commissioner*, 79 T.C.M. (CCH) 1642, 1643 (2000) ("It is undisputed that petitioner's interest in Gallant was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income is, subject to the limitations of section 1402(b), subject to the taxes imposed by section 1401 on self-employment income . . . That petitioner spent a minimal amount of time engaged in the operations of Gallant is irrelevant to this determination." (citations omitted.)).

[659] *See* Prop. Reg. § 1.1402(a)-18, *reprinted in* 94 TNT 254-1 (hereinafter "1994 Prop. Regs.").

[660] 1994 Prop. Regs. § 1.1402(a)-18(a).

[661] 1994 Prop. Regs. § 1.1402(a)-18(b).

On January 10, 1997, the Treasury withdrew the 1994 proposed regulations,[662] and re-proposed regulations under Section 1402.[663] The 1997 proposed regulations define which partners of a partnership for federal income tax purposes are considered limited partners for self-employment tax purposes. Generally, an individual is treated as a limited partner under the 1997 proposed regulations unless the individual (1) has personal liability for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year.[664] If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business is not a limited partner.[665] The regulations are proposed to be effective beginning with the individual's first taxable year beginning on or after the date the regulations are published as final regulations in the Federal Register.[666]

The 1997 proposed regulations were subject to substantial criticism from representatives of small business and some members of Congress.[667] The Taxpayer Relief Act of 1997 restricted Treasury's authority to issue final regulations for a period of time. The Act provided that any regulations relating to the definition of a limited partner for self-employment tax purposes shall not be issued or effective before July 1, 1998.[668] Thus far, Treasury has not finalized any regulations and the application of the self-employment tax to members of an LLC remains unclear.[669]

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[662] REG-209729-94; 62 F.R. 1701 (13 Jan 3-97), *reprinted in* 97 TNT 14-10.

[663] REG-209824-96; 62 F.R. 1702-1705 (13 Jan 3-97), *reprinted in* 97 TNT 14-11 (hereinafter "1997 Prop. Regs.").

[664] 1997 Prop. Regs. 1.1402(a)-2(h)(2).

[665] 1997 Prop. Regs. 1.1402(a)-2(h)(6).

[666] 1997 Prop. Regs. 1.1402(a)-2(j).

[667] *See, e.g*, "Tax Bill Blocks Controversial Self-Employment Tax Regulations," 97 TNT 149-2 (1997).

[668] Act § 935.

[669] *See generally* Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05 (January 27, 2005), *reprinted at* 2005 TNT 18-18 (discussing proposal for modifying determination of amounts subject to employment or self-employment tax for partners and S corporation shareholders); Culpepper, Holo, Keatinge, Lenz, Schippel, Shapack, and Yearout, "Self-Employment Taxes and Passthrough Entities: Where are We Now?" 2005 TNT 196-23 (Oct. 12, 2005); *cf. Renkemeyer, Campbell & Weaver LLP et al. v. Commissioner*, 136 T.C. No. 7 (Feb. 9, 2011) ("The insight [from the legislative history to Section 1402(a)(13) provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes. Aside from a nominal amount of income arising from recognition of certain pass-through income from RCGW, all of the law firm's revenues were derived from legal

On January 15, 2010, *Tax Notes* reported "[e]ven though a 1998 moratorium called into question the effectiveness of proposed regulations issued in 1997 to help partners determine whether and the extent to which their earnings are subject to self-employment tax, an IRS official on January 14 reassured practitioners that they can rely on the regs. However, they cannot rely on their predecessor, proposed regs from 1994."[670] *Tax Notes* quoted Dianna Miosi, special counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), as stating that "If you structure a transaction so that you're within the four corners of the proposed regulations, that's a reasonable position and we're not going to challenge it." The remainder of the story states as follows:

> Speaking at a District of Columbia Bar Taxation Section program sponsored by the section's Passthroughs and Real Estate Committee, Miosi said the IRS frequently gets calls from practitioners on the subject and that while there is a "level of frustration" surrounding it, the agency hasn't been able to provide or finalize guidance in that area.
>
> Miosi said the IRS will "get into the facts and circumstances" of each particular case for those transactions that don't fit within the parameters of the proposed regs -- for example, if they involve a tiered partnership.
>
> She pointed out that the 1994 regs were withdrawn when the 1997 regs were proposed. "You shouldn't be able to rely on the withdrawn regs," Miosi said, adding that the 1997 proposed regs represent "the more reasonable or more recent thinking of the Service."
>
> As for the likelihood that the IRS will finally issue temporary or final regs on the subject, Miosi said the Service must wait to see what Congress might do with the Self-Employment Contributions Act.[671]

G. Merger of Partnerships.

1. Background.

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services performed by petitioner and Messrs. Campbell, and Weaver in their capacities as partners. Petitioner and Messrs. Campbell, and Weaver each contributed a nominal amount ($110) for their respective partnership units. Thus it is clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not "earnings which are basically of an investment nature." Instead, the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm. To conclude, we hold that the respective distributive shares of petitioner and Messrs. Campbell, and Weaver arising from the legal services they performed in their capacity as partners in the law firm are subject to self-employment taxes for the 2004 and 2005 tax years."); *Howell v. Commissioner*, T.C. Memo 2012-303 (Nov. 1, 2012) ("In [Renkemeyer], we applied accepted principles of statutory construction to decide whether the taxpayers' partnership interests in a law firm should be considered limited partner interests for purposes of section 1402(a)(13) . . . .").

[670] Amy S. Elliott, "IRS Official Addresses Limited Partner Employment Tax Regs," *Tax Notes*, Jan. 18, 2010, p. 301, *Doc 2010-895, 2010 TNT 10-2*.

[671] *Id.*

a. Treatment of Partnership Mergers in the Code. The Code neither defines what constitutes a partnership merger or consolidation nor prescribes a form for a partnership merger. It provides only that "[i]n the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50-percent in the capital and profits of the resulting partnership."[672]

b. Treatment of Partnership Mergers in the Treasury Regulations. In 1997, the Internal Revenue Service issued proposed regulations providing guidance with respect to the treatment of partnership mergers for federal income tax purposes. On January 3, 2001, the Service issued final regulations applicable to mergers occurring on or after January 4, 2001.[673] A partnership may, however, elect to apply the rules in the final regulations for mergers occurring on or after January 11, 2000.[674] These regulations address (a) how to identify the continuing and terminating partnerships in a partnership merger; (b) the closing of the tax year for partnerships that are considered terminated in a partnership merger and the federal income tax return filing requirements for such terminated partnerships; and (c) the form of a partnership merger.[675] The final regulations do not define what constitutes a partnership merger. Although the Preamble to the final regulations does not state why Treasury did not provide such a definition, the Preamble states that some tax practitioners have stated that the selectivity that would be created by attempting to draw lines in such definitions could lead to planning opportunities that would be adverse to the government's interest.[676]

2. Resulting and Terminated Partnerships in a Partnership Merger; Closing of the Tax Year for Terminated Partnerships and Filing of Federal Income Tax Returns.

a. Identifying the Terminated Partnerships in a Partnership Merger. In the case of a merger or consolidation of two or more partnerships, the final regulations provide that the resulting partnership is, for federal income tax purposes, considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50-percent in the capital and profits of the resulting partnership.[677] If the resulting partnership can be considered a continuation of more than one of the merging partnerships, the resulting partnership is, unless the Commissioner permits otherwise, the continuation of the partnership that is credited with the contribution of the greatest fair market value (net of liabilities) to the resulting partnership.[678] Any other merging or consolidating partnerships is

[672]I.R.C. § 708(b)(2)(A).

[673]Treas. Reg. § 1.708-1(c)(7).

[674]Treas. Reg. § 1.708-1(c)(7).

[675]*See* Treas. Reg. Sec. 1.708-1(c).

[676]Preamble, T.D. 8925, 2001-1 C.B. 496, 499.

[677]I.R.C. § 708(b)(2)(A).

[678]Treas. Reg. § 1.708-1(c)(1).

considered as terminated.[679] If the members of none of the merging or consolidating partnerships have an interest of more than 50-percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.[680]

b. Closing of the Tax Year for Terminated Partnerships and Filing of Federal Income Tax Returns for Such Partnerships. Under the regulations, the tax years of the partnerships that are considered terminated in the merger are closed[681] and such partnerships are required to file their returns for the taxable year ending upon the date of termination (which is the date of merger or consolidation).[682] The resulting partnership in the merger is required to file a tax return for the tax year of the partnership that is considered to continue in the merger.[683] The resulting partnership uses the employer identification number ("EIN") of the continuing partnership on the return.[684] The return is required to state that the resulting partnership is a continuation of such merging or consolidating partnership, and must include the names, addresses, and EINs of the other merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and including the date of the merger or consolidation and subsequent to the date of merger or consolidation are required to be shown as a part of the return.[685]

c. Example. The regulations contain an example illustrating the closing of the tax year and filing requirements for the continuing and terminated partnerships in a merger. Assume that A and B, both calendar year taxpayers, each own a 50-percent interest in the capital and profits of the AB Partnership, a calendar-year partnership. Assume further that C and D, both calendar year taxpayers, each own a 50-percent interest in the capital and profits of the CD Partnership, a calendar-year partnership. The AB Partnership and the CD Partnership merge on September 30, 1999, and form the ABCD Partnership. After the merger, the partners have capital and profits interests as follows:

A	30%
B	30%
C	20%
D	20%

Since A and B together own an interest of more than 50-percent in the capital and profits of the ABCD Partnership, such partnership is considered a continuation of the AB Partnership

[679] Treas. Reg. § 1.708-1(c)(1).

[680] Treas. Reg. § 1.708-1(c)(1).

[681] Treas. Reg. § 1.708-1(c)(2); *see* I.R.C. § 706(c).

[682] Treas. Reg. § 1.708-1(c)(2).

[683] Treas. Reg. § 1.708-1(c)(2).

[684] Treas. Reg. § 1.708-1(c)(2).

[685] Treas. Reg. § 1.708-1(c)(2).

and is required to continue to file returns on a calendar year basis. Since C and D own an interest of less than 50-percent in the capital and profits of the ABCD Partnership, the taxable year of the CD Partnership closes as of September 30, 1999, the date of the merger, and the CD Partnership is terminated as of that date. The ABCD Partnership is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that, until September 30, 1999, it was the AB Partnership. The CD Partnership is required to file a return for its final taxable year, January 1 through September 30, 1999.[686]

3. Form of a Partnership Merger.

a. General Rules. Under the final regulations, the form of a partnership merger accomplished under applicable jurisdictional law generally will be respected if the partnership undertakes the steps of one of two forms prescribed for federal income tax purposes in the regulations: the assets-over form or the assets-up form.[687] Both of these forms are discussed in detail below. The default rule for partnership mergers is the assets-over form, so that if a transaction is effected without undertaking a form for the merger or the transaction is not characterized under the assets-up form, it will be characterized under the assets-over form (regardless of whether that form is followed).[688]

To accomplish a merger, partners in a terminating partnership may in certain cases desire to transfer their terminating partnership interests to the resulting partnership in exchange for resulting partnership interests, and then liquidate the terminating partnership into the resulting partnership (referred to as the "interests-over form"). Under the final regulations, the partnerships will be treated as following the assets-over form of merger for federal income tax purposes.[689]

(1) Assets-Over Form.

(a) Description of Assets-Over Form. Under the assets-over form, a terminating partnership contributes its assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership and, immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminating partnership.[690] The form of the merger for state law purposes does

[686]Treas. Reg. § 1.708-1(c)(5), Example 1.

[687]Treas. Reg. § 1.708-1(c)(3)(i); Preamble, T.D. 8925, 2001-1 C.B. at 497.

[688]Treas. Reg. § 1.703-1(c)(3)(i).

[689]Notice of Proposed Rulemaking, REG-111119-99, 2000-2 C.B. 455, 460 [hereinafter "Partnership Merger Regs Notice"].

[690]Treas. Reg. § 1.708-1(c)(3)(i); *see also* Partnership Merger Regs. Notice, 2000-2 C.B. at 461 ("[U]nder the Assets-Over Form, gain under sections 704(c)(1)(B) and 737 is not triggered. See sections 1.704-4(c)(4) and 1.737-2(b)."); Treas. Reg. § 1.704-4(c)(4) ("Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement."); Treas. Reg. § 1.737-2(b)(1) ("Complete transfer. Section 737 and this section do not apply to a transfer by a partnership (transferor partnership)

not override the mechanical rules of the Code dictating the continuing partnership for federal income tax purposes.[691] Thus, as noted by one commentator, if the partnership that in form receives assets is not the resulting partnership for federal income tax purposes, the state law "direction" of the merger will be "reversed" for tax purposes, and a partnership that in form transferred the assets may be treated as the resulting partnership.[692] This point is illustrated in the Example 1 below.

i) Example 1. A and B own 40-percent and 60-percent interests, respectively, in the capital and profits of the X Partnership. B and C own 60-percent and 40-percent interests, respectively, in the capital and profits of the Y Partnership. The X Partnership and the Y Partnership merge on September 30, 1999. The fair market value of the X Partnership's assets (net of liabilities) is $100X, and the fair market value of the Y Partnership's assets (net of liabilities) is $200X. The merger is accomplished under state law by the Y Partnership contributing its assets and liabilities to the X Partnership in exchange for interests in the X partnership, with the Y Partnership then liquidating and distributing its interests in the X Partnership to B and C.

B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, since the fair market value of the Y Partnership's assets (net of liabilities) was greater than that of the X Partnership, the X Partnership is considered to terminate in the merger. As a result, even though, for state law purposes, the transaction was undertaken with the Y Partnership contributing its assets and liabilities to the X Partnership and distributing X Partnership interests to its partners, for federal income tax purposes, the transaction is treated as if the X partnership contributed its assets to the Y Partnership in exchange for interests in the Y Partnership and then liquidated, distributing interests in the Y Partnership to A and B.[693]

ii) Example 2. The X Partnership and the Y Partnership merge when the partners of X transfer their X Partnership interests to Y in exchange for Y partnership interests. Immediately thereafter, X liquidates into Y. The resulting partnership is considered a continuation of Y, and X is considered terminated.

The partnerships are treated as undertaking the assets-over form because the partnerships undertook a form that is not the assets-up form. Accordingly, for federal income tax purposes, partnership X is deemed to contribute its assets and liabilities to partnership Y in exchange for interests in partnership Y, and, immediately thereafter, partnership X is deemed to have

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of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.").

[691] *See, e.g.,* Treas. Reg. § 1.708-1(c)(5), Example 2; *See also* Sloan, Lipton, Frediani, "Final Regulations Under Section 708 Provide Expanded Guidance on Partnership Mergers and Divisions – Part 1," 496 PLI/Tax 1125, 1135 (June 2001) [hereinafter "Sloan"].

[692] *See* Sloan, 496 PLI/Tax at 1135.

[693] Treas. Reg. § 1.708-1(c)(5), Example 2.

distributed the interests in partnership Y to its partners in liquidation of their interests in partnership X.[694]

(b) Treatment of Liabilities in Asset-Over Form. Upon the merger or consolidation of two or more partnerships, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger.[695]

The regulations provide an example illustrating the effect of liabilities in an assets-over form of merger. B owns a 70-percent interest in the T Partnership. T's sole asset is property X, which is encumbered by a $900 liability. T's adjusted basis in property X is $600, and the value of property X is $1,000. B's adjusted basis in its partnership interest in T is $420. B also owns a 20-percent interest in the S Partnership. S's sole asset is property Y, which is encumbered by a $100 liability. Partnership S's adjusted basis in property Y is $200, the value of property Y is $1,000, and B's adjusted basis in its partnership interest in S is $40.

Assume that the T and S Partnerships merge and that T is considered terminated and the resulting partnership is considered a continuation of partnership S. T and S undertake the assets-over form for the merger. T contributes property X and its $900 liability to S in exchange for an interest in S. Immediately thereafter, T distributes the interests in S to its partners in liquidation of their interests in T. B owns a 25-percent interest in S after T distributes the interests in S to B.

B nets the increases and decreases in its share of partnership liabilities associated with the merger of T and S. Before the merger, B's share of partnership liabilities was $650 (B had a $630 share of partnership liabilities in T and a $20 share of partnership liabilities in S immediately before the merger). B's share of S's partnership liabilities after the merger is $250 (25-percent of S's total partnership liabilities of $1,000). Accordingly, B has a $400 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a $400 distribution from partnership S. Since B's adjusted basis in its partnership S interest before the deemed distribution is $460 ($420 + $40), B will not recognize gain. After the merger, B's adjusted basis in its partnership S interest is $60.[696]

(2) Assets-Up Form.

(a) Description of Assets-Up Form. Under the assets-up form, the merged or consolidated partnership that is considered terminated distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the

[694]Treas. Reg. § 1.708-1(c)(5), Example 4.

[695]Treas. Reg. § 1.752-1(g), Example 2.

[696]Treas. Reg. § 1.752-1(g), Example 2.

terminated partnership,[697] and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.[698] The regulations provide that the form of this merger or combination will be respected "[d]espite the partners' transitory ownership of the terminated partnership's assets."[699] The Preamble to the final regulations states that a partnership can use the assets-up form for partnership mergers regardless of whether the partners could otherwise generally hold certain assets, such as undivided interests in goodwill, outside of a partnership.[700]

i) Conveyance of Ownership of Assets. While the final regulations provide that the assets-up form will be respected in accomplishing partnership mergers, the Preamble to the final regulations states that the IRS and Treasury do not intend to establish a regime whereby partners essentially can elect between the assets-up form and the assets-over form by creating different documents that have the same legal effect. The Preamble states that if the assets-up form is to be respected, a partnership must actually undertake the steps that are necessary, under the laws of the applicable jurisdiction, to convey ownership of the assets that are distributed to the partners.[701] In the Preamble, the Service rejects the proposal that, rather than actually conveying ownership of the assets under applicable jurisdictional law, the partners be allowed to assign their rights to receive title to the assets in liquidation of the partnership, or direct the partnership to transfer title to the assets to the resulting partnership.[702]

Some commentators have questioned whether a transfer of assets by a partnership to a single-member limited liability company ("LLC") followed by a distribution of interests in such LLC to the partners would qualify under the assets-up form since the partners would not actually be conveyed ownership of the assets under local law. Rather, the partners would be conveyed an interest in an LLC holding the assets.[703] These commentators have concluded that this result seems rather harsh and should be formally rejected by the Service.[704]

ii) Liabilities. The Preamble to the final regulations provides that, while the IRS and Treasury believe that it should be necessary for a partnership to actually convey ownership of the partnership's assets to its partners in order to

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[697]The Preamble to the proposed regulations cautions that under the assets-up form, partners could recognize gain under sections 704(c)(1)(B) and 737 when the terminating partnership distributes the assets to the partners. Partnership Merger Regs. Notice, 2000-2 C.B. at 460.

[698]Treas. Reg. § 1.708-1(c)(3)(ii).

[699]Treas. Reg. § 1.708-1(c)(3)(ii).

[700]Preamble, T.D. 8925, 2001-1 C.B. at 496, 497.

[701]Preamble, T.D. 8925, 2001-1 C.B. at 497.

[702]Preamble, T.D. 8925, 2001-1 C.B. at 497.

[703]*See* Hortenstine, Jackel, Ladin, "Final Partnership Merger and Division Regulations – Analysis, Commentary and Examples," 496 PLI/Tax 1043, 1049-50 (2001) [hereinafter "Hortenstine"].

[704]*Id.*

follow the assets-up form, it should not be necessary for the partners to actually assume the liabilities of the partnership in order to follow such form. The Preamble states that, under the Code and regulations,[705] a partner essentially is deemed to have directly incurred a share of the partnership's liabilities. The Service therefore concludes in the Preamble that requiring the partners to actually assume debt that they already are deemed to have incurred is unnecessary.[706]

(b) Example. A and B own 40-percent and 60-percent interests, respectively, in the capital and profits of the X Partnership. X is engaged in a trade or business and has, as one of its assets, goodwill. B and C own 60-percent and 40-percent interests, respectively, in the capital and profits of the Y Partnership. The X Partnership and the Y Partnership merge on September 30, 1999. The fair market value of the X Partnership's assets (net of liabilities) is $100X, and the fair market value of the Y Partnership's assets (net of liabilities) is $200X. The merger is accomplished under state law by having X convey an undivided 40-percent interest in each of its assets to A and an undivided 60-percent interest in each of its assets to B, with A and B then contributing their interests in such assets to the Y Partnership. Y also assumes all of the liabilities of partnership X.

B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, since the fair market value of the Y Partnership's assets (net of liabilities) was greater than that of the X Partnership, X is considered to terminate in the merger. The form of the partnership merger will be respected so that X will be treated as following the assets-up form for federal income tax purposes.[707]

b. Partner Buy-Out Rule. The final regulations contain a special buy-out rule to address the situation where one partner would prefer to be cashed out in an assets-over form of merger rather than becoming a partner in the resulting partnership.[708] This rule provides that a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership as part of an asset-over form of merger or consolidation will be respected as a sale of a partnership interest if (1) the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold; and (2) the selling partner in the terminated partnership, either prior to or contemporaneous with the transaction, consents to treat the transaction as a sale of the partnership interest.[709] The timing of the selling partner's consent is important. The regulations expressly require the selling partner in the terminated partnership to provide the requisite consent prior to or contemporaneous with the transaction.

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[705] *See generally* I.R.C. § 752 and the regulations thereunder.

[706] Preamble, T.D. 8925, 2001-1 C.B. at 497.

[707] Treas. Reg. § 1.708-1(c)(5), Example 3.

[708] Partnership Merger Regs. Notice, 2000-2 C.B. at 457.

[709] Treas. Reg. § 1.708-1(c)(4); For a discussion of the advantages and disadvantages of an exiting partner consenting to an interest sale as opposed to a partnership redemption, *see* Sloan, 496 PLI/Tax at 1140-47.

The special buy-out rule allows a resulting partnership in a merger to fund the purchase of one or more partners' interests in a terminating partnership without triggering the disguised sale rules, which otherwise would cause all of the partners in the terminating partnership to recognize gain or loss as a result of the purchase.[710] This treatment will apply even if the resulting partnership sends the consideration to the terminating partnership on behalf of the exiting partner, so long as the designated language is used in the relevant document.[711]

(1) Form of Merger Transaction Under Special Buy-Out Rule. Under the special buy-out rule, the exiting partner is treated as separately selling a partnership interest in the terminating partnership to the resulting partnership (and the resulting partnership is treated as purchasing the partner's interest in the terminating partnership) immediately prior to the merger.[712] Immediately after this sale, the resulting partnership becomes a momentary partner in the terminating partnership.[713] The terminating partnership is then treated as contributing its assets and liabilities attributable to the continuing partners' interests to the resulting partnership in exchange for interests in the resulting partnership and, immediately thereafter, distributing such interests to the continuing partners in liquidation of their interests in the terminating partnership.[714] At the same time, the terminating partnership, as part of the merger, is treated as distributing assets to the resulting partnership in liquidation of the resulting partnership's interest in the terminating partnership. The resulting partnership should take an exchanged basis in the distributed assets under Section 732(b).[715]

(2) Document Specifying Buy-Out and Consideration; Form of Consent from Selling Partner. The final regulations provide that the merger agreement or another document must specify that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold.[716] The Preamble clarifies that the exiting partner does not have to be a party to the merger agreement in order to obtain the benefit of the special buy-out rule. To ensure, however, that all partners to the transaction treat the transaction consistently when filing their returns, the final regulations require that, prior to or contemporaneous with the transfer, the exiting partner must consent to the sale treatment provided in the special buy-out rule.[717]

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[710]Treas. Reg. § 1.708-1(c)(4).

[711]Partnership Merger Regs Notice, 2000-2 C.B. at 458.

[712]Partnership Merger Regs Notice, 2000-2 C.B. at 459-460; Treas. Reg. § 1.708-1(c)(5), Example 5(iii).

[713]Partnership Merger Regs Notice, 2000-2 C.B. at 460.

[714]Treas. Reg. § 1.708-1(c)(5), Example 5(iii).

[715]Preamble, T.D. 8925, 2001-1 C.B. at 499; *see, e.g.*, Treas. Reg. § 1.708-1(c)(5), Example 5(iv); For some insightful criticism of some aspects of Example 5 in Treas. Reg. § 1.708-1(c)(5), *see* Hortenstine, 496 PLI/Tax at 1054.

[716]Treas. Reg. § 1.708-1(c)(4).

[717]Preamble, T.D. 8925, 2001-1 C.B. at 499.

(3) Example of Application of Special Buy-Out Rule. The regulations contain an example illustrating the application of the special buy-out rule. Assume that A, B, and C are partners in the X Partnership. D, E, and F are partners in the Y Partnership. The X Partnership and the Y Partnership merge. Assume that the resulting partnership is considered a continuation of the Y Partnership and that the X Partnership is considered terminated. Under state law, X and Y undertake the assets-over form to accomplish the partnership merger. C does not want to become a partner in Y, and X does not have the resources to buy C's interest before the merger. C, X Partnership, and Y Partnership enter into an agreement specifying that Y Partnership will purchase C's interest in X Partnership for $150 before the merger, and as part of the agreement, C consents to treat the transaction in a manner that is consistent with the agreement. As part of the merger, X Partnership receives from Y Partnership $150 that will be distributed to C immediately before the merger, and interests in the Y Partnership in exchange for X Partnership's assets and liabilities.

Since the merger agreement satisfies the requirements of the buy-out provisions of the regulations and C provides the necessary consent, C will be treated as selling its interest in partnership X to partnership Y for $150 before the merger.[718] Moreover, since the merger agreement satisfies the requirements of the regulations, partnership Y is considered to have purchased C's interest in partnership X for $150 immediately before the merger.

Partnership X is treated as contributing its assets and liabilities attributable to the interests of A and B to partnership Y in exchange for interests in partnership Y and, immediately thereafter, distributing the interests in partnership Y to A and B in liquidation of their interests in partnership X. At the same time, partnership X is treated as distributing assets to partnership Y in liquidation of partnership Y's interest in partnership X. Partnership Y's bases in the distributed assets are determined under Section 732(b).

(4) Sale of 50-Percent or More of Total Interests in the Partnership. Although not discussed in the final regulations, the Preamble states that if exiting partners sell 50-percent or more of the total interests in the terminating partnership's capital and profits as part of a merger, then a partnership termination under Section 708(b)(1)(B) will occur immediately before the merger.[719]

c. Treatment of Partnership Merger Utilizing More Than One Form. Under the final regulations, each partner must participate (or will be deemed to participate) in the partnership merger in the same manner (with the exception of those partners who are subject to the buy-out rule).[720] The Preamble to the final regulations offers some insight into the Service's thinking on this issue. It states that the final regulations were not intended to provide unlimited flexibility among the various structural alternatives for accomplishing merger or consolidation transactions. Instead, the regulations were intended to provide a set of administrable rules that taxpayers and the IRS could apply in characterizing these transactions.

[718] Treas. Reg. § 1.708-1(c)(5), Example 5(ii).

[719] Preamble, T.D. 8925, 2001-1 C.B. at 499.

[720] Treas. Reg. § 1.708-1(c)(3); Preamble, T.D. 8925, 2001-1 C.B. at 498.

The IRS and Treasury do not believe it is appropriate for a partnership merger to be accomplished using both the assets-over form and the assets-up form when all the assets and liabilities of the terminated partnership are transferred to a single resulting partnership. Therefore, if the partners wish for a partnership merger to be characterized under the assets-up form, the terminated partnership must undertake the steps of the assets-up form for all of its assets when it distributes the assets to its partners. Otherwise, the transaction will be characterized under the assets-over form.[721]

The final regulations provide a caveat to the foregoing rule. Where more than two partnerships are combined, each combination will be viewed under the final regulations as a separate merger so that the characterization of a merger of one partnership into the resulting partnership under the assets-over form will not prevent a simultaneous merger of another partnership into the same resulting partnership from being characterized under the assets-up form.[722]

d. Authority Granted to Revenue Service to Disregard Form of Transaction in Certain Cases. If a partnership merger is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form, the final regulations give the Revenue Service the authority to disregard such form and to recast the larger series of transactions in accordance with their substance.[723]

H. Partnership Divisions.

1. Effecting a Division. The Code neither defines what constitutes a partnership division nor prescribes a form for a partnership division. The Code provides that, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50-percent or less in the capital and profits of the prior partnership) are considered a continuation of the prior partnership.[724] The regulations provide that any other resulting partnership is not considered a continuation of the prior partnership but is considered a new partnership.[725] If none of the members of the resulting partnerships owned an interest of more than 50-percent in the capital and profits of the prior partnership, the prior partnership is terminated.[726] Where members of a partnership that has been divided do not become members of a resulting partnership that is considered a continuation of the prior partnership, such partner's interest is considered liquidated as of the date of the division.[727]

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[721] Preamble, T.D. 8925, 2001-1 C.B. at 498.

[722] Preamble, T.D. 8925, 2001-1 C.B. at 498; *see* Treas. Reg. § 1.708-1(c)(3).

[723] Treas. Reg. § 1.708-1(c)(6).

[724] I.R.C. § 708(b)(2)(B).

[725] Treas. Reg. § 1.708-1(b)(2)(ii).

[726] Treas. Reg. § 1.708-1(b)(2)(ii).

[727] Treas. Reg. § 1.708-1(b)(2)(ii).

2. Form of Partnership Division. Simultaneous with the issuance on January 3, 2001, of final regulations addressing the form of partnership mergers, the Revenue Service issued regulations addressing the form of partnership divisions.[728] These final regulations apply to partnership divisions occurring on or after January 4, 2001.[729] A partnership, however, may elect to apply the final regulations to partnership divisions occurring on or after January 11, 2000.[730]

The final regulations describe the tax consequences of a partnership division and the alternative forms of a division, but do not provide a comprehensive definition of what constitutes a partnership division.[731] The Preamble to the final regulations, however, provides some insight into the Service's thinking on the issue of what constitutes a partnership division. The Preamble states that "[t]o have a division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction." As an illustration of this point, the Preamble provides the following example of a transaction that the Service concludes does not constitute a division: ABC partnership owns X business and Y business. A and B each own a 20-percent interest, and C owns a 60-percent interest in the ABC partnership. C does not want to continue in the partnership with A and B and would like to operate X business with D. Accordingly, ABC partnership distributes X business to C in liquidation of C's interest in partnership ABC. Subsequently, C forms a partnership with D and contributes X business to the CD partnership. After the distribution and contribution of X business, AB partnership owns Y business and CD partnership owns X business. In concluding that the transaction does not constitute a division, the Service reasoned that, for a division to occur, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction. In the above example, C is the only member of the ABC partnership in the CD partnership. Accordingly, the Preamble states that this transaction would not be treated as a division for federal income tax purposes.[732] Some commentators have observed that this still leaves many unanswered questions.[733] For instance, suppose A is already a partner in CD (or, alternatively, assume A contributes other assets to CD as part of this transaction). Would this constitute a division even though A did not receive a distribution from ABC as part of this transaction? The Preamble does not address this issue.

a. Defined Terms Used in Treasury Regulations to Describe Form of Partnership Division. In describing the form of a partnership division, the final regulations use four defined terms: (1) prior partnership; (2) resulting partnership; (3) divided partnership;

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[728]Preamble, T.D. 8925, 2001-1 at 496.

[729]Treas. Reg. § 1.708-1(d)(7).

[730]Treas. Reg. § 1.708-1(d)(7).

[731]*See* Preamble, T.D. 8925, 2001-1 C.B. 496, 499; *see also* Treas. Reg. § 1.708-1(d)(4)(iv) (defining a resulting partnership as "a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two members who were partners in the prior partnership.").

[732]Preamble, T.D. 8925, 2001-1 at 503.

[733]*Hortenstine*, 496 PLI/Tax at 1057.

and (3) recipient partnership.[734] Knowing the meaning of these terms is key to understanding the form of a partnership division.

(1) Prior Partnership; Resulting Partnership. The terms prior partnership and resulting partnership describe partnerships that exist under the applicable jurisdictional law.

(a) Prior Partnership. The prior partnership is the partnership subject to division that exists under the applicable jurisdictional law before the division.[735]

(b) Resulting Partnership. A resulting partnership is a partnership resulting from the division that exists under the applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership.[736] For example, where a prior partnership divides into two partnerships, both partnerships existing after the division are resulting partnerships.[737]

(2) Divided Partnership and Recipient Partnership. The terms divided partnership and recipient partnership are federal income tax concepts prescribed by the regulations.[738]

(a) Divided Partnership. A divided partnership is the continuing partnership which is treated, for federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form).[739] The divided partnership must be a continuation of the prior partnership.[740] The rules in the regulations for identifying the divided partnership are as follows:

i) If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership.[741]

ii) If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership,

[734]*See* Treas. Reg. § 1.708-1(d)(4).

[735]Treas. Reg. § 1.708-1(d)(4)(ii).

[736]Treas. Reg. § 1.708-1(d)(4)(iv).

[737]Treas. Reg. § 1.708-1(d)(4)(iv).

[738]*See* Preamble, T.D. 8925, 2001-1 C.B. at 503.

[739]Treas. Reg. § 1.708-1(d)(4)(i).

[740]Preamble, T.D. 8925, 2001-1 at 502.

[741]Treas. Reg. § 1.708-1(d)(4)(i).

then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership.[742] Although the divided partnership is considered one continuing partnership for federal income tax purposes, it may actually be two different partnerships under the applicable jurisdictional law (i.e., the prior partnership and a different resulting partnership that is considered a continuation of the prior partnership for federal income tax purposes).[743]

iii) If a partnership divides into two or more partnerships without undertaking the assets over or assets up form for the division, or if the resulting partnership that had, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.[744]

(b) Recipient Partnership. A recipient partnership is a partnership that is treated as receiving, for federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form).[745]

b. General Rules Concerning Form of Partnership Division. The regulations respect for federal income tax purposes the form of a partnership division accomplished under laws of an applicable jurisdiction if the partnership undertakes the steps of either the assets-over form or the assets-up form as prescribed in the regulations. Thus, the same forms allowed for partnership mergers are allowed for partnership divisions. Consistent with partnership mergers, if a partnership divides using a form other than the two prescribed, it will be treated as undertaking the assets-over form.[746]

(1) Assets-Over Form.

(a) Assets-Over Form Where at Least One Resulting Partnership Is a Continuation of the Prior Partnership. In a division under the assets-over form where at least one resulting partnership is a continuation of the prior partnership, the divided partnership contributes certain assets and liabilities to a recipient partnership or recipient partnerships in exchange for interests in such recipient partnership or partnerships; and, immediately thereafter, the divided partnership distributes the interests in such recipient partnership or partnerships to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.[747]

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[742]Treas. Reg. § 1.708-1(d)(4)(i).

[743]Preamble, T.D. 8925, 2001-1 C.B. at 503.

[744]Treas. Reg. § 1.708-1(d)(4)(i).

[745]Treas. Reg. § 1.708-1(d)(4)(iv).

[746]Treas. Reg. § 1.708-1(d)(3)(i).

[747]Treas. Reg. § 1.708-1(d)(3)(i)(A).

i) Example 1. To illustrate, assume that the ABCD Partnership owns three parcels of property: property X, with a value of $500; property Y, with a value of $300; and property Z, with a value of $200. A and B each own a 40-percent interest in the capital and profits of the ABCD Partnership, and C and D each own a 10-percent interest in the capital and profits of the ABCD Partnership. On November 1, 1999, the ABCD Partnership divides into three partnerships (AB1, AB2, and CD) by contributing property X to a newly formed partnership (AB1) and distributing all interests in such partnership to A and B as equal partners, and by contributing property Z to a newly formed partnership (CD) and distributing all interests in such partnership to C and D as equal partners in exchange for all of their interests in the ABCD Partnership. While the ABCD Partnership does not transfer property Y, C and D cease to be partners in the partnership. Accordingly, after the division, the partnership holding property Y is referred to as partnership AB2.

The AB1 and AB2 Partnerships both are considered a continuation of the ABCD Partnership, while the CD partnership is considered a new partnership formed at the beginning of the day on November 2, 1999. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property X to the AB1 Partnership and property Z to the CD Partnership, and distributing the interests in such partnerships to the designated partners.[748]

ii) Example 2. Suppose that the facts are the same as in Example 1 except that the ABCD Partnership divides into three partnerships by operation of state law, without undertaking a form. The AB1 Partnership will be treated as the resulting partnership that is the divided partnership. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property Y to the AB2 Partnership and property Z to the CD partnership, and distributing the interests in such partnerships to the designated partners.[749]

iii) Example 3. Suppose the facts are the same as in Example 1, except that the ABCD Partnership divides into three partnerships by contributing property X to the newly-formed AB1 Partnership and property Y to the newly-formed AB2 Partnership and distributing all interests in each partnership to A and B in exchange for all of their interests in the ABCD Partnership. Because the resulting CD Partnership is not a continuation of the prior partnership (ABCD Partnership), the CD Partnership cannot be treated, for federal income tax purposes, as the partnership that transferred assets (i.e., the divided partnership), but instead must be treated as a recipient partnership. The AB1 Partnership will be treated as the resulting partnership that is the divided partnership. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property Y to the AB2 Partnership and property Z to the CD Partnership, and distributing the interests in such partnerships to the designated partners.[750]

[748]Treas. Reg. § 1.708-1(d)(5), Example 4.

[749]Treas. Reg. § 1.708-1(d)(5), Example 5.

[750]Treas. Reg. § 1.708-1(d)(5), Example 6.

(b) Assets-Over Form Where None of the Resulting Partnerships Is a Continuation of the Prior Partnership. In a division under the assets-over form where none of the resulting partnerships is a continuation of the prior partnership, the prior partnership will be treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships; and, immediately thereafter, the prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership's partners.[751]

(2) Assets-Up Form.

(a) Assets-Up Form Where the Partnership Distributing Assets Is a Continuation of the Prior Partnership. Despite the partners' transitory ownership of some of the prior partnership's assets, the form of a partnership division will be respected for federal income tax purposes if the divided partnership (which must be a continuing partnership) distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership, and immediately thereafter, such partners contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership or partnerships.[752] In order for such form to be respected for transfers to a particular recipient partnership, all assets held by the prior partnership that are transferred to the recipient partnership must be distributed to, and then contributed by, the partners of the recipient partnership.[753]

The regulations contain an example illustrating this form of division. Assume that the ABCD Partnership owns properties W, X, Y, and Z, and divides into the AB Partnership and the CD partnership. Assume further that the AB Partnership is considered a continuation of the ABCD Partnership and that the CD Partnership is considered a new partnership. The ABCD Partnership (i) distributes property Y to C and titles property Y in C's name and (ii) distributes property Z to D and titles property Z in D's name. C and D then contribute properties Y and Z, respectively, to the CD partnership in exchange for interests in the CD partnership. Properties W and X remain in partnership AB. The regulations conclude that the ABCD Partnership will be treated as following the assets-up form for federal income tax purposes.[754]

(b) Assets-Up Form Where None of the Resulting Partnerships Are a Continuation of the Prior Partnership. If none of the resulting partnerships are a continuation of the prior partnership, then despite the partners' transitory ownership of some or all of the prior partnership's assets, the form of a partnership division will be respected for federal income tax purposes if the prior partnership distributes certain assets (in

[751]Treas. Reg. § 1.708-1(d)(3)(i)(B).

[752]Treas. Reg. § 1.708-1(d)(3)(ii)(A).

[753]Treas. Reg. § 1.708-1(d)(3)(ii)(A).

[754]Treas. Reg. § 1.708-1(d)(5), Example 2.

a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the prior partnership, and immediately thereafter, such partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests in such resulting partnership or partnerships.[755] In order for such form to be respected for transfers to a particular resulting partnership, all assets held by the prior partnership that are transferred to the resulting partnership must be distributed to, and then contributed by, the partners of the resulting partnership.[756] If the prior partnership does not liquidate under the applicable jurisdictional law, then with respect to the assets and liabilities that, in form, are not transferred to a new resulting partnership, the prior partnership will be treated as transferring these assets and liabilities to a new resulting partnership under the assets-over form.[757]

c. Treatment of Partnership Division Utilizing More Than One Form. The final regulations require consistency in applying either the assets-over form or the assets-up form to characterize a transfer of assets to a resulting partnership.[758] Thus, the final regulations do not permit a partnership division to effect a transfer to a resulting partnership utilizing both the assets-over form and the assets-up form.[759] If, however, a single partnership is divided in a transaction that involves a transfer of assets (either actual or deemed) to multiple partnerships, the regulations permit the transfer to each resulting partnership to be viewed separately. As with mergers involving more than two partnerships, Treasury believes it is consistent with the purposes of the regulations, in the context of divisions, to allow the transfer to one resulting partnership to be characterized under the assets-over form while characterizing the transfer to another resulting partnership under the assets-up form.[760]

(1) Example 1. The final regulations contain an example illustrating when a division accomplished under both the assets-over form and the assets-up form will not be respected. Assume that the ABCD Partnership owns properties W, X, Y, and Z, and divides into the AB Partnership and the CD partnership. Assume further that the AB Partnership is considered a continuation of the ABCD Partnership and that the CD Partnership is considered a new partnership. ABCD Partnership distributes property Y to C and titles property Y in C's name. C then contributes property Y to partnership CD. Simultaneously, the ABCD Partnership contributes property Z to the CD Partnership in exchange for an interest in the CD Partnership. Immediately thereafter, the ABCD Partnership distributes the interest in the CD Partnership to D in liquidation of D's interest in the ABCD Partnership.

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[755]Treas. Reg. § 1.708-1(d)(3)(ii)(B).

[756]Treas. Reg. § 1.708-1(d)(3)(ii)(B).

[757]Treas. Reg. § 1.708-1(d)(3)(ii)(A).

[758]Preamble, T.D. 8925, 2001-1 C.B. at 498; *see* Treas. Reg. § 1.708-1(d)(3)(i).

[759]Treas. Reg. § 1.708-1(d)(3)(i).

[760]Preamble, T.D. 8925, 2001-1 C.B. at 498.

The regulations conclude that since the ABCD Partnership did not undertake the assets-up form with respect to all of the assets transferred to the CD Partnership, the ABCD Partnership will be treated as undertaking the assets-over form in transferring the assets to the CD Partnership. Accordingly, for federal income tax purposes, the ABCD Partnership is deemed to contribute property Y and property Z to the CD Partnership in exchange for interests in the CD Partnership, and immediately thereafter, the ABCD Partnership is deemed to distribute the interests in the CD Partnership to partner C and partner D in liquidation of their interests in the ABCD Partnership.[761]

(2) Example 2. The final regulations provide an example that illustrates when a division accomplished under both the assets-over form and the assets-up form will be respected. Assume that the Partnership ABCDE owns Blackacre, Whiteacre, and Redacre, and divides into the AB Partnership, the CD Partnership, and the DE Partnership. Assume that the ABCDE Partnership is considered terminated (and, hence, none of the resulting partnerships are a continuation of the prior partnership) because none of the members of the new partnerships (AB Partnership, CD Partnership, and DE Partnership) owned an interest of more than 50-percent in the capital and profits of the ABCDE Partnership.

ABCDE Partnership distributes Blackacre to A and B and titles Blackacre in the names of A and B. A and B then contribute Blackacre to the AB Partnership in exchange for interests in the AB Partnership. The regulations conclude that the ABCDE Partnership will be treated as following the assets-up form for federal income tax purposes.

ABCDE Partnership distributes Whiteacre to C and D and titles Whiteacre in the names of C and D. C and D then contribute Whiteacre to the CD Partnership in exchange for interests in the CD Partnership. ABCDE Partnership will be treated as following the assets-up form for federal income tax purposes.

ABCDE Partnership does not liquidate under state law so that, in form, the assets in the new DE partnership are not considered to have been transferred under state law. ABCDE Partnership will be treated as undertaking the assets-over form for federal income tax purposes with respect to the assets of the DE Partnership. Thus, the ABCDE Partnership will be treated as contributing Redacre to the DE Partnership in exchange for interests in the DE Partnership, and, immediately thereafter, ABCDE Partnership will be treated as distributing interests in the DE Partnership to D and E in liquidation of their interests in the ABCDE Partnership. The ABCDE Partnership then terminates.[762]

d. Authority Granted to Revenue Service to Disregard Form of Transaction in Certain Cases. If a partnership division is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form, the

[761] Treas. Reg. § 1.708-1(d)(5), Example 3.

[762] Treas. Reg. § 1.708-1(d)(5), Example 7.

final regulations grant the Revenue Service the authority to disregard such form and to recast the larger series of transactions in accordance with their substance.[763]

e. Application of Sections 704(c)(1)(B) and 737 to Partnership Divisions. The rules of Section 704(c)(1)(B) and 737 may be implicated in the context of partnership divisions and deserve careful consideration. Section 704(c)(1)(B) requires a contributing partner to recognize pre-contribution built-in gain if property contributed to a partnership is distributed by the partnership (other than to the contributing partner) within 7 years of being contributed to the partnership. Section 737(a) provides that a partner that contributed property to a partnership recognizes pre-contribution built-in gain if the partnership distributes property to him within 7 years of the contribution. Any portion of a distribution, however, that consists of property that had been contributed by the distributee partner to the partnership is not taken into account under section 737(a).[764]

The Preamble to the proposed regulations addressing partnership mergers and divisions discusses some of the Section 704(c)(1)(B) and 737 issues implicated in a partnership division.[765] The Service announced in the Preamble to the final regulations that it is studying these issues and is requesting comments on the application of Section 704(c)(1)(B) and 737 in situations where a division is non-pro rata as to the partners, where some property is extracted from or added to the partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division.[766]

3. Tax Return; Elections.

a. Tax Returns. The Treasury regulations provide that the resulting partnership that is treated as the divided partnership retains the EIN of the prior partnership and is required to file a return for the taxable year of the partnership that has been divided.[767] The return is required to include the information prescribed in Treas. Reg. § 1.708-1(d)(2)(i). All other resulting partnerships that are considered as continuing and all new partnerships (i.e., resulting partnerships that are not considered continuing) will file separate returns for the taxable year beginning on the day after the date of the division with new EINs for each partnership.[768] The return for a resulting partnership that is regarded as continuing and that is not the divided partnership is required to include the name, address, and EIN of the prior partnership.[769]

[763]Treas. Reg. § 1.708-1(d)(6).

[764]I.R.C. § 737(d)(1).

[765]Partnership Merger Regs. Notice, 2000-2 C.B. at 499.

[766]Preamble, T.D. 8925, 2001-1 C.B. at 499-500.

[767]Treas. Reg. § 1.708-1(d)(2)(i).

[768]Treas. Reg. § 1.708-1(d)(2)(i).

[769]Treas. Reg. § 1.708-1(d)(2)(i).

To illustrate, assume that the ABCD Partnership is in the real estate and insurance businesses. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of ABCD. The partnership and the partners report their income on a calendar year. On November 1, 1999, they separate the real estate and insurance businesses and form two partnerships. AB Partnership takes over the real estate business, and CD Partnership takes over the insurance business. Because members of resulting AB Partnership owned more than a 50-percent interest in the capital and profits of ABCD Partnership (A, 40-percent, and B, 20-percent), AB partnership is considered a continuation of ABCD Partnership. AB Partnership is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that until November 1, 1999, it was the ABCD Partnership. CD Partnership is considered a new partnership formed at the beginning of the day on November 2, 1999, and is required to file a return for the taxable year it adopts.[770]

b. Elections. All resulting partnerships that are regarded as continuing are subject to preexisting elections that were made by the prior partnership. A subsequent election that is made by a resulting partnership does not affect the other resulting partnerships.[771]

I. Partnership Interests as Compensation.

1. Receipt of a Capital Interest. The Eighth Circuit Court of Appeals has stated that "[w]hen a service partner receives an interest in partnership capital, the cases clearly hold that a taxable event has occurred. The receipt of the capital interest must be included in the service partner's income. *See, e.g. United States v. Frazell*, 335 F.2d 487, 489 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965) . . . There is little, if any, dispute that such a transaction involves the recognition of income."[772] The Internal Revenue Service defines a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest."[773]

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[770] Treas. Reg. § 1.708-1(d)(5), Example 1.

[771] Treas. Reg. § 1.708-1(d)(2)(ii).

[772] *Campbell v. Commissioner*, 943 F.2d 815, 820 (8th Cir. 1991); *Larson v. Commissioner*, 55 T.C.M. (CCH) 1637, 1638 (1988) ("Under Section 83, a compensatory transfer of a partnership capital interest results in taxable income to the transferee to the extent that the fair market value of the interest exceeds the amount paid for the interest, in the year that the rights to the interest are transferable or not subject to a substantial risk of forfeiture."); Rev. Proc. 93-27, 1993-2 C.B 343, 343 ("Under Section 1.721-1(b)(1) of the Income Tax Regulations, the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation."); *see Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15 (2013) ("Section 83 applies to the transfer of a partnership capital interest in exchange for the performance of services.").

[773] Rev. Proc. 93-27, § 2.01, 1993-2 C.B. 343; *cf.* Field Service Advice 1998-157 (Nov. 10, 1993) ("Prior to determining whether an interest received for services is includible on receipt, the interest must be classified as either an interest in capital or a mere interest in profits. While neither the Code nor the regulations provide a clear definition of capital and profits interests, a capital interest is generally defined as an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete

In *United States v. Frazell*, a geologist contributed maps and agreed to provide geologic services to a venture in exchange for a monthly salary (or drawing account), plus expenses. He also received a specified interest in the properties to be acquired. The parties agreed, however, "that Frazell shall not be entitled to, nor shall he be considered as owning, any interest in said properties until such time as Wheless and Woolf shall have recovered their full costs and expenses of said properties" including the amounts paid out to Frazell.[774] After the acquisition of several properties, the contract with Frazell was terminated and all of the properties acquired were transferred to a corporation in exchange for stock and debentures. Frazell received 13-percent of the stock issued (having a value of $91,000) in exchange for his share of the properties.[775] The taxpayer did not include the $91,000 in income. The Internal Revenue Service concluded that the $91,000 should have been included in income and assessed a deficiency. Frazell paid the deficiency and commenced a refund suit.[776]

Frazell argued in the District Court that he received stock for properties in a valid Section 351(a) exchange. The District agreed with the taxpayer and the Revenue Service appealed to the Fifth Circuit Court of Appeals.[777]

The Fifth Circuit Court of Appeals, reversing the District Court, determined that "so much of the interest Frazell was to receive in November 1955 as could be attributed to his services for the oil venture would have been ordinary income to him in the year of receipt." The Court reasoned that the transaction may be viewed in either of two ways: "(1) If Frazell's partnership interest became possessory immediately upon the termination of the 1951 contract, so much of that interest received as compensation was taxable to him under the rule of Treasury Regulation Sec. 1.721(b)(1). Thereafter, the transfer of his interest for W.W.F. stock was tax-free under Section 351(a). (2) If the $91,000.00 of W.W.F. stock was given in substitution for the partnership interest originally contemplated, so much of that stock received in compensation for services was taxable to Frazell under Section 351(a). As either view of the 1955 transactions results in ordinary income to Frazell there is no reason for us to split hairs and choose between them."[778]

2. Receipt of a Profits Interest. The issue of whether the receipt of a partnership profits interest for services is taxable has been the subject of litigation.[779] In Revenue Procedure 93-27, the Internal Revenue Service stated that:

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liquidation of the partnership . . . In contrast, a profits interest is a mere right to participate in the earnings and profits of the partnership.").

[774]335 F.2d at 487, 488 (1964).

[775]335 F.2d at 489.

[776]335 F.2d at 489.

[777]335 F.2d at 489.

[778]335 F.2d at 490.

[779]Rev. Proc. 93-27, 1993-2 C.B. at 343.

> Most recently, in *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991), the Eighth Circuit in dictum suggested that the taxpayer's receipt of a partnership profits interest received for services was not taxable, but decided the case on valuation. Other courts have determined that in certain circumstances the receipt of a partnership profits interest for services is a taxable event under Section 83 of the Internal Revenue Code. *See, e.g., Campbell v. Commissioner,* 59 T.C.M. (CCH) 236 (1990), rev'd, 943 F.2d 815 (8th Cir. 1991); *St. John v. United States*, 53 A.F.T.R. 2d 84-718 (C.D. I11. Nov. 16, 1983). The courts have also found that typically the profits interest received has speculative or no determinable value at the time of receipt. *See Campbell*, 943 F.2d at 823; *St. John. In Diamond v. Commissioner*, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974), however, the court assumed that the interest received by the taxpayer was a partnership profits interest and found the value of the interest was readily determinable. In that case, the interest was sold soon after receipt.[780]

Although, as discussed below, the Service announced in Rev. Proc. 93-27 a safe harbor applicable to the receipt of a profits interest, there is still some uncertainty in the law relating to the taxation of a partnership profits interest.[781]

a. Diamond v. Commissioner. In *Diamond v. Commissioner,*[782] the taxpayer, who was a mortgage broker, arranged financing for an individual who owned a right to purchase an office building.[783] The individual for whom the taxpayer arranged financing was to contribute all cash needed in excess of the loan proceeds. In addition to an interest in the profits and losses of the partnership, the taxpayer was entitled to 60-percent of the proceeds from any sale of the office building but only after repayment to the other individual of all cash advanced by him. Less than three weeks after acquiring his partnership interest the taxpayer sold his interest for $40,000. The taxpayer did not include the value of the interest he received in income, but reported the gain from sale of the interest as short-term capital gain.[784]

The taxpayer in the *Diamond* case argued that if a taxpayer receives an interest in partnership capital in exchange for the performance of services, he is required to recognize ordinary income immediately upon receipt of such interest but, if he merely receives an interest in future partnership profits and losses in exchange for services, he may defer recognition of income under Treas. Reg. Sec. 1.721-1(b)(1).[785] Without determining the exact nature of the partnership interest received by the taxpayer, the Tax Court noted that although the origin and effect of the parenthetical language in the regulation was by no means clear, nothing in Treas. Reg. Sec. 1.721-1(b)(1) explicitly required the application of Section 721(a) to the situation before the Court.[786] The Court further reasoned that the application of Section 721 to a

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[780] Rev. Proc. 93-27, § 3, 1993-2 C.B. 343.

[781] *See* Lori S. Hoberman, "Receipt of Partnership Interest in Exchange for Services: Still Polishing the Diamond," 15 J. Partnership Tax'n 336 (Winter 1999).

[782] 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

[783] 492 F.2d at 286-287.

[784] 492 F.2d at 287.

[785] 56 T.C. at 545.

[786] *Id.* at 546.

partnership interest which was received in exchange for a contribution of services would result in an impermissible distortion of the language of Section 721. In light of the fact that the taxpayer sold his interest for $40,000 just three weeks later, the Tax Court rejected the taxpayer's argument that the interest he received was worthless. The Court therefore concluded that, under the general rule of Section 61, the taxpayer was required to include the value of the interest he received in gross income immediately upon receipt.[787]

On appeal, the Seventh Circuit Court of Appeals affirmed the Tax Court's decision.[788] The Seventh Circuit proceeded on the theory that the taxpayer had received a profits interest.[789] The Court suggested that regulations be issued to clarify the proper treatment of the receipt of a profits interest in exchange for services. The Court concluded, however, that, in the absence of such regulations, it was best to sustain the decision of the Tax Court. [790]

b. St. John v. United States. In *St. John v. United States*,[791] the United States District Court determined that a taxpayer was taxable upon the receipt of a 15-percent partnership profits interest. The Court, however, determined that the taxpayers had sustained their burden of showing that the profits interest had a value of zero. In reaching this conclusion, the Court adopted a liquidation method to valuation. This method of valuation effectively determines the amount of money a taxpayer "would have received had the partnership dissolved and the assets been liquidated and distributed."[792]

c. Campbell v. Commissioner. In *Campbell v. Commissioner*,[793] the taxpayer performed services in the formation and syndication of certain limited partnerships in exchange for a profits interest in the partnerships. The taxpayer did not include the value of these interests received in income. The Revenue Service issued a notice of deficiency for the 1979 and 1980 tax years, alleging that Campbell should have included the value of his interests in these partnerships in ordinary income and the taxpayer filed a petition in Tax Court.[794]

The Tax Court rejected Mr. Campbell's contention that the regulations promulgated under Section 721 of the Internal Revenue Code and the general principles of partnership taxation exempt from taxation profits interests received in exchange for services.[795] The Court reaffirmed its holding in the *Diamond* case that Section 721 and the regulations thereunder are

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[787] 56 T.C. at 545.

[788] 492 F.2d at 292.

[789] 492 F.2d at 288.

[790] 492 F.2d at 291.

[791] 53 A.F.T.R. 2d 84-718 (C.D. Ill. 1983).

[792] 53 A.F.T.R. 2d 84-718 at 84-720

[793] 943 F.2d 815 (8th Cir. 1991), *rev'g* 59 T.C.M. (CCH) 236 (1990).

[794] 943 F.2d at 817.

[795] *Campbell*, 59 T.C.M. (CCH) at 248-49.

"inapplicable where, as in the *Diamond* case and the instant case, a partner receives his partnership interest in exchange for services he has rendered to the partnership."[796] The Court reasoned that Section 721 relates to contributions of property to partnerships, but not to contributions of services, which are not property within the meaning of that Section.[797] Section 721 was enacted to allow the contribution of property to a partnership without recognition of gain or loss. The rationale for nonrecognition is that no disposition of property has occurred. Rather, the partnership interest represents a change in form of the asset. The Court held that the receipt of profits interests represented compensation for services, not a change in the form of assets.[798]

The Court also noted the inconsistency in imposing immediate taxation upon a service partner who receives a capital interest and not upon a service partner who receives a profits interest, as Section 721 makes no distinction between the two.[799] Further, the Court determined that the Section 721 regulations do not expand the scope of the statute to provide non-recognition of income to partners who contribute services in exchange for a partnership interest.[800] Thus, the Tax Court found no authority to support different treatment for capital and profits interests received in exchange for services and held that Campbell received ordinary income upon receipt of the profits interests.[801]

After finding that Campbell's receipt of the profits interests were taxable events, the Court applied Section 83 to determine when the income should have been recognized.[802] The Tax Court determined that a profits interest is property rather than a promise to pay money or property in the future.[803] Further, the Court found no substantial risk of forfeiture. Thus, the interests were taxable upon receipt.[804] The taxpayer appealed.

On appeal to the Eighth Circuit Court of Appeals, Campbell argued that a partner who receives a partnership profits interest in exchange for services provided to the partnership should not realize income upon receipt of that interest. In the alternative, he argued that the interests he received had no value at the time he received them and, thus, he should not have been taxed. The Revenue Service conceded that the Tax Court erred in holding that the receipt of a profits interest in exchange for services to the partnership should be considered ordinary income to the service provider. The Commissioner argued, however, that Campbell actually received the

[796]*Id.* at 249.

[797]*Id.*

[798]*Id.*

[799]*Id.*

[800]*Id.*

[801]59 T.C.M. (CCH) at 249.

[802]*Id.* at 249-50.

[803]*Campbell*, 59 T.C.M. at 249-51.

[804]*See Id.* at 252.

partnership interests in exchange for services he provided to his employer, rather than services he provided to the partnerships. According to the Revenue Service, the Tax Court held that Campbell received the interests as compensation from his employer. Thus, the Service contended, Campbell "is not a service partner; the principles of partnership taxation do not apply; and Campbell's receipt of compensation from his employer was taxable upon receipt."[805]

After rejecting the Service's argument that Campbell received his partnership interests for services he performed for his employer rather than services performed for the partnerships,[806] the Eighth Circuit noted that "when the service partner receives solely a profits interest, the tax consequences are unclear."[807] The Court, however, agreed with the view that "the nonrecognition principles of Section 721 do not apply to a service partner because a service partner does not contribute property in exchange for his partnership interest . . . ." The Court said that Section 1.721-1(b)(1) outlines the tax treatment of the partner who receives a capital interest. The Court noted that "[a] substantial distinction, however, exists between a service partner who receives a capital interest and one who receives a profits interest. When one receives a capital interest in exchange for services performed, a shift in capital occurs between the service provider and the individual partners . . .The same is not true when a service partner receives a profits interest. In the latter situation, prior contributions of capital are not transferred from existing partners' capital accounts to the service provider's capital account. Receipt of a profits interest does not create the same concerns because no transfer of capital assets is involved. That is, the receipt of a profits interest never affects the nonrecognition principles of Section 721. Thus, some justification exists for treating service partners who receive profits interests differently than those who receive capital interests."[808]

The Court then shifted its analysis to Section 707 of the Code, which the Court said "supports Campbell's argument."[809] Section 707 provides that when a partner engages in a transaction with a partnership in a nonpartner capacity that transaction will be treated as between the partnership and one who is not a partner. When a partner receives payment for services performed for the partnership, that transaction falls under Section 707(a)(1) if "the performance of such services . . . and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership."[810] The Court said that "[a]rguably, Section 707(a) would be unnecessary if compensatory transfers of profits interests were taxable upon receipt because, if so, every such transfer would be taxed without this section . . . ."[811]

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[805] 943 F.2d at 818.

[806] 943 F.2d at 818.

[807] 943 F.2d at 820.

[808] 943 F.2d at 822.

[809] *Id.*

[810] *Id.*

[811] *Id.*

The Court noted that Campbell's interests were not transferable and were not likely to provide immediate returns. Thus, the Eighth Circuit "doubted" that the Tax Court correctly held that Campbell's profits interests were taxable upon receipt.[812]

The Eighth Circuit agreed with Campbell's argument that the profits interests he received had only speculative, if any, value and reversed the Tax Court. Campbell's expert testified that the values of the partnership interests were speculative and not in excess of $1,000. His opinion was based on the present values of the cash distributions projected in the offering memoranda. He discounted these values because of the restrictions on transferability and the lack of participation rights in management of the partnerships. He attached no present value to the projected tax benefits because of the substantial risk of disallowance upon likely audit. The Commissioner used the same basic method of valuation, except that he included the present value of the tax benefits in his calculations and used a much lower discount rate resulting in higher present values.[813]

The Tax Court accepted the method of valuation proposed by the parties, with some modifications. The Court rejected Campbell's expert's opinion that the tax benefits were so speculative that they had no value and rejected the Commissioner's determination of the appropriate discount rate. Then, based on the present value of the tax benefits and future cash payments, reduced by the speculative nature of the Phillips House interest, the Tax Court valued the interests as indicated above.[814]

The Eight Circuit was left with the firm belief that the Tax Court's valuation was erroneous. The Eighth Circuit concluded that the Tax Court relied too heavily on the fact that Class A limited partners were willing to pay substantial sums for their interests at the same time Campbell received his interest. Because of the difference in the nature of the investments, the Eighth Circuit viewed this fact as not relevant. The Class A limited partners had superior rights to cash distributions and return of capital, as well as some rights of participation. Further, the Court should not have disregarded the expert's belief that the tax benefits were speculative in nature. Thus, the Eight Circuit held that Campbell's profits interests in the limited partnerships were without fair market value at the time he received them and should not have been included in his income for the years in issue. The Eighth Circuit thus reversed the decision of the Tax Court holding that the Campbells should have included the receipt of profits interests in ordinary income in the year of receipt.[815]

d. Mark IV Pictures v. Commissioner. In *Mark IV Pictures v. Commissioner*,[816] the taxpayers performed services and assigned certain film rights to limited partnerships in exchange for general partnership interests. The taxpayer-general partners

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812 *Id.* at 822-23.

813 *Id.* at 823.

814 *Campbell*, 59 T.C.M. at 254-56.

815 *Id.*

816 969 F.2d 669 (8th Cir. 1992), *aff'g* 60 T.C.M. (CCH) 1171 (1990).

reported their assignment of film rights to the partnerships as nontaxable contributions of property in exchange for general partnership interests. In its notice of deficiency, the Service determined that the general partnership interests received by the general partners were capital interests representing additional compensation for services rendered to the partnership.[817]

The Tax Court first addressed whether the taxpayers contributed property, services, or some combination of both in exchange for general partnership interests in certain limited partnerships. In making this determination, the Court stated that "[t]he nonrecognition treatment provided by Section 721 only applies to the extent that property is contributed in exchange for a partnership interest."[818] Although the taxpayer and the Revenue Service agreed that the film rights transferred to the partnership were "property" for purposes of Section 721, the Tax Court determined that the taxpayer had failed to meet its burden of establishing the value of the film rights transferred to the partnership. The Tax Court stated that if the general partners could have proven that the limited partnerships paid them for all services performed, then they would have established that the partnerships interests were received solely in exchange for property. The Court concluded that the partners were unable to provide that they were fully compensated for their services because their reimbursements and fees were not set as a result of arm's-length transactions. The Court, therefore, upheld the Revenue Service's determination that the film rights were received entirely in exchange for services.[819]

The Tax Court then addressed whether the general partnership interests were capital interests or "mere profits interests."[820] The Court concluded that "[d]eciding whether a partner's interest in a partnership is a capital interest, rather than a mere profits interest, turns on whether that partner has the 'right to receive' a share of the partnership's assets upon a hypothetical winding up and liquidation immediately following acquisition of the interest, rather than the mere right to share in future earnings or profits."[821] The Court determined that the taxpayers had received capital interests because the partnership agreement indicated that "the general partners had the right to receive a specified share of the partnerships' liquidation proceeds (assets)."[822]

The Tax Court then examined whether the capital interests had a determinable market value. Citing the Tax Court's previous decisions in *Campbell v. Commissioner*, the Court stated that "[w]hen a taxpayer contributes services in exchange for a partnership interest, the taxpayer may be required to include the fair market value of the interests in gross income upon receipt."

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[817]60 T.C.M. at 1171-74.

[818]60 T.C.M. at 1174.

[819]60 T.C.M. at 1174-75.

[820]*Id.* at 1175.

[821]*Id.* at 1176.

[822]*Id.*

The Court valued the general partnership interests and held that the general partners must include these sums as compensation income. The taxpayers appealed to the Eighth Circuit.[823]

On appeal, the Eighth Circuit, citing its decision in *Campbell*, stated that "when a taxpayer exchanges services for a partnership interest, he must include the fair market value of that interest in gross income under 26 U.S.C. Section 61(a) (1988) . . . Similarly, when a taxpayer contributes both property and services to a partnership in exchange for a partnership interest, the taxpayer is entitled to exclude from gross income only that portion of the interest which was exchanged for property . . . ."[824] The Eighth Circuit saw "no reason to conclude that the Tax Court clearly erred in finding that the partners failed to carry their burden of proving that they received their interests in exchange for services rather than property."[825]

The Eighth Circuit then addressed the taxpayers' argument that the Tax Court erred in finding that the interests received by the taxpayers were capital interests rather than profits interests. The taxpayers argued that a general partner's "right to receive" assets (regardless of whether any assets remained to be received) does not constitute a sufficient basis for finding that a partner possesses a capital interest.[826]

The Court said "[a] capital interest received as compensation for services is 'a portion of the property contributed to the partnership by the other partners at the value which the property had when it was contributed' . . . * * * When such an interest is received in return for the performance of services, the value of that interest must be included in the taxpayer's gross income."[827] The Court said that "[t]o determine whether an interest is a capital one, we examine the effects of a hypothetical liquidation occurring immediately after the partners received their interest which, in this case, is the date the partnerships were formed."[828] The Eighth Circuit found that a capital shift occurred at formation of the partnerships because the limited partners agreed to allow the general partners 50-percent of any distributions of capital.[829] Thus the Court concluded that "[a]lthough we base our conclusion on different grounds than did the Tax Court, we see no basis for concluding that the Tax Court clearly erred in finding that the taxpayers received capital interests in the limited partnerships."[830]

[823]*Id*. at 1176-78.

[824]969 F.2d at 672.

[825]*Id.* at 673.

[826]*Id.* at 673-74.

[827]*Id.* at 673-74.

[828]*Id.* at 674.

[829]*Id.* at 674.

[830]*Id.* at 675.

The Eighth Circuit also rejected the taxpayers' argument that the Tax Court had erred in determining the fair market values of the interests and affirmed the decision of the Tax Court.[831]

e. Revenue Procedure 93-27. Revenue Procedure 93-27 "provides guidance on the treatment of the receipt of a partnership profits interest for services provided to or for the benefit of the partnership." The Procedure provides that "[o]ther than as provided below if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership." The procedure does not apply to the following:

1. If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

2. If within two years of receipt, the partner disposes of the profits interest; or

3. If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b) of the Internal Revenue Code.

While the safe harbor relief provided in Revenue Procedure 93-27 does not end the debate over the taxation of partnership profits interests received in exchange for services, it does allow taxpayers to go forward with some degree of certainty regarding their actions.[832]

f. Revenue Procedure 2001-43. In Revenue Procedure 2001-43,[833] the Service clarified the application of Rev. Proc. 93-27 by providing that the determination under Rev. Proc. 93-27 of whether an interest granted to a service provider is a profits interest is, if certain requirements are met, tested at the time the interest is granted, even if, at that time, the interest is substantially nonvested. Accordingly, where a partnership grants a profits interest to a service provider in a transaction meeting the requirements of Rev. Proc. 2001-43 and Rev. Proc. 93-27, the Revenue Service will not treat the grant of the interest or the event that causes the interest to become substantially vested as a taxable event for the partner or the partnership. Under Rev. Proc. 2001-43, the service provider will be treated as receiving the interest on the date of its grant, provided that the following requirements are met: (1) the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the

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[831] *Id.*

[832] For a detailed analysis of Revenue Procedure 93-27, *see* Jeffrey H. Paravano, "IRS Adopts 'Capacity Approach' for Treatment of Receipt of a Partnership Profits Interest," 94 TNT 4-57 (Jan. 3, 1994); John Lee, "Partnership Profits Share for Services: An Aggregate Exegesis of Revenue Procedure 93-27 (Part 1)," Tax Notes, March 28, 1994, at p. 1733; John Lee, "Partnership Profits Share for Services: An Aggregate Exegesis of Revenue Procedure 93-27 (Part 2)," 94 TNT 67-58 (April 4, 1994).

[833] Rev. Proc. 2001-43, 2001-2 C.B. 191.

interest; (2) upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (3) all other conditions of Rev. Proc. 93-27 are satisfied.[834]

3. Internal Revenue Service Issues Proposed Regulations on May 24, 2005. On May 24, 2005, the Internal Revenue Service issued proposed regulations relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services.[835] The proposed regulations provide that the transfer of a partnership interest in connection with the performance of services is subject to section 83 of the Internal Revenue Code (Code) and provide rules for coordinating section 83 with partnership taxation principles. The proposed regulations also provide that no gain or loss is recognized by a partnership on the transfer or vesting of an interest in the transferring partnership in connection with the performance of services for the transferring partnership. These regulations are proposed to apply to transfers of property on or after the date final regulations are published in the Federal Register.

VI: SERIES LLCs.

A. General Overview of 2009 Texas Series LLC Legislation. The 2009 Texas legislative session amended the Texas Business Organizations Code (the "TBOC") to add a new Subchapter M which authorizes the creation of series limited liability companies. TITLE 3. Subchapter M is part of Chapter 101 of the TBOC which consists of provisions related to limited liability companies. (All Section references in this Part A are to the TBOC.)

1. Company Agreement May Establish Series of Members, Managers, Membership Interests or Assets. Section 101.601(a) of the TBOC provides that a limited liability company agreement may establish or provide for the establishment of one or more designated series of members, managers, membership interests, or assets that has separate rights, powers, or duties with respect to specified property or obligations of the company or profits and losses associated with specified property or obligations, or that has a separate business purpose or investment objective. A series established under Section 101.601(a) may carry on any business, purpose, or activity, whether or not for profit, that is not prohibited by Section 2.003 of the TBOC.[836]

2. Enforceability of Obligations and Expenses Against Assets; Notice of Limitation on Liabilities of a Series. Section 101.602 of the TBOC sets out provisions relating to the enforceability of the obligations and expenses of a series against its assets and the requirements for a notice of limitation on the liabilities of a series.

[834] *Cf. Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15 (2013) ("[W]e hold that the transferor of a partnership capital interest must recognize in income the undistributed partnership profit or loss allocations attributable to a nonvested capital interest.").

[835] Notice of Proposed Rulemaking, REG-105346-03, *reprinted in* 2005 TNT 98-31.

[836] Tex. Bus. Org. Code Ann. § 101.601(b) (West 2013).

a. Enforceability of Obligations and Expenses Against Assets. Section 101.602(a) provides that, "[n]otwithstanding any other provision of this chapter or any other law, but subject to [Section 101.602(b)] and any other provision of this subchapter," the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series are enforceable against the assets of that series only, and are not enforceable against the assets of the limited liability company generally or any other series and none of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the limited liability company generally or any other series are enforceable against the assets of a particular series.

b. Notice of Limitation on Liabilities of a Series. The limitation of liability in Section 101.602(a) applies only if the following three requirements are satisfied:

(1) Maintenance of Records: The records maintained for the particular series at issue account for the assets associated with that series separately from the other assets of the company or any other series.[837] Section 101.603(b) provides that this first requirement is considered satisfied if the records of a series are maintained in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined.

(2) Company Agreement: The company agreement contains a statement to the effect of the limitations provided in Section 101.602(a).[838] and

(3) Certificate of Formation: The company's certificate of formation contains a notice of the limitations provided in Section 101.602(a).[839] Notice of the limitation on liabilities of a series that is contained in a certificate of formation filed with the secretary of state satisfies this third requirement regardless of whether: (1) the limited liability company has established any series when the notice is contained in the certificate of formation; and (2) the notice makes a reference to a specific series of the limited liability company.[840]

3. Holding of Assets Associated with a Series. Assets associated with a series may be held directly or indirectly, including being held in the name of the series, in the name of the limited liability company, through a nominee, or otherwise.[841]

4. General Powers of Series. Section 101.605 of the TBOC establishes the general powers of a series. A series has the power and capacity, in the series' own name, to: (1) sue and be sued; (2) contract; (3) acquire, sell and hold title to assets of the series, including real

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837 Tex. Bus. Org. Code Ann. § 101.602(b)(1).

838 Tex. Bus. Org. Code Ann. § 101.602(b)(2).

839 Tex. Bus. Org. Code Ann. § 101.602(b)(3).

840 Tex. Bus. Org. Code Ann. § 101.604.

841 Tex. Bus. Org. Code Ann. § 101.603(a).

property, personal property, and intangible property; (4) grant liens and security interests in assets of the series; and (5) exercise any power or privilege as necessary or appropriate to the conduct, promotion, or attainment of the business, purposes or activities of the series.[842]

5. Liability of Member or Manager for Obligations; Duties of Persons Associated with a Series.

a. Liability of Member or Manager for Obligations. Section 101.606(a) provides that a member or manager associated with a series or a member or manager of the company is not liable for a debt, obligation, or liability of a series, including a debt, obligation, or liability under a judgment, decree, or court order "except as and to the extent the company agreement specifically provides otherwise."

b. Duties of Persons Associated with a Series. Section 101.606(b) allows the company agreement to expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person associated with a series has to (1) the series or the company, (2) a member or manager associated with the series, or (3) a member or manager of the company.

6. Establishment of Classes or Groups of Members or Managers. Section 101.607 provides that the company agreement may:

a. Establish classes or groups of members or managers associated with a series each of which has certain express relative rights, powers, and duties, including voting rights;[843]

b. Provide for the manner of establishing additional classes or groups of one or more members or managers associated with the series each of which has certain express rights, powers, and duties, including providing for voting rights and rights, powers, and duties senior to existing classes and groups of members or managers associated with the series;[844]

c. Provide for the taking of an action, including the amendment of the company agreement, without the vote or approval of any member or manager or class or group of members or managers, to create under the provisions of the company agreement a class or group of the series of membership interests that was not previously outstanding;[845]

d. Provide that: (1) all or certain identified members or managers or a specified class or group of the members or managers associated with a series have the right to vote on any matter separately or with all or any class or group of the members or managers

[842] Tex. Bus. Org. Code Ann. § 101.605.

[843] Tex. Bus. Org. Code Ann. § 101.607(a)(1).

[844] Tex. Bus. Org. Code Ann. § 101.607(a)(2).

[845] Tex. Bus. Org. Code Ann. § 101.607(b).

associated with the series; (2) any member or class or group of members associated with a series has no voting rights; and (3) voting by members or managers associated with a series is on a per capita, number, financial interest, class, group, or any other basis.[846]

7. Governing Authority of a Series. Sec. 101.608 sets forth provisions relating to the governing authority of a series. Section 101.608(a) provides that, notwithstanding any conflicting provision of the certificate of formation of a limited liability company, the governing authority of a series consists of the managers or members associated with the series as provided in the company agreement. If the company agreement does not provide for the governing authority of the series, the governing authority of the series consists of: (1) the managers associated with the series, if the company's certificate of formation states that the company will have one or more managers; or (2) the members associated with the series, if the company's certificate of formation states that the company will not have managers.[847]

8. Effect of Certain Events on Members or Managers. Section 101.610 addresses the effect of certain events on a manager or member with respect to a series. Section 101.610(a) provides that an event that under Chapter 101 of the TBOC (addressing limited liability companies) or the company agreement causes a manager to cease to be a manager with respect to a series does not, in and of itself, cause the manager to cease to be a manager of the limited liability company or with respect to any other series of the company. An event that under Chapter 101 or the company agreement causes a member to cease to be associated with a series does not, in and of itself, cause the member to cease to be associated with any other series or terminate the continued membership of a member in the limited liability company or require the winding up of the series, regardless of whether the member was the last remaining member associated with the series.[848]

9. Status of a Member Associated With a Series With Respect to a Distribution. Section 101.611 of the TBOC addresses the status of a member with respect to a distribution. Sec. 101.611(a) provides that, subject to Sections 101.613, 101.617, 101.618, 101.619, and 101.620, when a member associated with a series is entitled to receive a distribution with respect to the series, the member, with respect to the distribution, has the same status as a creditor of the series and is entitled to any remedy available to a creditor of the series. Section 101.611(b) provides that Section 101.206 (addressing prohibited distributions) does not apply to a distribution with respect to the series.

10. Establishment of a Record Date for Allocations and Distributions. Section 101.612 provides that a company agreement may establish or provide for the establishment of a record date for allocations and distributions with respect to a series.

11. Distributions. Section 101.613 addresses the making of distributions with respect to a series.

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[846]Tex. Bus. Org. Code Ann. § 101.607(c).

[847]Tex. Bus. Org. Code Ann. § 101.608(b).

[848]Tex. Bus. Org. Code Ann. § 101.610(b).

a. Authority to Make Distributions With Respect to a Series. Section 101.613(a) provides that a limited liability company may make a distribution with respect to a series.

b. Prohibition on Certain Distributions. Section 101.613(b) provides that a limited liability company may not make a distribution with respect to a series to a member if, immediately after making the distribution, the total amount of the liabilities of the series, other than certain excluded liabilities described in Section 101.613(c), exceeds the fair value of the assets associated with the series.[849]

(1) Certain Liabilities Excluded for Purposes of Section 101.613(b). For purposes of Section 101.613(b), the liabilities of a series do not include: (1) a liability related to the member's membership interest; or (2) except as provided by Section 101.613(e), a liability of the series for which the recourse of creditors is limited to specified property of the series.[850]

(2) Assets Associated With a Series. For purposes of Section 101.613(b), the assets associated with a series include the fair value of property of the series subject to a liability for which recourse of creditors is limited to specified property of the series only if the fair value of that property exceeds the liability.[851]

(3) Liability of Member Receiving Prohibited Distribution. Section 101.613(e) provides that a member who receives a distribution from a series in violation of Section 101.613 is not required to return the distribution to the series unless the member had knowledge of the violation. Section 101.613(f) provides that Section 101.613 may not be construed to affect the obligation of a member to return a distribution to the series under the company agreement or other state or federal law. Section 101.613(g) provides that Section 101.206 (dealing with certain prohibited distributions by limited liability companies) does not apply to a distribution with respect to a series.

c. Distribution Does Not Include Reasonable Compensation. Section 101.613(h) provides that, for purposes of this section, "distribution" does not include an amount constituting reasonable compensation for present or past services or a reasonable payment made in the ordinary course of business under a bona fide retirement plan or other benefits program.

12. Applications of Provisions of Law Related to Limited Liability Companies. Section 101.609(a) establishes that the provisions of law related to limited liability companies apply to a series limited liability company and its associated members and managers, to the extent the provisions governing each company are not inconsistent. Section 101.609(b) provides that, for purposes of the application of any other provision related to limited liability

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[849]Tex. Bus. Org. Code Ann. § 101.613(b).

[850]Tex. Bus. Org. Code Ann. § 101.613(c).

[851]Tex. Bus. Org. Code Ann. § 101.613(d).

companies to a provision related to series limited liability companies, and as the context requires: 1) a reference to "limited liability company" or "company" means the "series"; (2) a reference to "member" means "member associated with the series"; and 3) a reference to "manager" means "manager associated with the series."

13. Wind Up and Termination.

a. Authority of Series to Wind Up and Terminate. Sec. 101.614 authorizes a series and its business and affairs to wind up and terminate without causing the winding up of the company "[e]xcept to the extent otherwise provided in the company agreement and subject to Sections 101.617, 101.618, 101.619, and 101.620."

b. Termination of Series on Completion of Winding Up. Section 101.615(a) provides that, except as otherwise provided by Sections 101.617, 101.618, 101.619, and 101.620, the series terminates on the completion of the winding up of the business and affairs of the series in accordance with Sections 101.617, 101.618, 101.619, and 101.620. Section 101.615(b) provides that the limited liability company shall provide notice of the termination of a series in the manner provided in the company agreement for notice of termination, if any. Section 101.615(c) provides that the termination of the series does not affect the limitation on liabilities of the series provided by Section 101.602.

c. Conditions Requiring the Winding Up of a Series. Section 101.616 specifies the conditions that require the winding up of a series. Subject to Sections 101.617, 101.618, 101.619, and 101.620, the business and affairs of a series are required to be wound up:

(1) If the winding up of the limited liability company is required under Section 101.552(a) or Chapter 11 of the TBOC; or

(2) On the earlier of: (A) the time specified for winding up the series in the company agreement; (B) the occurrence of an event specified with respect to the series in the company agreement; (C) the occurrence of a majority vote of all of the members associated with the series approving the winding up of the series or, if there is more than one class or group of members associated with the series, a majority vote of the members of each class or group of members associated with the series approving the winding up of the series; (D) if the series has no members, the occurrence of a majority vote of all of the managers associated with the series approving the winding up of the series or, if there is more than one class or group of managers associated with the series, a majority vote of the managers of each class or group of managers associated with the series approving the winding up of the series; or (E) a determination by a court in accordance with Section 101.621.

d. Other Winding Up Provisions. Section 101.617 sets out procedures for the winding up and termination. Section 101.618 provides for the revocation of a voluntary winding up. Section 101.619 addresses the cancellation of an event requiring a winding up. Section 101.620 addresses the authority of a series to continue business following revocation under Section 101.618 or the cancellation under Section 101.619. Section 101.621 addresses the winding up by order of a district court with appropriate jurisdiction.

B. IRS Issues Proposed Regulations. On September 14, 2010, the IRS issued proposed regulations regarding the classification for Federal tax purposes of a series of a domestic series limited liability company (LLC), a cell of a domestic cell company, or a foreign series or cell that conducts an insurance business.[852]

1. Status of an Individual Series as an Entity for Federal Tax Purposes. The Preamble to the Proposed Regulations provides that "the threshold question for determining the tax classification of a series of a series LLC or a cell of a cell company is whether an individual series or cell should be considered an entity for Federal tax purposes."[853]

a. Status of a Series Organized or Established Under the Laws of the United States or of any State.

(1) Treated as an Entity Formed Under Local Law. The Proposed Regulations provide that provide generally that, for Federal tax purposes, a "series" organized or established under the laws of the United States or of any State, whether or not a juridical person for local law purposes, is treated as an entity formed under local law.[854] (The regulations do not define the term "juridical.")

(a) Definition of Series. The Regulations define a "series" as a segregated group of assets and liabilities that is established pursuant to a "series statute" by agreement of a "series organization."[855] A series includes a series, cell, segregated account, or segregated portfolio, including a cell, segregated account, or segregated portfolio that is formed under the insurance code of a jurisdiction or is engaged in an insurance business. The term series, however, does not include a segregated asset account of a life insurance company.[856]

(b) Definition of Series Statute. The Proposed Regulations define a "series statute" as a statute of a State or foreign jurisdiction that explicitly provides for the organization or establishment of a series of a juridical person and explicitly permits (1) members or participants of a series organization to have rights, powers, or duties with respect to the series; (2) a series to have separate rights, powers, or duties with respect to specified property or obligations; and (3) the segregation of assets and liabilities such that none of the debts and liabilities of the series organization (other than liabilities to the State or foreign jurisdiction related to the organization or operation of the series organization, such as franchise

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[852]Notice of Proposed Rulemaking, REG-119921-09, 2010-45 IRB 626 75 F.R. 55699-55709, *reprinted at* 2010 TNT 177-12. For helpful analysis of issues relating to the proposed regulations *see generally* "NYSBA Report Addresses Proposed Regs on Series Organizations," *reprinted at* 2011 TNT 152-62 (Aug. 5, 2011); "ABA Tax Section Recommends Revisions to Proposed Regs on Series LLCs and Cell Companies," *reprinted at* 2011 TNT 84-72.

[853]Preamble to Notice of Proposed Rulemaking, REG-119921-09; 2010-45 IRB 626; 75 F.R. at 55700 (hereinafter "Preamble"), *reprinted at* 2010 TNT 177-12.

[854]Prop. Reg. § 301.7701-1(a)(5)(i).

[855]Prop. Reg. § 301.7701-1(a)(5)(viii)(C).

[856]Prop. Reg. § 301.7701-1(a)(5)(viii)(C).

fees or administrative costs) or of any other series of the series organization are enforceable against the assets of a particular series of the series organization.[857] The Preamble provides that, for purposes of this definition, a "participant" of a series organization includes an officer or director of the series organization who has no ownership interest in the series or series organization, but has rights, powers, or duties with respect to the series.[858]

(c) Definition of Series Organization. The Proposed Regulations define a "series organization" as a juridical entity that establishes and maintains, or under which is established and maintained, a series.[859] A series organization includes a series limited liability company, series partnership, series trust, protected cell company, segregated cell company, segregated portfolio company, or segregated account company.[860]

(d) Jurisdiction in Which Series is Organized or Established. A series is treated as created or organized under the laws of a State or foreign jurisdiction if the series is established under the laws of such jurisdiction.[861] The Preamble states that "[b]ecause a series may not be a separate juridical entity for local law purposes, this rule provides the means for establishing the jurisdiction of the series for Federal tax purposes."[862]

(2) Determining Whether Series is Recognized as a Separate Entity for Federal Tax Purposes. Treas. Reg. § 301.7701-1 and general tax principles determine whether a series that is treated as a local law entity under the proposed regulations is recognized as a separate entity for Federal tax purposes.[863] The Preamble provides that if a domestic series is treated as a separate entity for Federal tax purposes, then the series generally is subject to the same treatment as any other entity for Federal tax purposes. For example, a series that is treated as a separate entity for Federal tax purposes may make any Federal tax elections it is otherwise eligible to make independently of other series or the series organization itself, and regardless of whether other series (or the series organization) do not make certain elections or make different elections.[864]

Notwithstanding that a domestic series or a foreign series engaged in an insurance business is treated as an entity formed under local law under the proposed regulations, the Preamble states that the Commissioner may under applicable law, including common law tax principles, characterize a series or a portion of a series other than as a separate entity for Federal

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[857]Prop. Reg. § 301.7701-1(a)(5)(viii)(B).

[858]Preamble, 75 F.R. at 55702.

[859]Prop. Reg. § 301.7701-1(a)(5)(viii)(A).

[860]Prop. Reg. § 301.7701-1(a)(5)(viii)(A).

[861]Prop. Reg. § 301.7701-1(a)(5)(v).

[862]Preamble, 75 F.R. at 55702-55703.

[863]Prop. Reg. § 301.7701-1(a)(5)(iii).

[864]Preamble, 75 F.R. at 55704.

tax purposes.[865] Series covered by the proposed regulations are subject to applicable law to the same extent as other entities. Thus, a series may be disregarded under applicable law even if it satisfies the requirements of the proposed regulations to be treated as an entity formed under local law. For example, if a series has no business purpose or business activity other than tax avoidance, it may be disregarded under appropriate circumstances. Furthermore, the anti-abuse rule of Treas. Reg. § 1.701-2 is applicable to a series or series organization that is classified as a partnership for Federal tax purposes.[866]

(3) Classification of Series Treated as a Separate Entity. If a domestic series or a foreign series engaged in an insurance business is treated as a separate entity for Federal tax purposes, then Treas. Reg. § 301.7701-1(b) applies to determine the proper tax classification of the series.[867] Under Treas. Reg. § 301.7701-1(b), Treas. Reg. § 301.7701-2(b) applies to a series that is recognized as a separate entity for Federal tax purposes. Thus, a series that is itself described in Treas. Reg. §§ 301.7701-2(b)(1) through (8) would be classified as a corporation regardless of the classification of the series organization."[868] The proposed regulations do not provide how a series should be treated for Federal employment tax purposes.[869]

Example 1 of the Proposed Regulations provides the following illustration of the operation of the rules: Assume Series LLC is a series organization. Series LLC has three members (1, 2, and 3). Series LLC establishes two series (A and B) pursuant to the LLC statute of state Y, a series statute. Under general tax principles, Members 1 and 2 are the owners of Series A, and Member 3 is the owner of Series B. Series A and B are not described in Treas. Reg. § 301.7701-2(b) or Treas. Reg. § 301.7701-1(a)(3) and are not trusts within the meaning of Treas. Reg. § 301.7701-4. Example 1 concludes that Series A and Series B are each treated as an entity formed under local law. The classification of Series A and Series B is determined under Treas. Reg. § 301.7701-1(b). The default classification under Treas. Reg. § 301.7701-3 of Series A is a partnership and of Series B is a disregarded entity.

(4) Effect of Local Law Classification on Tax Collection. The Proposed Regulations provide that, to the extent that a series is a taxpayer against whom tax may be assessed, then any tax assessed against the series may be collected by the Internal Revenue Service from the series in the same manner the assessment could be collected by the Internal Revenue Service from any other taxpayer.[870] In addition, to the extent Federal or local law permits a creditor to collect a liability attributable to a series from the series organization or

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[865] Preamble, 75 F.R. at 55704.

[866] Preamble, 75 F.R. at 55704.

[867] Prop. Reg. § 301.7701-1(a)(5)(iv).

[868] Preamble, 75 F.R. at 55703.

[869] Preamble, 75 F.R. at 55704; *see* Prop. Reg. § 301.7701-1(a)(5)(ix) (reserving treatment of series and series organizations under Subtitle C—Employment Taxes and Collection of Income Tax).

[870] Prop. Reg. § 301.7701-1(a)(5)(vii).

other series of the series organization, the series organization and other series of the series organization may also be considered the taxpayer from whom the tax assessed against the series may be collected pursuant to administrative or judicial means.[871] Further, when a creditor is permitted to collect a liability attributable to a series organization from any series of the series organization, a tax liability assessed against the series organization may be collected directly from a series of the series organization by administrative or judicial means.[872]

(5) Effect of Limitation of Liability Provisions of State Series Statutes. The Preamble to the Proposed Regulations recognizes that certain series statutes provide that the series liability limitation provisions do not apply if the series organization or series does not maintain records adequately accounting for the assets associated with each series separately from the assets of the series organization or any other series of the series organization.[873] The Preamble states that the IRS and the Treasury Department considered whether a failure to elect or qualify for the liability limitations under the series statute should affect whether a series is a separate entity for Federal tax purposes. The Preamble notes, however, that limitations on liability of owners of an entity for debts and obligations of the entity and the rights of creditors to hold owners liable for debts and obligations of the entity generally do not alter the characterization of the entity for Federal tax purposes.[874] Thus, the proposed regulations provide that an election, agreement, or other arrangement that permits debts and liabilities of other series or the series organization to be enforceable against the assets of a particular series, or a failure to comply with the record keeping requirements for the limitation on liability available under the relevant series statute, will be disregarded and will not prevent a series from meeting the definition of "series" in the proposed regulations.[875] By way of example, the Preamble provides that "a series generally will not cease to be an entity under the proposed regulations simply because it guarantees the debt of another series within the series organization."[876]

(6) Ownership of Interests in a Series and Ownership of Assets Associated with a Series. For Federal tax purposes, the ownership of interests in a series and of the assets associated with a series is determined under general tax principles.[877] The Preamble states that "[i]n general, the same legal principles that apply to determine who owns interests in other types of entities apply to determine the ownership of interests in series and series organizations. These principles generally look to who bears the economic benefits and burdens of ownership. The Preamble cites Rev. Rul. 55-39[878] as an example.[879] The Preamble

[871] Prop. Reg. § 301.7701-1(a)(5)(vii).

[872] Prop. Reg. § 301.7701-1(a)(5)(vii).

[873] Preamble, 75 F.R. at 55702.

[874] Preamble, 75 F.R. at 55702.

[875] Prop. Reg. § 301.7701-1(a)(5)(viii)(C); Preamble, 75 F.R. at 55702.

[876] Preamble, 75 F.R. at 55702.

[877] Prop. Reg. § 301.7701-1(a)(5)(vi).

[878] 1955-1 CB 403.

provides further that common law principles apply to the determination of whether a person is a partner in a series that is classified as a partnership for Federal tax purposes under Treas. Reg. § 301.7701-3. By way of example, the Preamble cites *Commissioner v. Culbertson*[880] and *Commissioner v. Tower*.[881] The Proposed Regulations provide that a series organization is not treated as the owner for Federal tax purposes of a series or of the assets associated with a series merely because the series organization holds legal title to the assets associated with the series.[882] By way of example, the Preamble states that if a series organization holds legal title to assets associated with a series because the statute under which the series organization was organized does not expressly permit a series to hold assets in its own name, the series will be treated as the owner of the assets for Federal tax purposes if it bears the economic benefits and burdens of the assets under general Federal tax principles.[883] The Preamble provides that, similarly, for Federal tax purposes, the obligor for the liability of a series is determined under general tax principles.[884]

b. Status of Series Organized or Established Under Foreign Laws. With one exception, the proposed regulations do not apply to series or cells organized or established under the laws of a foreign jurisdiction.[885] The one exception is that the proposed regulations apply to a foreign series that engages in an insurance business.[886] The Preamble provides that until further guidance is issued, the entity status of a foreign series that does not conduct an insurance business will be determined under applicable law. [887]

c. Additional Approaches Considered by IRS and Treasury With Respect to the Classification of a Series for Federal Tax Purposes. The Preamble states that the IRS and the Treasury Department considered other approaches to the classification of series for Federal tax purposes.[888] In particular, the IRS and the Treasury Department considered whether series should be disregarded as entities separate from the series organization for Federal tax purposes.[889] According to the Preamble, this approach would be supported by the fact that series are not generally considered entities for local law purposes (except, for example, potentially under the statutes of Illinois and Iowa, where a series may be treated as a separate entity to the extent set forth in the articles of organization). Additionally, the Preamble notes,

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[879]Preamble, 75 F.R. at 55703.

[880]337 U.S. 733 (1949).

[881]327 U.S. 280 (1946).

[882]Prop. Reg. § 301.7701-1(a)(5)(vi).

[883]Preamble, 75 F.R. at 55703.

[884]Preamble, 75 F.R. at 55703.

[885]Preamble, 75 F.R. at 55702.

[886]Prop. Reg. § 301.7701-1(a)(5)(ii); Preamble, 75 F.R. at 55702.

[887]Preamble, 75 F.R. at 55703.

[888]Preamble, 75 F.R. at 55703.

[889]Preamble, 75 F.R. at 55703..

that while the statutes enabling series organizations grant series significant autonomy, under no current statute do series possess all of the attributes of independence that entities recognized under local law generally possess. For example, series generally cannot convert into another type of entity, merge with another entity, or domesticate in another jurisdiction independent of the series organization.[890] In addition, the dissolution of a series organization generally will terminate all of its series.[891]

The Preamble states that the IRS and the Treasury Department believe that, notwithstanding that series differ in some respects from more traditional local law entities, domestic series generally should be treated for Federal tax purposes as entities formed under local law.[892] Because Federal tax law, and not local law, governs the question of whether an organization is an entity for Federal tax purposes, it is not dispositive that domestic series generally are not considered entities for local law purposes. Additionally, the IRS and the Treasury Department believe that, overall, the factors supporting separate entity status for series outweigh the factors in favor of disregarding series as entities separate from the series organization and other series of the series organization. Specifically, managers and equity holders are "associated with" a series, and their rights, duties, and powers with respect to the series are direct and specifically identified.[893] Also, individual series may (but generally are not required to) have separate business purposes and investment objectives. The IRS and the Treasury Department believe these factors are sufficient to treat domestic series as entities formed under local law.[894]

Although some statutes creating series organizations permit an individual series to enter into contracts, sue, be sued, and/or hold property in its own name, the IRS and the Treasury Department do not believe that the failure of a statute to explicitly provide these rights should alter the treatment of a domestic series as an entity formed under local law.[895] According to the Preamble, these attributes primarily involve procedural formalities and do not appear to affect the substantive economic rights of series or their creditors with respect to their property and liabilities. Even in jurisdictions where series may not possess these attributes, the statutory liability shields would still apply to the assets of a particular series, provided the statutory requirements are satisfied.[896]

The Preamble further states that the rule provided in the proposed regulations would provide greater certainty to both taxpayers and the IRS regarding the tax status of domestic series and foreign series that conduct insurance businesses. In effect, taxpayers that establish domestic

[890]Preamble, 75 F.R. at 55703.

[891]Preamble, 75 F.R. at 55703.

[892]Preamble, 75 F.R. at 55703.

[893]Preamble, 75 F.R. at 55703.

[894]Preamble, 75 F.R. at 55703.

[895]Preamble, 75 F.R. at 55703.

[896]Preamble, 75 F.R. at 55703.

series are placed in the same position as persons that file a certificate of organization for a state law entity.[897] The IRS and the Treasury Department believe that the approach of the proposed regulations is straightforward and administrable, and is preferable to engaging in a case by case determination of the status of each series that would require a detailed examination of the terms of the relevant statute. Finally, the IRS and the Treasury Department believe that a rule generally treating domestic series as local law entities would be consistent with taxpayers' current ability to create similar structures using multiple local law entities that can elect their Federal tax classification pursuant to Treas. Reg. § 301.7701-3.[898]

The IRS and the Treasury Department believe that domestic series should be classified as separate local law entities based on the characteristics granted to them under the various series statutes. However, except as specifically stated in the proposed regulations, a particular series need not actually possess all of the attributes that its enabling statute permits it to possess. The IRS and the Treasury Department believe that a domestic series should be treated as a separate local law entity even if its business purpose, investment objective, or ownership overlaps with that of other series or the series organization itself. Separate state law entities may have common or overlapping business purposes, investment objectives and ownership, but generally are still treated as separate local law entities for Federal tax purposes.[899]

2. **Entity Status of Series Organizations.** The proposed regulations do not address the entity status or filing requirements of series organizations for Federal tax purposes. The Preamble states that a series organization generally is an entity for local law purposes.[900] An organization that is an entity for local law purposes generally is treated as an entity for Federal tax purposes. However, an organization characterized as an entity for Federal income tax purposes may not have an income or information tax filing obligation.[901] By way of example, the Preamble notes that Treas. Reg. § 301.6031(a)-(1)(a)(3)(i) provides that a partnership with no income, deductions, or credits for Federal income tax purposes for a taxable year is not required to file a partnership return for that year. Generally, filing fees of a series organization paid by series of the series organization would be treated as expenses of the series and not as expenses of the series organization. Thus, a series organization characterized as a partnership for Federal tax purposes that does not have income, deductions, or credits for a taxable year need not file a partnership return for the year.[902]

3. **Statement Containing Identifying Information about Series.** The Proposed Regulations require that each series and series organization file a statement for each taxable year containing the identifying information with respect to the series or series

[897]Preamble, 75 F.R. at 55703.

[898]Preamble, 75 F.R. at 55703.

[899]Preamble, 75 F.R. at 55703.

[900]Preamble, 75 F.R. at 55704.

[901]Preamble, 75 F.R. at 55704.

[902]Preamble, 75 F.R. at 55704.

organization as prescribed by the Internal Revenue Service for this purpose and shall include the information required by the statement and its instructions.[903] The IRS and Treasury Department are considering what information should be required by these statements.[904] Information tentatively being considered includes (1) the name, address, and taxpayer identification number of the series organization and each of its series and status of each as a series of a series organization or as the series organization; (2) the jurisdiction in which the series organization was formed; and (3) an indication of whether the series holds title to its assets or whether title is held by another series or the series organization and, if held by another series or the series organization, the name, address, and taxpayer identification number of the series organization and each series holding title to any of its assets.[905]

4. Proposed Effective Date. The proposed regulations generally apply on the date final regulations are published in the Federal Register.[906] The Preamble provides that, generally, when final regulations become effective, taxpayers that are treating series differently for Federal tax purposes than series are treated under the final regulations will be required to change their treatment of series.[907] In this situation, a series organization that previously was treated as one entity with all of its series may be required to begin treating each series as a separate entity for Federal tax purposes. General tax principles will apply to determine the consequences of the conversion from one entity to multiple entities for Federal tax purposes. By way of example, the Preamble cites section 708 (relating to partnership divisions) in the case of a series organization previously treated as a partnership for Federal tax purposes converting into multiple partnerships upon recognition of the series organization's series as separate entities.[908] The regulations include an exception for series established prior to publication of the proposed regulations that treat all series and the series organization as one entity.[909] If the requirements for this exception are satisfied, after issuance of the final regulations the series may continue to be treated together with the series organization as one entity for Federal tax purposes. This exception will cease to apply on the date any person or persons who were not owners of the series organization (or series) prior to September 14, 2010 own, in the aggregate, a 50 percent or greater interest in the series organization (or series).[910]

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[903]Prop. Reg. § 301.6011-6(a).

[904]Preamble, 75 F.R. at 55705.

[905]Preamble, 75 F.R. at 55705..

[906]Prop. Reg. § 301.7701-1(f)(3).

[907]Preamble, 75 F.R. at 55706.

[908]Preamble, 75 F.R. at 55706.

[909]Prop. Reg. § 301.7701-1(f)(3)(ii)(A).

[910]Prop. Reg. § 301.7701-1(f)(3)(ii)(B).

VII: S CORPORATIONS.

Subchapter S of the Code allows certain qualified corporations to elect essentially to be relieved from corporate level taxation and to pass the corporate items of taxable income and loss through to the shareholders of the corporation. Thus, a corporation that elects subchapter S (an "S corporation") and its shareholders are generally treated more like a partnership and its partners than a C corporation and its shareholders, respectively. In order to make an election to be treated as an S corporation, a corporation must meet certain requirements primarily regarding its capital structure and the identity of its shareholders.

A. Eligibility for S Election. To be eligible to make an S election, a corporation must satisfy the following requirements: (1) the corporation must be a domestic corporation;[911] (2) it must have no more than 100 shareholders[912] (for this purpose, stock owned by a husband and wife is treated as owned by one shareholder[913] and all family members[914] can elect to be treated as one shareholder[915]); (3) its shareholders must consist only of individuals (other than nonresident aliens[916]), certain tax-exempt organizations[917] and certain trusts and estates;[918] and (4) the corporation cannot have more than one class of stock.[919] Certain financial institutions that use the reserve method of accounting for bad debts and certain insurance companies are not eligible to make an S election.[920]

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[911]I.R.C. § 1361(b)(1); Treas. Reg. § 1.1361-1(b)(1).

[912]I.R.C. § 1361(b)(1)(A) (as amended by The American Jobs Creation Act of 2004); see also Treas. Reg. § 1.1361-1(e) (providing rules relating to number of shareholders).

[913]Treas. Reg. § 1.1361-1(e)(2).

[914]*See* I.R.C. § 1361(c)(1)(B) (defines "members of the family").

[915]I.R.C. § 1361(c)(1)(A)(ii); ***see also*** Treas. Reg. § 1.1361-1(e)(3) (special rules relating to stock owned by members of a family).

[916]I.R.C. § 1361(b)(1)(C); Treas. Reg. § 1.1361-1(b)(1)(iii).

[917]I.R.C. § 1361(c)(6).

[918]I.R.C. § 1361(b)(1)(B); Treas. Reg. § 1.1361-1(b)(1)(ii).

[919]I.R.C. § 1361(b)(1)(D); Treas. Reg. § 1.1361-1(l); *cf.* PLR 200533002 (Apr. 28, 2005) ("X, A, B, C, Trust 1, Trust 2, LP1, LP2 and LP3 were restored to the relative positions they would have occupied if the X stock had never been sold to the Partnerships. In addition, this restoration was achieved within the same taxable year. Therefore, the legal doctrine of rescission applies to (1) disregard the creation of convertible preferred stock and X's issuance of that stock to the Partnerships, and (2) prevent the termination of X's S corporation status. Based solely on the facts submitted and representations made, we rule that X will be treated as continuing to be an S corporation during the period from d2 to d3, and thereafter, provided that X's S election was valid and was not otherwise terminated under § 1362(d). We further rule that during the period from d2 to d3, A, B, C, Trust 1 and Trust 2 will be treated as the shareholders of X. Accordingly, A, B, C, Trust 1 and Trust 2 must include in income their pro rata shares of the separately and nonseparately stated items of X as provided in § 1366 and must make any adjustments to stock basis as provided in § 1367 and take into account any distributions made by X as provided in § 1368. This ruling is null and void if X, A, B, C, Trust 1 or Trust 2 fail to comply with these requirements.").

[920]I.R.C. § 1361(b)(2); Treas. Reg. § 1.1361-1(d)(1).

1. Classes of Stock. Generally, a corporation is treated as having only one class of stock if all outstanding shares of the corporation confer identical rights to distribution and liquidation proceeds.[921] Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.[922] Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board.[923]

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds.[924] In determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, the second-class-of-stock rules in the Treasury regulations provide specific guidance with respect to (a) the effect of state law requirements for payment and withholding of income tax on behalf of S corporation shareholder;[925] (b) buy-sell and redemption agreements;[926] (c) distributions that take into account varying interest in stock;[927] (d) instruments (for example, certain call options[928], warrants or similar instruments),[929] (e) short-term unwritten advances[930] and proportionately-held obligations;[931] (f) convertible debt;[932] and (g) substantially nonvested stock with respect to which an election under Section 83(b) has been made.[933]

The regulations also contain a straight-debt "safe harbor" to the second class of stock rules. An instrument or obligation that satisfies the definition of straight debt in the regulations

[921] Treas. Reg. § 1.1361-1(l)(1).

[922] Treas. Reg. § 1.1361-1(l)(1).

[923] Treas. Reg. § 1.1361-1(l)(1).

[924] Treas. Reg. § 1.1361-1(l)(2)(i).

[925] *See* Treas. Reg. § 1.1361-1(l)(2)(ii).

[926] *See* Treas. Reg. § 1.1361-1(l)(2)(iii).

[927] Treas. Reg. § 1.1361-1(l)(2)(iv).

[928] *Cf.* PLR 200617006 (Jan. 10, 2006) (proposed stock option plan satisfies safe harbor for options).

[929] Treas. Reg. § 1.1361-1(l)(4)(iii).

[930] Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(1).

[931] Treas. Reg. § 1.1361-1(l)(4)(ii)(B)(2).

[932] Treas. Reg. § 1.1361-1(l)(4)(iv).

[933] Treas. Reg. § 1.1361-1(b)(3); *see also* Treas. Reg. § 1.1361-1(b)(3) (stock that is issued for services and that is substantially nonvested is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes a Section 83(b) election with respect to the stock.).

is not treated as a second class of stock.[934] Straight debt means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, which (a) does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock or similar factors;[935] (b) is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation;[936] and (c) is held by an individual (other than a nonresident alien), an estate, or certain trusts, or by a person which is actively and regularly engaged in the business of lending money.[937]

2. Method of Election. An S election may be made by an eligible corporation only if all of the corporation's shareholders at the time of the election consent to such election.[938] If stock of the corporation is owned by husband and wife as community property (or the income from the stock is community property), both spouses must consent to the election.[939]

An eligible corporation makes an S election by filing a completed Form 2553 with the Internal Revenue Service.[940] The S election may be made at any time during the tax year that immediately precedes the tax year for which the election is to be effective, or during the tax year for which the election is to be effective provided that the election is made before the 16th day of the third month of the year.[941] A timely S election made by a corporation during the tax year for which it is intended to be effective is nonetheless treated as made for the following tax year if (a) the corporation did not meet the requirements for making a valid S election during the entire portion of tax year which occurs before the date the election is made; or (b) any person who held stock in the corporation at any time during the portion of the tax year which occurs before the time the election is made, and who does not hold stock at the time the election is made, does not consent to the election.[942]

3. Termination of S Election. An S election can terminate by (1) revocation of the S election with the consent of shareholders holding more than 50-percent of the stock;[943] (2) the corporation ceasing to meet the S election requirements; or (3) the corporation has C corporation earnings and profits at the close of each of three consecutive tax years, and has

[934] Treas. Reg. § 1.1361-1(l)(5).

[935] I.R.C. § 1361((c)(5)(b)(i); Treas. Reg. § 1.1361-1(l)(5)(i)(A).

[936] I.R.C. § 1361(c)(5)(b)(ii); Treas. Reg. § 1.1361-1(l)(5)(i)(B).

[937] I.R.C. § 1361(c)(5)(b)(iii); Treas. Reg. § 1.1361-1(l)(5)(i)(C).

[938] I.R.C. § 1362(a)(2); Treas. Reg. § 1.1362-1(a).

[939] Treas. Reg. § 1.1362-6(b).

[940] Treas. Reg. § 1.1362-6(a)(2)(i).

[941] I.R.C. § 1362(b)(1); Treas. Reg. § 1.1362-6(a)(2)(ii).

[942] Treas. Reg. § 1.1362-6(a)(2)(ii).

[943] I.R.C. § 1362(d)(1); Treas. Reg. § 1.1362-2(a)(1).

excess passive investment income (i.e., in excess of 25-percent of gross receipts) for each of those years.[944]

B. Qualified Subchapter S Subsidiary. Generally, a qualified subchapter S subsidiary ("Qsub) is a domestic corporation if (a) 100-percent of the stock of the Qsub is held by an S corporation; and (2) the S corporation elects to treat the Qsub as a qualified subchapter S subsidiary.[945] An S corporation makes an election to treat an eligible subsidiary as a Qsub by filing a completed Form 8869 (Qualified Subchapter S Subsidiary Election) with the Service.[946] The election can be made at any time during the tax year.[947] A Qsub election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified.[948] The effective date specified on the form cannot be more than two months and 15 days prior to the date of filing and cannot be more than 12 months after the date of filing.[949] The regulations contain rules for revoking a Qsub election.[950]

For federal tax purposes, a corporation which is a Qsub is not generally treated as a separate corporation and all assets, liabilities, and items of income, deduction, and credit of a Qsub are treated as assets, liabilities and items of income, deduction and credit of the S corporation parent.[951] If an S corporation makes a valid Qsub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation.[952] The tax treatment of the liquidation or of a larger transaction that includes the liquidation is determined under the Internal Revenue Code and general principles of tax law. Thus, for example, if an S corporation forms a subsidiary and makes a valid Qsub election (effective upon the date of the Qsub's formation) for the Qsub, the transfer of assets to the subsidiary and the deemed liquidation are disregarded, and the corporation will be deemed to be a Qsub from its inception.[953]

The Treasury regulations provide rules governing the termination of a Qsub election and the federal income tax consequences of a termination of a Qsub election.[954] If a Qsub election terminates, the former Qsub is treated as a new corporation acquiring all of the assets (and

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[944]I.R.C. § 1362(d)(3); Treas. Reg. § 1.1362-2(c).

[945]I.R.C. § 1361(a)(3)(B); Treas. Reg. § 1.1362-2(a).

[946]Treas. Reg. § 1.1361-2(b)(2).

[947]Treas. Reg. § 1.1361-2(b)(3).

[948]Treas. Reg. § 1.1361-2(b)(4).

[949]Treas. Reg. § 1.1361-3(b)(4).

[950]*See* Treas. Reg. § 1.1361-3(b).

[951]I.R.C. § 1361(b)(3)(B); Treas. Reg. § 1.1361-4(a)(1).

[952]Treas. Reg. § 1.1361-4(a)(2).

[953]Treas. Reg. § 1.1361-4(a)(2).

[954]*See* Treas. Reg. § 1.1361-5.

assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation.[955]

C. Tax Treatment of S Corporation.

1. Pass-Thru Nature of an S Corporation. S corporations generally are treated for federal income tax purposes as pass-through entities and are not subject to tax at the corporate level.[956] Each shareholder of an S corporation is required to take into account in the shareholder's return his pro rata share of the corporation's items of income (regardless of whether the income is distributed to the shareholders), loss, deduction and credit.[957]

There are two principal exceptions to the general pass-through treatment of S corporations. Both are applicable only if the corporation was previously a C corporation. First, an S corporation is subject to tax (at the highest corporate tax rate[958]) on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments[959]), if the corporation has subchapter C earnings and profits, and more than 25-percent of its gross receipts consist of passive investment income for the tax year.[960] Second, for the first 10 years after a corporation that was previously a regular C corporation[961] elects to be an S corporation, certain net "built-in" capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level (at the highest corporate tax rate).[962]

2. Limitation on Shareholder's Deduction of Losses. A shareholder's deduction for corporate losses is limited to the sum of the amount of the shareholder's adjusted basis in his stock and in the indebtedness of the corporation to such shareholder.[963] To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.[964]

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[955]Treas. Reg. § 1.1361-5(b).

[956]I.R.C. § 1363(a); Treas. Reg. § 1.1363-1(a); I.R.C. § 1366(a)(1); Treas. Reg. § 1.1366-1(a)(2).

[957]I.R.C. § 1366(a)(1); Treas. Reg. § 1.1366-1(a)(1).

[958]I.R.C. § 1367(a).

[959]I.R.C. § 1375(b)(1)(B).

[960]I.R.C. § 1375(a).

[961]I.R.C. § 1374(c)(1).

[962]I.R.C. § 1374(a).

[963]I.R.C. § 1366(d)(1); Treas. Reg. § 1.1366-2(a)(3)(ii); *see also* I.R.C. § 1367(b)(2)(A) and Treas. Reg. § 1.1367-2 (adjustments in basis of indebtedness).

[964]I.R.C. § 1366(d)(2)(A); Treas. Reg. § 1.1366-2(a)(2); see also I.R.C. § 1366(d)(2)(B) (enacted by the American Jobs Creation Act of 2004; provides for treatment of disallowed losses in connection with transfers of stock between spouses or incident to divorce).

3. Shareholder Basis Adjustments. A shareholder's basis in the stock of an S corporation is increased by the shareholder's pro rata share of (1) items of income (including tax-exempt income) of the corporation which are separately stated; (2) nonseparately computed income of the corporation; and (3) with respect to non-oil and gas mineral properties,[965] the excess of the depletion deduction over the basis of the property.[966] A shareholder's basis in S corporation stock is decreased by a shareholder's pro rata share of (1) nontaxable distributions;[967] (2) separately-stated items of loss;[968] (3) nonseparately-stated losses;[969] (4) noncapital, nondeductible expense items;[970] and (5) the amount of the shareholder's deduction for depletion with respect to oil and gas properties to the extent that such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder.[971] Corporate liabilities are not included in a shareholder's basis for his interest in an S corporation.

4. Distributions by an S Corporation. Generally, an S corporation shareholder is not subject to tax on cash distributions from an S corporation unless the distributions exceed the shareholder's basis in the stock of the corporation or the corporation was formerly a C corporation and has remaining earnings and profits.[972] To the extent of such earnings and profits, corporate distributions are treated like dividends of C corporations and generally are subject to tax as ordinary income in the hands of the shareholders.[973]

The C corporation rules applicable to distributions of property generally apply to S corporations.[974] Thus, the gain recognition provisions that generally apply to a C corporation apply to determine the recognition of gain in the case of a property distribution by an S corporation.[975] Under these rules, an S corporation should generally recognize gain on a distribution (whether operating or liquidating) of property (other than an obligation of the distributing corporation) if the fair market value of the property exceeds its adjusted basis in the hands of the corporation.[976]

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[965] I.R.C. § 1367(a)(1)(C); I.R.C. § 613A(c)(11).

[966] I.R.C. § 1367(a)(1); Treas. Reg. § 1.1367-1(b)(1).

[967] I.R.C. § 1367(a)(2)(A); Treas. Reg. § 1.1367-1(c)(1).

[968] I.R.C. § 1367(a)(2)(B).

[969] I.R.C. § 1367(a)(2)(C).

[970] I.R.C. § 1367(a)(2)(D).

[971] I.R.C. § 1367(a)(2)(E).

[972] I.R.C. §§ 1368(a), 1368(b)(1).

[973] I.R.C. § 1368(c)(2).

[974] I.R.C. § 1371(a).

[975] *See* S. Rep. No. 100-445 at 66, 100th Cong., 2d Sess. (1988); *cf.* Priv. Ltr. Rul. 8908016 (Nov. 22, 1988).

[976] *See* I.R.C. §§ 311(a), 336(a).

D. Self-Employment Tax. A shareholder's pro-rata share of income from an S corporation should not be subject to self-employment tax.[977]

[977]*See* Rev. Rul. 59-221, 1959-1 C.B. 225; *see also Ding v. Commissioner*, 200 F.3d 587 (9th Cir. 1999) ("The Dings fail to offer anything in support of their reading of section 1402(a) beyond their conjecture as to what Congress silently intended. In light of the 1959 revenue ruling, the fundamental distinction between shareholders and corporations and their respective businesses, and the structure of the tax code, this conjecture cannot support our reading into section 1402(a) the inclusion of S corporation pass-through items."), *aff'g* 74 T.C.M. (CCH) 708 (1997) ("[W]e hold that petitioner must compute his net earnings from self-employment, and correspondingly his section 1401 self-employment tax liabilities for the years in issue, without taking into account pass-through items from the S corporations."); *Durando v. U.S.*, 70 F.3d 548, 552 (9th Cir. 1995) ("[T]he IRS has ruled that S corporation pro rata shares are not included in net earnings for Self-Employment Contributions Act purposes."); *Veterinary Surgical Consultants, P.C. v. Commissioner*, 117 T.C. 141, 148 (2001) ("Rev. Rul. 59-221, supra, holds that where a small business corporation elects under section 1372 not to be subject to Federal income tax, the amount of its income required to be included in each shareholder's gross income does not constitute "net earnings from self-employment" to such shareholders for purposes of the Self-Employment Contributions Act. That ruling, like the Durando case, deals solely with whether amounts a shareholder receives are derived from a trade or business carried on by the shareholder. In the case at hand, the issue is whether an officer is an employee of a corporation. Rev. Rul. 59-221, supra, makes no mention of either corporate officers or their Federal employment tax status.") *aff'd without published opinion*, 2003-1 USTC ¶ 50,141 (3d Cir. 2002); *cf.* Tech. Adv. Memo. (May 16,1997) ("Rev. Rul. 59-221, 1959-1 C.B. 225, held that amounts of an S corporation's income required to be included in each shareholder's gross income are not subject to the self-employment tax under section 1402 because these amounts are not derived from a trade or business carried on by the shareholders."); *but cf. IRS Information Letter 2003-0026 (Mar. 31, 2003) (*"Generally, under the rules described above, if a shareholder of an S corporation performs services for the corporation, any distribution to the shareholder, even if legally declared under state law by the S corporation as a dividend, will be characterized as "wages" subject to employment taxes where in reality the payments are for services. An S corporation cannot avoid employment taxes merely by paying the corporate shareholder "dividends" in lieu of reasonable compensation for services performed.").

VIII: CODIFICATION OF ECONOMIC SUBSTANCE DOCTRINE

The Health Care and Education Reconciliation Act of 2010[978] (the "Health Care Act") enacted new Section 7701(o) which codifies the common law economic substance doctrine. The new statute is effective for transactions entered into after March 30, 2010.[979] The new provision provides that in the case of any transaction to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction.[980] The legislative history to the statute states as follows:

> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity; (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C; and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied. Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.[981]

The Health Care Act also enacted a penalty under Section 6662(b)(6) for an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of new Section 7701(o)) or failing to meet the requirements of any similar rule of law.[982]

On September 13, 2010, the IRS issued Notice 2010-62[983] which provides interim guidance regarding the codification of the economic substance doctrine under section 7701(o) and related penalties. The notice applies with respect to transactions entered into on or after March 31, 2010. On April 3, 2012, the Chief Counsel's Office issued CCA-2012-008, reprinted at 2012 TNT 67-8, providing (1) instructions regarding Counsel's role during an examination that involves the application of the economic substance doctrine under the common law or section 7701(o), including any penalties related to the codified economic substance doctrine under section 6662, 6662A, or 6676; (2) instructions for reviewing a statutory notice of deficiency or a notice of final partnership administrative adjustment if a Business Operating Division concludes that a transaction lacks economic substance; and (3) coordination procedures for litigating the

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[978]Pub. L. No. 111-152, § 1409(a), 124 STAT. 1029, 1067 (2010).

[979]Pub. L. No. 111-152, § 1409(e)(1), 124 STAT. 1029, 1070 (2010).

[980]New I.R.C. § 7701(o).

[981]H.R. Rep. No. 111-443, at 296 (2010)(footnotes omitted).

[982]*See* New I.R.C. § 6662(b)(6).

[983]2010-40 IRB 411.

common law economic substance doctrine or the codified economic substance doctrine and a related penalty.

On September 14, 2010, the IRS Large and Midsize Business Division issued Directive LMSB-04-0910-024[984] stating that, "[t]o ensure consistent administration of the accuracy-related penalty imposed under section 6662(b)(6), any proposal to impose a section 6662(b)(6) penalty at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed."

[984] *Reprinted at* 2010 TNT 178-47.

IX: EMPLOYMENT TAXES PAID BY EMPLOYER.

A tax is imposed on both employers[985] and employees[986] under the Federal Insurance Contributions Act ("FICA") for social security (old-age, survivors and disability insurance - "OASDI") and hospital insurance purposes. The FICA tax rate and maximum wage base subject to tax for 2014 are as follows:

Tax Rate	Maximum Earnings Base	Maximum Tax on Employee	Maximum Tax on Employer
For 2014, employee OASDI rate is 6.2%; employer OASDI rate is 6.2%[987]	$117,000[988]	$7,254	$7,254
1.45%(HI)	No limit	No limit	No limit

For tax years beginning after December 31, 2012, the Code imposes on every taxpayer (other than a corporation, estate or trust) a tax equal to .9% of wages which are in excess of (1) in the case of a joint return, $250,000; (2) in the case of a married taxpayer filing a separate return, ½ of the dollar amount determined under (1); and (3) in any other case, $200,000.[989]

A tax is also imposed on employers under the Federal Unemployment Tax Act.[990] The tax rate is equal to 6.2-percent (through 2010 and the first 6 months of calendar year 2011; changing to 6.0 percent in the case of the remainder of calendar year 2011 and each calendar year thereafter[991]) of the taxable wages paid by the employer during the calendar year.[992] The FUTA tax applies to the first $7,000 in wages paid to each employee annually.[993] An employer generally may deduct FUTA taxes and the employer's share of FICA taxes as an ordinary and

[985]*See* I.R.C. § 3111.

[986]*See* I.R.C. § 3101.

[987]I.R.C. § 3101(a); P.L. 111-312, §§ 601(a)(2), 601(c) (as amended by P.L. 112-96, § 1001(a)).

[988]IRS Notice 2013-72, 2013-48 I.R.B. 592.

[989]I.R.C. § 3101(b)(2).

[990]I.R.C. § 3301.

[991]I.R.C. § 3301(2) (as amended by P.L. 111-92, § 10(a).

[992]I.R.C. § 3301.

[993]*See* I.R.C. § 3306(b).

necessary business expense (assuming the payment of such taxes meets the ordinary and necessary business expense tests).[994]

[994]*See* I.R.C. § 162(a); *Eastman Kodak Co. v. U.S.*, 534 F.2d 252 (Ct. Cl. 1976); Rev. Rul. 96-51, 1996-2 C.B. 36, *modified by* Rev. Rul. 2007-12, 2007-1 C.B. 685; Rev. Rul. 86-14, 1986-1 CB 304.

X: TAX ACCOUNTING METHODS.

The selection of an accounting method is often an important consideration for a small business. For example, for a sole proprietorship, the cash method of accounting is often easier to administer than the accrual method of accounting.

A taxpayer generally is required to compute taxable income for federal income tax purposes under the method of accounting regularly used in keeping his books.[995] If, however, no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income is required to be made under such method as, in the opinion of the Treasury, does clearly reflect income.[996]

A. Methods of Accounting under the Code. The permissible methods of accounting under the Code consist of the cash method, the accrual method, any other method permitted or required under the Code, or any hybrid method allowed under the regulations.[997] A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business; however, the method used for each trade or business must clearly reflect the income of that particular trade or business.[998] A taxpayer may change its method of accounting with the consent of the Internal Revenue Service.[999]

1. Cash Method of Accounting. Generally, under the cash method of accounting, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the tax year in which such items are actually or constructively received.[1000] Expenditures are to be deducted for the tax year in which actually paid.[1001]

2. Accrual Method of Accounting. Under an accrual method of accounting, income generally is recognized in the year in which all the events have occurred that establish the taxpayer's right to receive the income and the amount of the income can be determined with reasonable accuracy.[1002] A deduction is allowed for an expense in the year in which (i) all events have occurred that establish the liability of the taxpayer for the expense, (ii) the amount of the

[995] I.R.C. § 446(a); Treas. Reg. § 1.446-1(a)(1).

[996] I.R.C. § 446(b); Treas. Reg. § 1.446-1(a)(2); Treas. Reg. § 1.446-1(b); Treas. Reg. § 1.446-1(c)(1)(ii)(C).

[997] I.R.C. § 446(c); Treas. Reg. § 1.446-1(c)(1).

[998] I.R.C. § 446(d); Treas. Reg. § 1.446-1(d)(1).

[999] I.R.C. § 446(e); Treas. Reg. § 1.446-1(e)(2)(i).

[1000] Treas. Reg. § 1.446-1(c)(1)(i).

[1001] Treas. Reg. § 1.446-1(c)(1)(i).

[1002] Treas. Reg. § 1.446-1(c)(1)(ii).

liability can be determined with reasonable accuracy, and (iii) economic performance has occurred with respect to the item of expense.[1003]

a. Use of Inventory. A taxpayer is generally required to use an accrual method of accounting for federal income tax purposes in any case in which it is necessary to use an inventory.[1004]

b. Certain Taxpayers Are Generally Not Permitted to Use the Cash Method of Accounting.

(1) General Rule. The following taxpayers are generally not permitted to use the cash method of accounting: (1) C corporations, (2) partnerships with a C corporation as a partner, and (3) tax shelters.[1005]

(a) Definition of C corporation. For this purpose, the term "C corporation" includes any corporation that is not an S corporation.[1006] For example, a regulated investment company and a real estate investment trust are treated as a C corporation for this purpose.[1007] In addition, a trust subject to the tax on unrelated business income (under Section 511(b) of the Code) is treated as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business.[1008] Similarly, a corporation that is exempt from federal income tax is treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business.[1009]

(b) Definition of Tax Shelters. The term "tax shelter" generally means any of the following:[1010]

i) An enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale.[1011]

[1003] Treas. Reg. § 1.446-1(c)(1)(ii).

[1004] Treas. Reg. § 1.446-1(c)(2)(i).

[1005] I.R.C. § 448(a).

[1006] Treas. Reg. § 1.448-1T(a)(3).

[1007] Treas. Reg. § 1.448-1T(a)(3).

[1008] Treas. Reg. § 1.448-1T(a)(3).

[1009] Treas. Reg. § 1.448-1T(a)(3).

[1010] This definition of tax shelter is modified in the case of a farming business. *See* I.R.C. § 448(d)(3).

[1011] I.R.C. §§ 448(d)(3), 461(i)(3); Treas. Reg. § 1.448-1T(b)(1)(i).

ii) A syndicate, which generally refers to a partnership or other entity (other than a C corporation) if more than 35-percent of the losses of such entity are allocated to limited partners or limited entrepreneurs.[1012] For this purpose, a "limited entrepreneur" means a person who has an interest in an enterprise other than as a limited partner, and does not actively participate in the management of such enterprise.[1013]

iii) A partnership or other entity, plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the tax avoidance or tax evasion.[1014]

(2) Exceptions to General Rule. The limitation on the use of the cash method of accounting applicable to C corporations and partnerships with a C corporation as a partner is subject to certain exceptions.[1015] These exceptions do not apply to tax shelters.[1016]

(a) Exception for Farming Business. The general limitation on the use of the cash method of accounting does not apply to a C corporation (or a partnership with a C corporation as a partner) engaged in the trade or business of farming.[1017] Other statutory provisions in the Code, however, provide that a C corporation (or a partnership with a C corporation as a partner) must use an accrual method of accounting for such activities unless such corporation (or partnership), for each prior taxable year beginning after December 31, 1975, did not have gross receipts exceeding $1 million.[1018] Special rules apply to a family corporation. A family corporation (or a partnership with a family corporation as a partner) must use an accrual method of accounting for its farming business unless, for each prior taxable year beginning after December 31, 1985, such corporation did not have gross receipts exceeding $25 million.[1019] A family corporation is defined as a corporation in which at least 50-percent of the stock of the corporation is held by one family (or in some limited cases, two or three families.).[1020]

(b) Exception for Qualified Personal Service Corporations. The general limitation on the use of the cash method of accounting does not

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[1012] I.R.C. §§ 448(d)(3), 461(i)(3); Treas. Reg. § 1.448-1T(b)(1)(ii); Treas. Reg. § 1.448-1T(b)(3).

[1013] I.R.C. § 464(e)(2); *cf.* Priv. Ltr. Rul. 9350013 (Sept. 15, 1993) (limited liability company engaged in practice of law through its members; held, company not prohibited from using cash method of accounting).

[1014] I.R.C. §§ 448(d)(3), 461(i)(3), 6662(d)(2)(C)(ii); *see also* Treas. Reg. § 1.448-1T(b)(1)(iii).

[1015] I.R.C. § 448(b).

[1016] I.R.C. § 448(b).

[1017] I.R.C. §§ 448(b)(1), 448(d)(1).

[1018] I.R.C. §§ 447(a), 447(d)(1).

[1019] I.R.C. § 447(d)(2)(A).

[1020] I.R.C. § 447(d)(2)(C).

apply to a "qualified personal service corporation."[1021] A qualified personal service corporation is a corporation that meets (1) a function test, and (2) an ownership test.[1022]

i) Function Test. A corporation meets the function test if substantially all the corporation's activities for a tax year involve the performance of services in one or more of the following fields: (1) health, (2) law, (3) engineering, (4) architecture, (5) accounting, (6) actuarial science, (7) performing arts and (8) consulting.[1023] Substantially all of the activities of a corporation are involved in the performance of services in a prescribed field only if 95-percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field.[1024]

ii) Ownership Test. A corporation meets the ownership test if, at all times during the tax year, substantially all the corporation's stock, by value, is held, directly or indirectly, by: (a) employees performing services for the corporation in connection with the qualified services performed by the corporation, (b) retired employees who performed such services for the corporation, (c) the estate of any individual described in (a) or (b), or (d) any other person who acquired such stock by reason of the death of an individual described in (a) or (b), but only for the 2-year period beginning on the date of the death of such individual.[1025] Certain attribution rules apply.[1026]

(c) Exception for Small Businesses. The general limitation on the use of the cash method of accounting does not apply to a C corporation (or a partnership with a C corporation as a partner) if, for all prior tax years beginning after December 31, 1985, such corporation or partnership (or any predecessor) meets a $5,000,000 gross receipts test.[1027] A corporation meets the $5,000,000 gross receipts test for any prior tax year if the average annual gross receipts of such corporation for the 3 tax years (or, if shorter, the tax years during which such corporation was in existence) ending with such prior tax year does not exceed $5,000,000.[1028] A partnership with a C corporation as a partner meets the $5,000,000 gross receipts test for any prior tax year if the average annual gross receipts of such partnership for the 3 tax years (or, if shorter, the tax years during which such partnership was in existence) ending with such prior tax year does not exceed $5,000,000.[1029] The gross receipts of the corporate

[1021] I.R.C. § 448(b)(2).

[1022] I.R.C. § 448(d)(2); Treas. Reg. § 1.448-1T(e)(3).

[1023] I.R.C. § 448(d)(2); Treas. Reg. .§ 1.448-1T(e)(4)(i).

[1024] Treas. Reg. § 1.448-1T(e)(4)(i).

[1025] I.R.C. § 448(d)(2)(B); Treas. Reg. § 1.448-1T(e)(5)(i).

[1026] Treas. Reg. § 1.448-1T(e)(5)(iii).

[1027] I.R.C. § 448(b)(3); Treas. Reg. 1.448-1T(f)(1).

[1028] Treas. Reg. § 1.448-1T(f)(2).

[1029] Treas. Reg. § 1.448-1T(f)(2).

partner are not taken into account in determining whether the partnership meets the $5,000,000 gross receipts test.[1030]

The IRS has provided that, as a matter of administrative convenience, a qualifying taxpayer with average annual gross receipts of $1 million or less will be permitted to use the cash method of accounting and will not be required to use an accrual method of accounting for purchases and sales of merchandise.[1031] A taxpayer has average annual gross receipts of $1,000,000 or less if, for each prior tax year ending on or after December 17, 1998, the taxpayer's average annual gross receipts for the 3-tax-year period ending with the applicable prior tax year does not exceed $1,000,000.[1032]

Subsequently, the IRS expanded the class of small businesses eligible to use the cash method of accounting to qualified taxpayers with average annual gross receipts of $10 million or less unless the taxpayer's principal business activity consists of mining, manufacturing, wholesale trade, retail trade, or a listed information industry.[1033] A taxpayer has average annual gross receipts of $10,000,000 or less if, for each prior taxable year ending on or after December 31, 2000, the taxpayer's average annual gross receipts for the three taxable-year period ending with the applicable prior taxable year do not exceed $10,000,000.[1034]

[1030]Treas. Reg. § 1.448-1T(f)(2).

[1031]Rev. Proc. 2001-10, §§ 3, 4.01, 2001-1 C.B. 272.

[1032]Rev. Proc. 2001-10, § 5.01.

[1033]Rev. Proc. 2002-28, § 4.01(1)(a) 2002-1 C.B. 815.

[1034]Rev. Proc. 2002-28, §§ 5.01, 5.02.

XI: TENANT-IN-COMMON ARRANGEMENTS.

A. Co-Ownership of Rental Property. The Revenue Service defines a "co-ownership" as "tenants in common" or other ownership arrangements in which each owner has a right to, and the responsibility for, an undivided fractional interest in each asset that is owned. The Service has stated that the central characteristic of a tenancy in common is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. Each tenant in common is entitled to share with the other tenants the possession of the whole parcel and has the associated rights to a proportionate share of rents or profits from the property, to transfer the interest, and to demand a partition of the property. These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common.[1035]

A tax partnership does not include mere co- ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased.[1036] In Rev. Rul. 75-374,[1037] two parties each own an undivided one-half interest in an apartment project. A management company retained by the co-owners manages the building. Customary tenant services such as heat and water, unattended parking, trash removal, normal repairs, and cleaning of public areas are furnished at no additional charge. Additional services, such as attendant parking, cabanas, and gas and electricity are provided by the management company for a separate charge. The ruling holds that the furnishing of customary services in connection with the maintenance and repair of an apartment project will not render co-ownership a partnership. The furnishing of additional services by the owners or through an agent will render a co-ownership a partnership. The revenue ruling concludes that since the management company is not an agent of the owners and the owners did not share the income earned from the additional services, the owners were not furnishing services. Therefore, the owners are to be treated as co-owners and not partners.

In *McManus v. Commissioner*,[1038] taxpayers acquired real estate for development and title to the property was placed in their names as individuals. During the tax years the taxpayers held the property, financial transactions were recorded in books that contained capital accounts for the “partners”; bank records indicated the taxpayers were partners; and their attorneys, with the taxpayers' affirmation, referred to the taxpayers as partners. Moreover, partnership returns were filed on behalf of the taxpayers until, upon the advice of legal counsel, the practice was discontinued. The taxpayers argued that they never intended to enter into a partnership and thus were not partners for federal tax purposes. The Tax Court found that the parties had acted in a way that sufficiently evidenced the relationship to be that of partners in a partnership. In affirming the Tax Court, the Court of Appeals for the Ninth Circuit considered the keeping of

[1035]Rev. Proc. 2002-22, 2002-1 C.B. 733 (citing 7 Richard R. Powell, Powell on Real property §§ 50.01-50.07 (Michael Allan Wolf ed., 2000)); Tech. Adv. Mem. 200540010 (Oct. 7, 2005).

[1036]Treas. Reg. § 301.7701-1(a)(2).

[1037]1975-2 C.B. 261.

[1038]583 F.2d 443 (9th Cir. 1978), *cert. denied,* 440 U.S. 959 (1979).

books on a partnership basis, the maintaining of a "partnership" bank account, and "most importantly" the filing of partnership returns. The Ninth Circuit stated that the holding of the property as tenants in common was at best neutral evidence. The court found that the Tax Court's decision was not erroneous and noted that, in any case, a taxpayer is estopped from later denying the status he claimed on his tax returns.

In the case where a sponsor packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing, the courts have looked at the relationships not only among co-owners, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership. For example, in *Bergford v. Commissioner*,[1039] seventy-eight investors purchased co-ownership interests in computer equipment that was subject to a 7-year net lease. As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent.

The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances).[1040] In the case where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes.[1041]

B. Election Out of Partnership Treatment. Certain unincorporated organizations are permitted to elect to be excluded from the application of all or a part of the partnership tax rules under "Subchapter K" of the Internal Revenue Code. In order to qualify for the election out of subchapter K, an organization must be availed of (i) for investment purposes only and not for the active conduct of a business, or (ii) for the joint production, extraction, or use of property but not for the purpose of selling services or property produced or extracted. The members of the organization must be able to compute their income without the necessity of computing partnership taxable income.[1042] If the participants in the joint purchase, retention, sale, or

[1039] 12 F.3d 166 (9th Cir. 1993).

[1040] *Bergford*, 12 F.3d 169-170.

[1041] *Bergford*, 12 F.3d at 169; see also *Bussing v. Commissioner*, 88 T.C. 449 (1987), *reconsideration denied by* 89 T.C. 1050 (1987).

[1042] Treas. Reg. 1.761-2(a)(1).

exchange of investment property: (i) own the property as coowners, (ii) reserve the right separately to take or dispose of their shares of any property acquired or retained, and (iii) do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, then such group may be excluded from the application of the provisions of subchapter K.[1043]

C. Revenue Procedure 2002-22 and Undivided Fractional Interests in Real Property.

1. Background. In structuring a like-kind exchange involving fractional undivided interests in real property, the issue is whether such an undivided interest is an interest in an entity that is not eligible for tax-free exchange under § 1031(a)(1) of the Internal Revenue Code and whether arrangements where taxpayers acquire undivided fractional interests in real property constitute separate entities for federal tax purposes. In Rev. Proc. 2002-22,[1044] the Revenue Service provided certain conditions under which it would consider a request for a ruling that an undivided fractional interest in rental real property is not an interest in a business entity for federal tax purposes.

2. Scope of Rev. Proc. 2002-22. Rev. Proc. 2002-22 applies to co-ownership of rental real property (other than mineral interests) in an arrangement classified under local law as a tenancy-in-common. It provides guidelines for requesting advance rulings solely to assist taxpayers in preparing ruling requests and the Service in issuing advance ruling letters as promptly as practicable. The guidelines set forth therein "are not intended to be substantive rules and are not to be used for audit purposes."

3. Conditions for Issuance of Ruling Under Rev. Proc. 2002-22. The Service ordinarily will not consider a request for a ruling under Rev. Proc. 2002-22 unless the following conditions are satisfied. If the conditions are not satisfied, the Service may still consider a request for a ruling where the facts and circumstances clearly establish that such a ruling is appropriate. Even if the conditions are satisfied, however, the Service may decline to issue a ruling under whenever warranted by the facts and circumstances of a particular case and whenever appropriate in the interest of sound tax administration.

a. Tenancy in Common Ownership. Each of the co-owners must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the property as a whole may not be held by an entity recognized under local law.

b. Number of Co-Owners. The number of co-owners must be limited to no more than 35 persons. For this purpose, a husband and wife are treated as a single

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[1043]Treas. Reg. § 1.761-2(a)(2).

[1044]2002-14 I.R.B. 733,

person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

c. No Treatment of Co-Ownership as an Entity. The co-ownership may not take any of the following actions:

(1) File a partnership or corporate tax return;

(2) Conduct business under a common name;

(3) Execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity; or

(4) Otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity).

The Service generally will not issue a ruling if the co-owners hold interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.

d. Co-Ownership Agreement. The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition; or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property.

e. Voting.

(1) Co-Owners Must Retain Right to Approve Certain Actions. The co-owners must retain the right to approve the following:

(a) The hiring of any manager;

(b) The sale or other disposition of the property;

(c) Any leases of a portion or all of the property, or

(d) The creation or modification of a "blanket lien" (i.e., a mortgage or trust deed that is recorded against the property as a whole).

Any sale, lease, or re- lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners.

(2) Voting Threshold on Other Actions. For all other actions on behalf of the co- ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property.

(3) Limited Power of Attorney to Execute Specific Documents Is Permitted. A co-owner who has consented to an action may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

f. Restrictions on Alienation. In general, each co-owner must have the rights to transfer, partition, and encumber the co- owner's undivided interest in the property without the agreement or approval of any person. The following, however, are permitted:

(1) Restrictions on the right to transfer, partition, or encumber interests in the property that are required by a lender and that are consistent with customary commercial lending practices are not prohibited.

(2) The co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to offer to purchase the co-ownership interest) with respect to any co-owner's exercise of the right to transfer the co-ownership interest in the property.

(3) A co-owner may agree to offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition.

g. Sharing Proceeds and Liabilities upon Sale of Property. If the property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

h. Proportionate Sharing of Profits and Losses. Each co- owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

i. Proportionate Sharing of Debt. The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

j. Options. A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the property is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

k. No Business Activities. Citing Rev. Rul. 75-374, Rev. Proc. 2002-22 provides that the co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). Rev. Proc. 2002-22 provides, however, that activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. An organization described in Section 511(a)(2) refers to an organization subject to the unrelated business income tax. The regulations under 512(b)(3)(A) provide that "payments for the use or occupancy of rooms or other space where services are also rendered to the occupant . . . does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant."[1045]

Rev. Rul. 75-374 concludes that a two-person co-ownership of an apartment building that was rented to tenants did not constitute a partnership for federal tax purposes. In the revenue ruling, the co-owners employed a management company to manage the apartments on their behalf; the management company collected rents, paid property taxes, insurance premiums, repair and maintenance expenses, and provided the tenants with customary services, such as heat, air conditioning, trash removal, unattended parking, and maintenance of public areas. The ruling concludes that the management company's activities in providing customary services to the tenants did not cause the co-ownership to be characterized as a partnership.

In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the property for less than 6 months.

l. Management and Brokerage Agreements. The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the property against any revenues before disbursing each co-

[1045]Treas. Reg. § 1.512(b)-1(c)(5).

owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the property, subject to the approval of the co-owners. The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

m. Leasing Agreements. All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the property, cash flow, increases in equity, or similar arrangements.

n. Loan Agreements. The lender with respect to any debt that encumbers the property or with respect to any debt incurred to acquire an undivided interest in the property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the property.

o. Payments to Sponsor. Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property. For this purpose, a "sponsor" means any person who divides a single interest in the property into multiple co-ownership interests for the purpose of offering those interests for sale.

4. Treatment of Multiple Parcels of Property Leased to a Single Tenant. Where multiple parcels of property owned by the co-owners are leased to a single tenant pursuant to a single lease agreement and any debt of one or more co-owners is secured by all of the parcels, the Service will generally treat all of the parcels as a single "property." In such a case, the Service will generally not consider a ruling request unless:

a. Each co- owner's percentage interest in each parcel is identical to that co- owner's percentage interest in every other parcel;

b. Each co- owner's percentage interests in the parcels cannot be separated and traded independently; and

c. The parcels of property are properly viewed as a single business unit.

Rev. Proc. 2002-22 states that the Service will generally treat contiguous parcels as comprising a single business unit. Even if the parcels are not contiguous, however, the Service may treat multiple parcels as comprising a single business unit where there is a close connection between the business use of one parcel and the business use of another parcel. By way of example, Rev. Proc. 2002-22 provides that an office building and a garage that services the tenants of the office building may be treated as a single business unit even if the office building and the garage are not contiguous.

5. Recent Illustrations of Tenancy-In-Common Arrangements.

a. Private Letter Ruling 200327003 (Mar. 7, 2003). In Priv. Ltr. Rul. 200327003 (Mar. 7, 2003), the Service considered whether an undivided fractional interest in property is an interest in a business entity for purposes of qualification of the interest as eligible replacement property under section 1031(a).

(1) Proposed Structure in Ruling. The proposed structure in the ruling is as follows:

(a) Company to Acquire Commercial Real Property. Taxpayer/Company intends to acquire a fee interest in commercial real property with its own cash.

(b) No Liens on the Property. There will be no liens on the property.

(c) Single Corporate Tenant. Company will lease the property to a single corporate tenant.

(d) Rent at Fair Market Value. Rent under the lease will be at fair market value and will not depend on the income or profits derived by any person from the leased property.

(e) Triple Net Lease. The lease will be a "triple net lease" under which the Lessee is responsible for all costs and expenses related to the property, including real estate taxes, maintenance, insurance and repairs.

(f) Sales of Undivided Interests to No More Than 35 Persons. After acquiring and leasing the property, Company will create and sell undivided fractional interests in the property at fair market value to no more than 35 persons, including itself if it retains an interest, some or all of whom intend to acquire such interests as replacement property under § 1031. Company will continue to hold an interest in the property until all fractional interests are sold, which may take up to 18 months or longer to complete.

(g) No Financing of Sales of Fractional Interests. Neither Company nor any person related to Company will finance any portion of the purchase price of a purchaser's fractional interest.

(h) Title Held as Tenants in Common. Each Co-owner will hold legal title to the property as a tenant in common under local law.

(i) Business Will Not Be Conducted Under a Common Name; No Partnership Return Will Be Filed. The Co-owners will not hold themselves out as partners to third parties, conduct business under a common name, or file a partnership income tax return.

(j) No Business Activities. Company represents that the only activities of the Co-owners (or any person related to the Coowners) with respect to the property will be activities that would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder.

(k) Written Co-Tenancy Agreement. Each Co-owner will enter into a co-tenancy ownership agreement ("Co-tenancy Agreement"), which will govern the relationship among the Co-owners. The Co-tenancy Agreement will provide as follows:

i) Any sale of the entire property, any lease or re-lease of a portion or all of the property, any negotiation or renegotiation of any indebtedness secured by any blanket lien, and the appointment of any manager must be approved by unanimous vote of the Co-owners.

ii) For all other actions, only the approval by holders of more than 50 percent on the undivided fractional interests is required.

iii) Income and expenses will be allocated among the Co-owners in proportion to their individual ownership interests in the property.

iv) A Co-owner may, at any time, sell, finance, or otherwise create a lien upon the Co- owner's own interest, subject to terms of the Co-tenancy Agreement, provided it does not create a lien on anyone else's interest.

v) Any Co- owner is free to sell, assign, or transfer all or a part of its interest in the property, subject to the terms of the Co-tenancy Agreement.

vi) There is no waiver of partition rights among the Co-owners.

(l) Management Agreement. Each Co-owner may, but will not be required to, enter into Management Agreement with Management Company/Manager, to provide accounting, insurance monitoring, and lease monitoring activities for the Coowners. Management Company is an entity that is part of a controlled group of corporations. The Management Agreement will provide as follows:

i) Each Co-owner who enters into the agreement retains the Manager to act as the manager and oversee all administrative, operational and management matters of the property, which include the management of the Lease, the obtaining of various consents when required, monitoring and enforcing the terms of the Lease, re-leasing the property, maintenance of the property, receiving and monitoring the rental revenue and paying certain expenses, distributing the rental proceeds after the payment of expenses, sending notices of default and otherwise overseeing collection efforts as required, monitoring the payment of taxes by the lessee, and inspecting the underlying premises.

ii) Each Co-owner agrees to be obligated for a proportionate share of all cost's associated with the property.

iii) Distributions of each Co-owner's share of net revenue will be made quarterly.

iv) Any Co-owner may terminate the Management Agreement provisions concerning accounting and distributions at any time and seek to collect its share directly from the tenant.

v) If the property operates at a loss or if capital improvements, repairs or replacements are required, the Co-owners will, upon request, make necessary payments in proportion to their individual ownership interests in the property.

vi) Not less than annually, the Manager will provide each Co-owner with an annual written notice of the renewal of the agreement. The notice will provide each Co-owner with the opportunity to exercise the Co- owner's right to terminate the agreement, which can be done at any time under the agreement with just 60 days notice. Otherwise, the Management Agreement will continue in force until the sale of the entire fee interest in the premises by each Coowner.

vii) Any advance made by the Manager on behalf of any Co-owner is on a recourse basis and must be repaid within a 30-day period following the advance.

viii) Each Co- owner is obligated to pay a fee set a fair market value for the services provided. The fee is payable irrespective of whether rents are actually collected.

ix) The Manager is authorized to offset the costs of operating the property against any revenues derived from the property before distributing each Co-owner's proportionate share of net income.

x) Finally, the books and records relating to the property will be maintained at the principal office of the Manager.

(2) Conclusion of Ruling and Analysis. The Revenue Service determined that Company's co-ownership arrangement satisfies all of the conditions set forth in Rev. Proc. 2002-22 and concluded that the undivided fractional interest in the property will not constitute an interest in a business entity for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a). The Ruling made the following observations:

(a) Company's Co-tenancy Agreement provides that any sale, lease, or re-lease of a portion or all the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, and the hiring of a manager, requires the unanimous approval of the Coowners. All other actions on behalf of the co-ownership require the vote of those holding more than 50 percent of the undivided interests in the property.

(b) Company's Management Agreement, which the Co-owners may enter into, requires the manager to send a notice of renewal to each Co-owner annually at which time each Co-owner could exercise its right to terminate the management agreement at any time with just 60 days notice. Although not an affirmative consent, the notice requirement in Company's management agreement containing the right of any Co-owner to terminate the agreement at any time with just 60 days notice satisfies the conditions in Rev. Proc. 2002-22 regarding unanimous annual renewals of any management agreement.

(c) The activities of Company and any person related to Company with respect to the property must be taken into account in determining whether the coowners' activities are customary activities. After acquiring and leasing the property, Company will create and sell undivided fractional interests in the property at fair market value. Company will continue to own some undivided interests in the property until all are sold, which may take 18 months or longer to complete. During this period, the property will be leased to a lessee under a triple net lease, thereby limiting the activities by the Co-owners. In addition, Company represented that the only activities of the Co- owners, including Company, (or any person related to the Co-owners) with respect to the property will be activities that would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. Thus, Company's activities in the capacity as a Co-owner during this period after acquiring and leasing the property will not violate the condition regarding no business activity.

b. Private Letter Ruling 200513010 (Dec. 6, 2004). In Private Letter Ruling 200513010, the Revenue Service again considered whether an undivided fractional interest in rental real property is an interest in a business entity for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a) of the Internal Revenue Code.

(1) Proposed Structure in Ruling. The proposed structure in the ruling is as follows:

(a) Fee Interest in Property. Company intends to acquire a fee interest in property.

(b) Property Subject to Existing Leases. Prior to the acquisition by Company, portions of property will have been leased to certain tenants. None of the tenants are related to Company. Under each lease, the tenant will be responsible for:

i) Its pro-rata share of real estate taxes and operating expenses.

ii) The maintenance, repair and replacement of heating and air conditioning fixtures, equipment and systems, all lighting and plumbing fixtures, all interior walls, partitions, doors and windows, all exterior entrances, windows, doors and docks and the replacement of all broken glass.

iii) Keeping and maintaining property and areas adjoining property in a clean and orderly condition, free of accumulation of dirt, rubbish, snow and ice.

(c) **Rent at Fair Market Value.** The rent due under each lease will reflect the fair market value for the use of property and will not depend, in whole or in part, on the income or profits derived by any person from property. All future leases entered into with respect to property will be consistent with the leases in existence when property is acquired.

(d) **Sales of Undivided Interests to No More Than 35 Persons.** Following acquisition, Company will create and sell undivided fractional interests in property at fair market value to no more than 35 persons (Co-owners). Company will retain a percentage undivided fractional interest in property. Each Co-owner will acquire its interest in property by paying cash and/or assuming a pro-rata share of a blanket debt on, and all obligations relating to, property.

(e) **Written Co-Tenancy Agreement.** Each Co-owner will be required to enter into a co-tenancy ownership agreement (co-tenancy agreement). The co-tenancy agreement will provide as follows:

i) The unanimous consent of all Co-owners will be required to enter into any amendments, consents to assignment, subleases, re-leases, or modifications of any lease of property or guarantees of lease, the sale of the property, the appointment or reappointment of a property manager for property under the management agreement, or the incurrence of any indebtedness secured by property. For all other actions, the approval by holders of more than 50 percent of the undivided fractional interests will be required.

ii) Income, expenses (including debt service payments for any debt which is a blanket lien on property), and any net proceeds from a sale or refinancing of property, will be allocated among the Co-owners in proportion to their respective ownership interests in property.

iii) A Co-owner may, at any time, sell, finance, or otherwise create a lien upon the Co-owner's own interest, provided it does not create a lien on anyone else's interest.

iv) Any Co-owner may freely sell, assign, or transfer all or a part of its interest in property.

v) Each Co-owner will also have the right, subject to any restrictions contained in any documents related to any loan on property, to exercise a right of partition with respect to its interest in property, and to file a complaint or institute any proceeding at law or in equity to have property partitioned. However, before exercising any right to partition, each Co-Owner will agree to offer its interest for sale to the other Co-Owners at fair market value, as determined by an independent appraisal.

vi) Each Co-owner will grant an option to the other Co-owners to acquire its interest at fair market value in the event: (i) there is a proposal to sell part or all of property, or to incur indebtedness to be secured by property, or to modify any lease (or guarantee of a lease) of property and the Co-owner votes not to proceed in circumstances where holders of more than 50% of the Co-Ownership interests vote to proceed with the proposed action; or (ii) a Co-owner provides a notice of termination of the management agreement. If the proposed action is to sell part or all of property to an unrelated third party who has made a bona fide offer, the fair market value will be determined by reference to the price proposed for the entire property multiplied by the Co-owner's percentage interest in property. Otherwise, the fair market value will be determined by an independent appraisal of the total fair market value of the entire property multiplied by the Co-owner's percentage interest in property.

(f) **Management Agreement.** Following the purchase of an interest, each Co-owner will enter into a management agreement with Management Company. Management Company is related to Company through a common parent. The management agreement will provide as follows:

i) Management Company will agree to manage all administrative, operational and management matters of property, including but not limited to the management of all lease agreements.

ii) Each Co-owner who enters into the agreement retains the Management Company to act as the manager and oversee all administrative, operational and management matters of property, which include the following:

a) Monitoring the submission of rents and any other payments due under the lease;

b) Monitoring the payment of any taxes and special assessments with respect to property;

c) Ensuring that they are paid in a timely fashion and commencing collection activities if a lessee is delinquent;

d) Requesting annual financial statements and other reports to the extent required from any lessee under the terms of the lease;

e) Overseeing the inspection of the property;

f) Monitoring lessee's compliance with terms of the lease;

g) Establishing accounts to hold funds collected pursuant to each lease and disbursing those funds to the Co-owners;

h) Providing customary property management services necessary to preserve, protect and enhance the value of the property;

i) Re-leasing the property; and

j) Providing for timely payment of principal, interest and other amounts due to any lender which has a blanket lien on the property.

All activities with respect to property will be customary services as defined in Rev. Rul. 75-374.[1046]

iii) Management Company will maintain full, accurate and complete records of the Co-owners' income and operating expenses at its principal office and each Co-owner will have access to the records.

iv) Management Company will distribute to each Co-owner: (i) within 30 days after the end of each calendar quarter, financial statements prepared by the Management Company; (ii) within 90 days after the end of each calendar year, financial statements prepared by an independent accounting firm; and (iii) annual tax information relating to the property.

v) Each Co-owner agrees to be obligated for a proportionate share of all costs associated with the property, to the extent that the revenues from property are insufficient to cover the costs. If the property operates at a loss or if capital improvements, repairs or replacements are required, for which capital reserves do not exist, the Co-owners will, upon request, make necessary payments in proportion to their individual ownership interests in the property. Distributions of each Co-owner's share of net revenue will be made at least quarterly.

vi) The term of the management agreement will be 12 months (12-month term), renewable annually under the following procedures:

a) Within a prescribed range of dates prior to the end of each 12-month term (renewal period), the Management Company will provide Co-owners with a notice of renewal of the management agreement. Such notice will provide each Co-owner the opportunity to object to specific provisions of the agreement as well as to terminate the agreement as set forth in the notice of renewal. The notice of renewal will be sent to each Co-owner at the address provided by the Co-owner for this purpose using certified mail,

[1046] 1975-2 C.B. 261.

return receipt requested (postage prepaid), or by using a nationally recognized courier service that guarantees overnight delivery, either alternative being an "approved notice method". The notice of renewal will set forth the following procedures and will include the names and addresses of each Co-owner.

b) Any Co-owner (objecting Co-owner) may cause the management agreement not to be renewed by providing a notice of termination to the Manager and to the other Co-owners by the approved notice method prior to the end of the renewal period, provided the objecting Co-owner sets forth a substitute manager and the material terms under which the substitute manager will be engaged. The engagement of the substitute manager will be subject to the approval of each of the other Co-owners.

c) Each Co-owner will have a certain number of days after the date of the notice of termination to provide written notice by the approved notice method to the Objecting Co-owner and the other Co-owners that the substitute manager is unacceptable and the reasons therefore. If any Co-owner provides notice that the substitute manager is unacceptable, the following procedures apply:

d) The other non-objecting Co-owners may exercise the option to acquire the ownership interest(s) of the objecting Co-owner at fair market value.

e) If the other non-objecting Co-owners do not exercise their option to acquire the ownership interest of the objecting Co-owner, the objecting Co-owner, within a certain number of days of being notified that the alternative management arrangements are not acceptable, on its own behalf and at its own expense, may retain the substitute management company. As a result, the objecting Co-owner will cease to be a party to the original management agreement and will no longer be responsible to Management Company for any fees or associated expenses. However, the objecting Co-owner will remain subject to the terms of the co-tenancy agreement. In this event the objecting Co-owner must provide written notice to Management Company and the other non-objecting Co-owners. In such case, the managers must consult on all actions; however, except in cases in which unanimous approval of all Co-owners is required, the manager representing the controlling Co-owners will be able to act without the approval of the co-manager.

f) The Co-owners who did not provide a notice of termination will be treated as consenting to a renewal of the Management Agreement.

g) A Co-owner may object to specific provisions in the Management Agreement by providing a notice of objection to the Management Company and to the other Co-owners within days of the receipt of the notice of renewal. The Management Company and the Co-owner(s) may negotiate to modify specific terms of the Management Agreement. If no agreement is reached, a Co-owner may provide a notice of termination as described above on or before a prescribed day before the end of the renewal period. Subsequently, the procedures described above will apply.

h) Notwithstanding the requirement that the Management Company otherwise obtain unanimous consent for the lease or re-lease of all or Zany portion of the property, the Management Company may, without obtaining consent of the Co-owners, lease (or re-lease) up to a prescribed percentage of the total leaseable space, in the aggregate. Any leases entered into by the Management Company pursuant to this provision must meet certain unanimously approved lease guidelines provided by the Co-owners annually. Such lease guidelines will include parameters relating to credit worthiness, type of tenants, rental ranges and length of rental term. Once unanimously agreed to, the lease guidelines cannot be altered or amended except upon the unanimous consent of all the Co-owners.

i) Each Co-owner will be obligated to pay the Co-owner's pro rata share of a fee set at fair market value for the services provided. The fee will be payable irrespective of whether rents are actually collected. Management Company will be authorized to offset the costs of operating property against any revenues derived from property before distributing each Co-owner's proportionate share of net income. In addition, Management Company may advance funds on behalf of any Co-owner. The advance will be recourse as to each Co-owner and each Co-owner will be obligated to repay the advance within a prescribed number of days. In the event that the Co-owner is a disregarded entity that provides limited liability to the owner of the entity, the advance will be recourse to the owner of the disregarded entity.

(2) Conclusion and Analysis. The Revenue Service determined that Company co-ownership arrangement satisfied all of the conditions set forth in Rev. Proc. 2002-22 and concluded that an undivided fractional interest in property will not constitute an interest in a business entity for purposes of qualification of the undivided fractional interest as eligible replacement property under § 1031(a). The Revenue Service made the following observations:

(a) Company's co-tenancy agreement provides that any sale, lease, or re-lease of a portion or all the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, and the hiring of a manager, requires the unanimous approval of the Co-owners. All other actions on behalf of the co-ownership require the vote of those holding more than 50 percent of the undivided interests in the property. The management agreement requires the Management Company to send a notice of renewal to each Co-owner annually at which time each Co-owner could exercise its right to terminate the management agreement. The renewal procedures allow each Co-owner to exercise the right of an owner of real property to control the use of the property. As a result, the provisions relating to changing managers and altering the management agreement satisfy the requirements of Rev. Proc. 2002-22.

(b) Company's management agreement provides that Management Company may lease or re-lease up to a prescribed percentage in the aggregate of the total leaseable space of property based on specific lease guidelines unanimously approved by the Co-owners. The lease guidelines will relate to the credit worthiness and type of tenant, rental ranges, and length of lease term. The guidelines can be amended only by unanimous agreement of the Co-owners. This arrangement to provide some limited flexibility in managing the leasing of property while maintaining the owners' rights to direct and limit that flexibility satisfies the requirements of Rev. Proc. 2002-22.

(c) After acquiring and leasing the property, Company will create and sell undivided fractional interests in the property at fair market value. Company will continue to own a percentage undivided interest in the property and is related to Management Company through a common parent. The property will be leased under a net lease to unrelated tenants. In addition, Company represents that the only activities of the Co- owners, including Company, (or any person related to the Co-owners) with respect to the property will be customary activities within the meaning of Rev. Proc. 2002-22.

XII: ALLOCATION RULES APPLICABLE TO SALES OF A TRADE OR BUSINESS.

A. Background.

1. Sale of Ongoing Business Viewed as Sale of Individual Assets. For U.S. federal income tax purposes, the sale of an ongoing trade or business for a lump sum amount is viewed as a sale of each individual asset rather than a single capital asset.[1047] The seller must allocate the purchase price among the assets sold to determine the amount and character of its realized gain or loss on the sale. The purchaser's allocation determines its basis in each asset and will affect its amount of allowable depreciation, cost depletion, or amortization deductions, its realized gain or loss on a subsequent sale of those assets, and may have other tax consequences.

2. Application of Asset Allocation Rules of Section 1060. In 1986, Congress added the asset allocation rules of Section 1060(a) to the Internal Revenue Code (the "Code"). These rules generally provide that, in certain asset acquisitions, the seller and

[1047] *See Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945); Rev. Rul. 70-465, 1970-2 C.B. 162 ("For Federal income tax purposes, the sale of a going business is a sale of the individual assets. The selling price must be allocated among all the assets sold according to their respective fair market values, and separate computations must be made of the gain or loss with respect to each asset sold for which there is a separately identifiable basis making this computation possible."); *cf. Leon H. Perlin Co. Inc. v. Commissioner*, 65 T.C.M. (CCH) 2013, 2022 n. 11 (1993) ("Williams v. McGowan holds that the sale of a hardware business as a going concern should not be treated as a single piece of property representing a "capital asset" but rather should be divided into its components, each of which would then be separately matched against the statutory definition of capital asset. Although Williams does not specifically require that an allocation of purchase price be based upon fair market value of the assets sold, such a requirement is generally recognized." [Citation omitted.]), *rev'd on other grounds*, 47 F.3d 1165 (4th Cir. 1995) ("The parties agree that the tax court properly attempted to allocate the proceeds of the Realtec sale among the assets purchased based on their fair market value on the date of the sale and that to the extent that a portion of the sales price was properly allocated to the claim for the unsecured advances the claim correctly could be viewed as having that value for purposes of determining whether the Perlin Company was entitled to a bad-debt deduction and the amount of the constructive dividend received by Perlin."); Tech. Adv. Memo 9639009 (Sept. 27, 1996) ("Where several capital assets are sold as a group at the same time, the transaction must be treated as the sale of separate assets, and the holding period of each asset determined independently."); Priv. Ltr. Rul. 8946001 (June 28, 1989) ("When a group of assets is purchased for a lump sum purchase price, the basis of each asset acquired must be determined by an allocation of purchase price among the assets purchased, Williams v. McGowan." [Citation omitted.]). Although private letter rulings, field service advice and technical advice memoranda are not binding as "precedent," they often represent a substantial indication of the position of the Internal Revenue Service on an issue.

purchaser must allocate the purchase price among the assets transferred in accordance with the method prescribed by the Treasury in regulations. The Service has observed that "Section 1060 provides no independent basis for determining the amount a taxpayer realizes on the sale of the assets or the time such amount may be taken into account; the amount realized and the time such amount is taken into account are determined solely under generally applicable tax accounting principles."[1048]

3. **Weight Accorded to Allocation.** If parties to an acquisition of a business make a specific contractual allocation with appropriate regard to value, they are generally bound by this allocation for U.S. federal income tax purposes.[1049] The Internal Revenue Service ("Revenue Service" or the "Service"), however, is not bound by the parties' allocation agreement. The Service is not restricted from challenging the allocations or values set forth in the allocation agreement.[1050] When reviewing the parties' allocation agreement, two different standards apply. The Tax Court will generally give deference to the parties when they have competing tax interests. If, on the other hand, the parties do not have adverse tax interests, the Tax Court will strictly scrutinize the allocation agreement.[1051] The courts use a higher standard in such cases because competing tax interests deter allocations which lack economic reality.[1052]

[1048]*Cf.* Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) ("Section 1060 provides no independent basis for determining the amount a taxpayer realizes on the sale of the assets or the time such amount may be taken into account; the amount realized and the time such amount is taken into account are determined solely under generally applicable tax accounting principles.").

[1049]I.R.C. § 1060(a); *see* Treas. Reg. § 1.1060-1(c)(4); *see also* H. Rept. 101-881, 101st Cong., 2nd Sess. at 351 (1990) ("The committee does not intend to restrict in any way the ability of the IRS to challenge the taxpayer's allocation to any asset or to challenge the taxpayers' determination of the fair market value of any asset by any appropriate method, particularly where there is a lack of adverse tax interests between the parties."); *cf.* F.S.A. 1999-960 (Oct. 14, 1992) ("If a buyer and seller agree upon a specific purchase price allocation upon the sale of a business, they are bound by such allocation for tax purposes.").

[1050]*See* Treas. Reg. § 1.1060-1(c)(4); *Langdon v. Commissioner*, 2003-1 USTC 50,244, at 87,520 (8th Cir. 2003), *aff'g* 82 T.C.M. (CCH) 677 (2001); *cf.* NSAR 020063 (Apr. 4, 2002) ("In our case, the government has determined that the allocation of the purchase price made by the taxpayers was not appropriate. The government can go beyond the formal dealings of the parties to see if they reflect meaningful substance. One thing that the government should consider is whether different allocations of the purchase price would result in adverse tax consequences for the purchaser. This is important because adverse tax interests deter allocations which lack economic reality. The court strictly scrutinizes an allocation if it does not have adverse tax consequences for the parties. In our opinion, no adverse tax consequences existed for the purchaser." [Citations omitted.]).

[1051]*Langdon*, 2003-1 USTC ¶ 50,244, at 87,520 ("When reviewing the parties' allocation agreement, two different standards apply. The tax court will give deference to the parties when they have competing tax interests. If, on the other hand, the parties do not have adverse tax interests, the tax court will strictly scrutinize the allocation agreement. Courts use a higher standard in such cases because competing tax interests deter allocations which lack economic reality."), *aff'g Bemidji Distributing Co., Inc. v. Commissioner*, 82 T.C.M. (CCH) 677, 681 (2001) ("We strictly scrutinize an allocation if it does not have adverse tax consequences for the parties; adverse tax interests deter allocations which lack economic reality."); *Lorvic Holdings, Inc. v. Commissioner*, 76 T.C.M. (CCH) 220, 226 (1998) ("We strictly scrutinize an allocation if it does not have adverse tax consequences for the parties; adverse tax interests deter allocations which lack economic reality."); *Howard Pontiac-GMC Inc. v. Commissioner*, 74 T.C.M. (CCH) 45, 49 (1997) ("The amount a taxpayer pays or allocates to a covenant not to compete is not always controlling for tax purposes. We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality."); *Thompson v. Commissioner*, 73

B. When Does Section 1060 Apply? Section 1060(a) applies in the case of an "applicable asset acquisition," which is generally any transfer of a group of assets constituting a trade or business (in the hands of either the seller or purchaser)[1053] if the purchaser's tax basis in the assets is determined wholly by reference to the amount paid for the assets.[1054]

1. Group of Assets Constituting a Trade or Business. A group of assets constitutes a trade or business if: (1) the use of such assets would constitute an active trade or business (within the meaning of Section 355 of the Code); or (2) its character is such that goodwill or going concern value could under any circumstances attach to such group.[1055]

a. Active Trade or Business. In determining whether a group of assets constitutes an active trade or business, a "trade or business" is generally defined as a specific group of activities carried on for the purpose of earning income or profit.[1056] Such

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T.C.M. (CCH) 3169, 3174 (1997) ("The amount a taxpayer pays or allocates to a covenant not to compete is not always controlling for tax purposes. We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality."); *Heritage Auto Center, Inc. v. Commissioner*, 71 T.C.M. (CCH) 1839, 1846 (1996) ("In the case at bar, respondent has noted this lack of a tax rate differential, and she argues that the buyers and Mr. Wright did not have adverse tax interests when negotiating the allocations which are the subject of this case. We agree. Accordingly, we strictly scrutinize these allocations." [Citations omitted.]); *Freres v. Commissioner*, 70 T.C.M. (CCH) 1549, 1553 (1995) ("We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality."); *Beaver Bolt, Inc. v. Commissioner*, 70 T.C.M. (CCH) 1364, 1368 (1995) ("We must decide whether any of the amount allocated to the covenant not to compete was a disguised payment for Grecco's stock in petitioner. The amount a taxpayer allocates to a covenant not to compete is not always controlling for tax purposes. We strictly scrutinize an allocation if the parties do not have adverse tax interests because adverse tax interests deter allocations which lack economic reality.").

[1052]*Langdon*, 2003-1 USTC ¶ 50,244, at 87,520.

[1053]*See* Treas. Reg. § 1.1060-1(b)(3), Example 1 (purchaser cannot avoid application of Section 1060 by arguing that assets of acquired business will not be used in same business).

[1054]I.R.C. § 1060(c); Treas. Reg. § 1.1060-1(b)(1); *West Covina Motors, Inc. v. Commissioner*, 98 T.C.M. (CCH) 615, 616 (2009) ("An applicable asset acquisition is any transfer (whether direct or indirect) of assets constituting a trade or business and in which the transferee's basis is determined wholly by reference to the consideration paid for such assets. Generally, a written agreement is binding in such an acquisition as to the allocation of the consideration or as to the fair market value of any of the assets. Where the parties do not allocate the consideration entirely, however, the residual method of purchase price allocation may apply to determine both the purchaser's basis in, and the seller's gain or loss from, each of the transferred assets."); *cf.* Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) ("Seller's nuclear assets, including Plant, equipment, operating assets, and the assets of the nonqualified nuclear decommissioning fund, constitute a trade or business in Seller's hands and the gain or loss recognized with respect to those assets will be determined wholly by reference to Seller's amount realized. Thus, Seller's transfer of it's c percent undivided interest in Plant, equipment, operating assets, and the assets of the nonqualified nuclear decommissioning fund to Buyer in exchange for cash, the assumption of Seller's nuclear decommissioning liability is an applicable asset acquisition as described in section 1060 and the regulations thereunder." [Footnote omitted.]). For a recent insightful article discussing the application of Section 1060, see Rizzi, *Purchasing Assets in a Depreciating Economy: Allocations and Anomalies*, 36 J. Corp. Tax'n 22 (Jan/Feb 2009).

[1055]Treas. Reg. § 1.1060-1(b)(2).

[1056]Treas. Reg. § 1.355-3(b)(2)(ii).

group of activities ordinarily must include the collection of income and the payment of expenses.[1057] The determination whether a trade or business is actively conducted will be made from all of the facts and circumstances.[1058]

b. Attachment of Goodwill or Going Concern Value. For purposes of determining whether goodwill or going concern value could under any circumstances attach to a group of assets, the regulations provide that goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.[1059]

2. Purchaser's Tax Basis Must Be Determined Wholly by Reference to Amount Paid. Section 1060 applies in cases where a purchaser of assets obtains a "cost" basis in an applicable asset acquisition.[1060]

C. How Does Section 1060 Allocate Consideration Among Assets? Section 1060(a) provides that, in the case of an applicable asset acquisition, the consideration received for such assets must be allocated among the acquired assets in the same manner as amounts are allocated to assets under Section 338(b)(5) of the Code.[1061] Treasury Regulation § 1.1060-1(a)(1) provides additional guidance by prescribing rules relating to the allocation requirements of Section 1060.[1062] That section of the regulations provides that, in the case of an applicable asset acquisition, sellers and purchasers must allocate the consideration under the "residual

[1057] *Id.*

[1058] Treas. Reg. § 1.355-3(b)(2)(iii).

[1059] Treas. Reg. § 1.1060-1(b)(2)(ii).

[1060] I.R.C. § 1060(c); *West Covina Motors Inc. v. Commissioner*, 98 T.C.M. (CCH) 615, 616 ("An applicable asset acquisition is any transfer (whether direct or indirect) of assets constituting a trade or business and in which the transferee's basis is determined wholly by reference to the consideration paid for such assets.").

[1061] Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) ("Section 1060 provides that, in the case of an 'applicable asset acquisition,' the consideration received shall be allocated among the acquired assets in the same manner as amounts are allocated to assets under section 338(b)(5). Section 1.1060- 1(a)(1) provides that, in the case of an applicable asset acquisition, the seller and the purchaser each must allocate the consideration paid or received in the transaction under the residual method as described in sections 1.338-6 and 1.338-7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets.").

[1062] Treas. Reg. § 1.1060-1(a)(1).

method" as described in Treasury Regulation §§ 1.338-6 and 1.338-7 in order to determine, respectively, the amount realized from, and the basis in, each of the transferred assets.[1063]

1. Description of Residual Method. The residual method is based on a division of assets into seven classes. Sale consideration is first reduced by the amount of Class I assets (if any) transferred by the seller.[1064] The remaining consideration is then allocated among Class II assets (to the extent of and in proportion to fair market value), then among Class III assets (to the extent of and in proportion to fair market value), then among Class IV assets (to the extent of and in proportion to fair market value), then among Class V assets (to the extent of and in proportion to fair market value), then among Class VI assets (to the extent of and in proportion to fair market value), and finally to Class VII assets.[1065]

2. Description of Seven Classes of Assets. The seven classes of assets set forth in the regulations are as follows:

[1063]Treas. Reg. § 1.1060-1(a)(1); Treas. Reg. § 1.1060-1(c)(2); *cf.* F.S.A. 200144028 (Nov. 2, 2001) ("Sections 338(b) and 1060 address the potential controversies and measurement issues that may arise regarding purchase price allocations by mandating the use of a residual method of allocation. Under the residual method, the assets of a going business, other than goodwill and going concern value, must be placed into distinct asset classes, as follows: (1) Class I — Cash and cash equivalents; (2) Class II — Certificates of deposit, U.S. government (3) All assets not in securities, readily marketable stock or securities, and foreign currency; Class I, II, IV, and V; and (4) Class IV — all section 197 intangibles, except those in the nature of goodwill and going concern value; (5) Class V —section 197 assets in the nature of goodwill and going concern value. The purchase price is then allocated among these asset classes in priority order. Under this allocation scheme, no asset in any class (except the residual class) may be allocated more than its fair market value. If the consideration allocable to a particular asset class is less than the aggregate fair market value of the assets within that class, each asset is allocated an amount of consideration in proportion to its relative fair market value and nothing is allocated to any junior class. * * * Application of the residual method eliminates the need for a separate determination of the value of goodwill and going concern value. Instead, under the residual method, any "premium." in excess of the total fair market value of the purchased assets (other than goodwill and going concern value) is treated as a payment for goodwill and going concern value. The assignment of goodwill and going concern value to a true residual class reflects the concept that assets in the nature of goodwill and going concern value cannot be valued independently from the purchase price of the overall transaction because these intangible assets are not transferable apart from the business as a whole.").

[1064]Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(1).

[1065]Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(i); *cf.* Priv. Ltr. Rul. 200602028 (Jan. 13, 2006) ("The residual method is based on a division of assets into seven classes: Class I (generally consisting of cash, and general deposit accounts held in banks, savings and loan associations, and other depository institutions), Class II (generally consisting of actively traded personal property like U.S. government securities and publicly traded stock, but also including certificates of deposit and foreign currency even if they are not actively traded personal property), Class III (accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business), Class IV (stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business), Class V (all assets other than Class I, II, III, IV, VI, and VII assets), Class VI (all section 197 intangibles, as defined in that section, except goodwill and going concern value), and Class VII (goodwill and going concern value, whether or not it qualifies as a section 197 intangible).").

a. Class I Assets. Class I assets consist of cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions.[1066]

b. Class II Assets. Class II assets consist of actively-traded personal property, certificates of deposit and foreign currency. Examples of Class II assets include U.S. government securities and publicly-traded stock.[1067]

c. Class III Assets. Class III assets consist of debt instruments (including accounts receivable) and assets that the taxpayer marks to market at least annually for federal income tax purposes.[1068]

d. Class IV Assets. Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.[1069]

e. Class V Assets. Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.[1070]

f. Class VI Assets. Class VI assets are all Section 197 intangibles, as defined in Section 197, except those in the nature of goodwill and going concern value.[1071] Thus, Class VI should include such items as (1) certain specified types of intangible property generally relating to workforce, information base, know how, customers, suppliers, or other similar items;[1072] (2) any license, permit, or other right granted by a government unit or agency;[1073] (3) any covenant not to compete or similar arrangement entered into in connection with the acquisition of an interest in a trade or business;[1074] and (4) any franchise, trademark, or trade name.[1075]

[1066] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(1).

[1067] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(ii).

[1068] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(iii).

[1069] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(iv).

[1070] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(v).

[1071] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(b)(2)(vi).

[1072] I.R.C. § 197(d)(1)(C).

[1073] I.R.C. § 197(d)(1)(D).

[1074] I.R.C. § 197(d)(1)(E).

[1075] I.R.C. § 197(d)(1)(F); see Instructions to IRS Form 8594 (Rev. December 2008).

g. Class VII Assets. Class VII assets consist of Section 197 intangibles in the nature of goodwill and going concern value.[1076]

3. Allocation Not to Exceed Fair Market Value. The amount of consideration allocated to an asset (other than Class VII assets) cannot exceed the fair market value of that asset on the purchase date.[1077] Generally, the "fair market value" of an asset is its gross fair market value determined without regard to mortgages, liens, pledges, or other liabilities.[1078]

4. Example Illustrating Operation of Section 1060. Suppose that on January 1, 2001, S, a sole proprietor, sells to P, a corporation, a group of assets that constitutes a trade or business for purposes of Section 1060. S, who plans to retire immediately, also executes in P's favor a covenant not to compete. P pays S $3,000 in cash and assumes $1,000 in liabilities. Thus, the total consideration is $4,000.

On the purchase date, P and S also execute a separate agreement that states that the fair market values of the Class II, Class III, Class V, and Class VI assets S sold to P are as follows:

Asset Class	Asset	Fair Market Value
II	Actively traded securities	$500
	Total Class II	500
III	Accounts receivable	200
	Total Class II	200
V	Furniture and fixtures	800
	Building	800
	Land	200
	Equipment	400
	Total Class V	2,200
VI	Covenant not to compete	900
	Total Class VI	900

P and S each allocate the consideration in the transaction among the assets transferred in accordance with the agreed upon fair market values of the assets, so that $500 is allocated to Class II assets, $200 is allocated to the Class III asset, $2,200 is allocated to Class V assets, $900 is allocated to Class VI assets, and $200 ($4,000 total consideration less $3,800 allocated to assets in Classes II, III, V, and VI) is allocated to the Class VII assets (goodwill and going concern value).

[1076] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(vii).

[1077] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(c)(1).

[1078] Treas. Reg. § 1.1060-1(c)(2); Treas. Reg. § 1.338-6(a)(2)(i).

In connection with the examination of P's return, the Revenue Service, in determining the fair market values of the assets transferred, may disregard the parties' agreement. Assume that the Revenue Service correctly determines that the fair market value of the covenant not to compete was $500. Since the allocation of consideration among Class II, III, V, and VI assets results in allocation up to the fair market value limitation, the $600 of unallocated consideration resulting from the Revenue Service's redetermination of the value of the covenant not to compete is allocated to Class VII assets (goodwill and going concern value).[1079]

D. Reporting Requirements Under Section 1060.

1. In General. If Section 1060 applies to an asset acquisition, the seller and the purchaser are each required to file Form 8594 with respect to the allocation of the consideration among the assets transferred.[1080] Each must file Form 8594 with its income tax return for the tax year that includes the purchase date.[1081]

[1079]Treas. Reg. § 1.1060-1(d), *Example 2*.

[1080]Treas. Reg. § 1.1060-1(e)(1)(i).

[1081]Treas. Reg. § 1.1060-1(e)(1)(ii)(A). In I.L.M. 1998-478 (Sept. 16, 1998), the IRS Chief Counsel's Office stated as follows:

> This responds to the Technical Coordination Report submitted by George K. Nunziata of the Pacific Northwest District. Mr. Nunziata states that the Internal Revenue Code does not include an information reporting requirement for the sale of various asset components involved in the sale of a trade or business. Section 6045 of the Internal Revenue Code requires the filing of Form 1099-S to report the sale of real property, but, as Mr. Nunziata states, there is no similar reporting requirement for the sale of goodwill or a covenant not to complete.
>
> Rev. Rul. 55-79, 1955-1 C.B. 370, states that for federal income tax purposes, the sale of a going business operated as a sole proprietorship does not constitute the sale of a single asset, but is instead a sale of the individual assets comprising the business. Section 1060 and section 1.1060-1T(h) require the filing of an information return by both transferor and transferee in any applicable asset acquisition. An "applicable asset acquisition" is defined in section 1060(c) as any transfer (1) of assets which constitute a trade or business, and (2) with respect to which the transferee's basis in those assets is determined wholly by reference to the consideration paid for the assets. If goodwill or a going concern value could under any circumstances attach to the group of assets, the group constitutes a trade or business for purposes of section 1060 (section 1.1060-1T(b)(2)). Both seller and purchaser in an applicable asset acquisition must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. Each must file Form 8594, Asset Acquisition Statement Under Section 1060, with their respective income tax returns or returns of income for the taxable year that includes the purchase date.
>
> Very often, the sale of a trade or business that is operated as a sole proprietorship involves the sale of real property from which that trade or business had been operated. Section 6045(e) requires the filing of Form 1099-S for real estate transactions. Section 1.6045-4(b)(1) states that a "real estate transaction" is a transaction that consists in whole or in part of the sale or exchange of reportable real estate. Section 1.6045-4(b)(2) states that "reportable real estate" includes any inherently permanent structure, including any residential, commercial, or industrial building. Certain types of transactions and certain types of property are exempt from section 6045's reporting requirement; but in general, the sale of real estate as part of the sale of a trade or business must be reported under the requirements of section 6045. We are not aware of any authority that holds that Form 8594 need not be filed merely because a Form 1099-S has been filed.

2. **Subsequent Adjustments to Consideration.** The purchaser and seller are also required to make a supplemental statement on Form 8594 concerning increases (or decreases) in the amount of consideration allocated to an asset if such increases (or decreases) in consideration occur after the end of its tax year that includes the purchase date. Form 8594, reporting the increase (or decrease) in consideration, must be filed with the return for the tax year in which the increase (or decrease) is taken into account.[1082]

E. Information Required in Case of Certain Transfers of Interests in Entities. If a taxpayer owning at least a 10% interest (directly or indirectly) in an entity transfers an interest in the entity and, in connection with the transfer, the transferor enters into an employment contract, covenant not to compete, royalty, lease or other agreement with the transferee, Section 1060(e) requires that the transferor and the transferee report the transfer at such time and in such manner as may be required by the Revenue Service.[1083] Thus far, the Service has not issued regulations prescribing such information.

F. Sale of Disregarded Entity. For federal income tax purposes, the sale by a partnership of an interest in an entity that is disregarded should be treated as a sale of the assets of the disregarded entity.[1084] If an entity is disregarded, its activities are treated in the same

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> Under section 6041, all persons engaged in a trade or business and making payment in the course of that trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income of $600 or more in any taxable year must file an information return. The form most commonly used for this purpose is Form 1099-MISC, which fully identifies both the payor and the recipient, and states the amount of income paid to the recipient. Neither the Code nor the regulations impose on the payor a duty to determine how much of the payment will be income to the payee, e.g., if inventory is being sold, the payor/buyer is not required to determine the payee/seller's basis in the inventory, to allocate a portion of the selling price to it, and to compute the payee's gain on the sale of the inventory. As a result, very often the sale of a sole proprietorship may not require the filing of Form 1099-MISC under section 6041. However, neither the Code nor the regulations exempt a transaction from the requirements to file Form 8594 merely because section 6041's information return requirements are not applicable to the transaction.

[1082] Treas. Reg. § 1.1060-1(e)(1)(ii)(B).

[1083] I.R.C. § 1060(e).

[1084] *See* Treas. Reg. §§ 301.7701-2, 301.7701-3; Rev. Rul. 99-5, 1999-1 C.B. 434 ("In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, *B*, purchases an interest in the disregarded entity from the owner, *A*. *B*'s purchase of 50% of *A*'s ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by *A* for federal tax purposes. Immediately thereafter, *A* and *B* are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership."). The Service concluded in Rev. Rul. 2004-77 and in several private letter rulings that a partnership with a single owner for federal income tax purposes is disregarded under the check-the-box regulations. *cf.* Priv. Ltr. Rul. 200201005 (Sept. 27, 2001) ("[Qualified subchapter S subsidiary X's] merger into Y, a state law limited partnership that is owned 1% by W, [a limited liability company] wholly owned by Z and 99% by Z will be disregarded for federal income tax purposes if no election is made under 301.7701-3(c) to treat W as an association because, at the end of the series of transactions, the assets of X continue to be held by Z for federal tax purposes."); Priv. Ltr. Rul. 200107025 (Nov. 17, 2000) ("[E]ach of the individual shareholders of X will be the sole owner of the limited partnership that the individual shareholder formed, owning m% through the respective individual's limited manner as a sole proprietorship, branch or division of the owner.[1085] In Private Letter Ruling 200807005 (Feb. 15, 2008), the Service held that, for federal income tax purposes, a taxpayer's acquisition of 100% of the interests in a partnership will be treated as the acquisition of the partnership's assets by the taxpayer.[1086]

XIII: INSTALLMENT SALES.

A. Background. Section 453 allows gain on an installment sale to be reported on a deferred basis. It permits "the spreading of the income tax over the period during which payments of the sales price are received" and, thus, "alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not actually been received."[1087] "This spreading of gain is achieved by dividing each installment payment and applying 'part [to] return of capital and part to profit.'"[1088]

B. Installment Sale Reporting.

1. General Rule. Unless otherwise elected, a taxpayer must report income from an installment sale on the installment method if any payment is to be received in a tax year

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liability company, a disregarded entity, and n% directly. Because each of the limited partnerships are treated as owned by a single owner, they will be disregarded for federal tax purposes and each individual shareholder will be treated as directly owning the X stock held by their respective limited partnership."); Priv. Ltr. Rul. 199947001 (Dec. 7, 1998) ("If Company A [taxed as a partnership] makes an election under section 754, Company A's basis in its assets, including the assets of the Partnerships that are disregarded entities for federal income tax purposes, will be adjusted under section 743(b) as a result of the transaction."); Priv. Ltr. Rul. 199915030 (Jan. 12, 1999) ("Corporation B and Disregarded LLC1 organized a limited partnership, Disregarded Partnership. Corporation B owns the limited partnership interest and Disregarded LLC1 owns the general partnership interest. Corporation B and Disregarded LLC1 will not elect to treat Disregarded Partnership as a separate entity for federal income tax purposes * * * Disregarded LLC1, Disregarded Partnership . . . will not be treated for federal income tax purposes as entities separate from Corporation B . . . ."); Priv. Ltr. Rul. 9807013 (Feb. 13, 1998) ("Because each Replacement Entity will be disregarded as an entity separate from its owner for federal tax purposes, the assets of each Replacement Entity will be treated as assets of the Taxpayer.").

[1085] Treas. Reg. § 301.7701-2(a).

[1086] *See* Priv. Ltr. Rul. 200807005 (Feb. 15, 2008) ("Taxpayer will acquire 100 percent of the partners' interests in Partnership. Pursuant to Rev. Rul. 99-6, Partnership is considered to have terminated under § 708(b)(1)(A) and made a liquidating distribution of its real property assets to its partners, and Taxpayer is treated as having acquired such real property assets from the partners for federal tax purposes. Since Taxpayer will acquire 100 percent of the partners' interests in Partnership, Taxpayer is treated as having acquired the real property assets of Partnership rather than as having acquired partnership interests from the partners. Further, this transaction does not constitute an abuse of the type that Congress sought to remedy in the Deficit Reduction Act of 1984, which appears to be aimed at abuses by sellers of partnership interests. We view this transaction as a like-kind exchange under § 1031(a)(1), rather than as an exchange of partnership interests in violation of § 1031(a)(2)(D). * * * Accordingly, Taxpayer may defer the gain on the sale of Relinquished Property under § 1031 if Taxpayer, through QI, acquires 100 percent of the interests of the partners in Partnership, which owns the Replacement Property.").

[1087] H. Rept. 96-1042, 96th Cong., 2d Sess. 5 (1980); S. Rept. 96-1000, 96th Cong., 2d Sess. 7 (1980), 1980-2 C.B. 494, 497; *see also Professional Equities, Inc. v. Commissioner*, 89 T.C. 165, 169 (1987).

[1088] *Professional Equities, Inc.*, 89 T.C. at 169 (quoting *Burnet v. S.&L. Bldg. Corp.*, 288 U.S. 406, 413 (1933)).

after the year of sale.[1089] The installment sale rules also apply to sales for which payment is to be made in a lump sum after the tax year of sale.[1090]

2. Exceptions.

a. Exception for Dealers. The installment method does not apply to dispositions of (1) personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan; or (2) real property held by the taxpayer for sale in the ordinary course of business ("dealer disposition").[1091]

(1) Dealer Disposition Does Not Include Disposition of Certain Residential Lots or Timeshares. A dealer disposition does not include certain dispositions on the installment plan of residential lots or "timeshares" if the taxpayer elects to pay interest on the amount of deferred tax attributable to the use of the installment method.[1092] The disposition must occur in the ordinary course of the taxpayer's business and the transferee must be an individual.[1093]

(2) Dealer Disposition Does Not Include Disposition of Farming Property. A dealer disposition does not include a disposition on the installment plan of property used or produced in the trade or business of farming.[1094]

b. Exception for Inventories of Personal Property. The installment method does not apply to dispositions of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the tax year.[1095]

c. Exception for Installment Obligations Arising out of Sales of Stocks or Securities Traded on an Established Securities Market. Any installment obligation arising out of a sale of stock or securities traded on an established securities market is not eligible for the installment method of reporting income under Section 453(a), and all payments to be received are treated as received in the year of disposition.[1096]

[1089] I.R.C. §§ 453(a), 453(b)(1); cf. F.S.A. 200004009 (Jan. 28, 2000).

[1090] Temp. Reg. § 15A.453-1(b).

[1091] I.R.C. §§ 453(a)(2), 453(l); *see, e.g., United States v. Winthrop*, 417 F.2d 905 (5th Cir. 1969); *Major Realty Corp. v. Commissioner*, 749 F.2d 1483 (11th Cir. 1985).

[1092] I.R.C. § 453(l)(2)(B).

[1093] I.R.C. § 453(l)(2)(B)(ii).

[1094] I.R.C. § 453(l)(2)(A).

[1095] I.R.C. § 453(b)(2)(B).

[1096] I.R.C. § 453(k)(2)(A).

d. Dispositions of Personal Property Under a Revolving Credit Plan. The installment method does not apply to any dispositions of personal property under a revolving credit plan.[1097]

3. Installment Method Does Not Apply to Losses. The installment method does not apply to losses incurred by a taxpayer on an installment sale. A loss sustained on an installment sale should be claimed as a deduction for the tax year of sale and not over the period during which payments are to be received.[1098]

C. Determining the Amount of Income Includible Under the Installment Method. The amount of income includible under the installment method is calculated as follows:

$$\text{Installment Payment Received During The Year} \times \frac{\text{Gross Profit Realized}}{\text{Contract Price}}$$ [1099]

1. Gross Profit. The "gross profit" is the selling price less the taxpayer's adjusted tax basis in the property.[1100]

a. Selling Price. "Selling price" is the gross selling price without reduction for any existing mortgage on the property (whether assumed or taken subject to by the buyer) or for any selling expenses. Neither interest nor original issue discount is considered to be a part of the selling price.[1101]

b. Adjusted Tax Basis Includes Selling Expenses. The seller's adjusted tax basis in the property includes commissions and other selling expenses.[1102]

2. Contract Price. "Contract price" is the selling price reduced by the amount of any qualifying indebtedness (as defined below) assumed or taken subject to by the buyer which does not exceed the seller's adjusted tax basis in the property.[1103]

a. Definition of "Qualifying Indebtedness." "Qualifying indebtedness" means:

(1) A mortgage or other debt encumbering the property; and

[1097] I.R.C. § 453(k)(1).

[1098] Rev. Rul. 70-430, 1970-2 C.B. 51.

[1099] I.R.C. § 453(c); Temp. Reg. § 15A.453-1(b)(2)(i).

[1100] Temp. Reg. § 15A.453-1(b)(2)(v).

[1101] Temp. Reg. § 15A.453-1(b)(2)(ii).

[1102] Temp. Reg. § 15A.453-1(b)(2)(v).

[1103] Temp. Reg. § 15A.453-1(b)(2)(iii).

(2) Unsecured debt incurred or assumed by the purchaser incident to the acquisition, holding, or operation of the property in the ordinary course of business or investment.[1104]

b. Obligations Not Included Within "Qualifying Indebtedness." "Qualifying indebtedness" does not include:

(1) an obligation incurred incident to the disposition of property (for example, legal fees relating to the taxpayer's sale of the property); or

(2) an obligation functionally unrelated to the acquisition, holding, or operating of the property (for example, the taxpayer's medical bill).[1105]

3. Payment.

a. Cash or Other Property. Payment may be received in cash or other property, including foreign currency, marketable securities, and readily-tradeable debt instruments.[1106] Payment also generally includes the receipt of a third-party note from the purchaser.[1107]

b. Amounts Actually and Constructively Received Under Installment Note. Payment includes amounts actually or constructively received under an installment note.[1108]

c. Receipt of Notes Secured by Cash or a Cash Equivalent. The receipt of a note which is secured by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment.[1109]

d. Installment Note Generally Does Not Constitute Payment. An installment note generally does not constitute payment to the seller even if that note is guaranteed by a third party. A standby letter of credit is treated as a third party guarantee.[1110]

e. Obligations Payable on Demand or Readily Tradable.

[1104] Temp. Reg. § 15A.453-1(b)(2)(iv).

[1105] Temp. Reg. § 15A.453-1(b)(2)(iv).

[1106] *See* I.R.C. § 453(f)(2)(B); Temp. Reg. § 15A.453-1(b)(3)(i).

[1107] Temp. Reg. § 15A.453-1(b)(3)(i).

[1108] Temp. Reg. § 15A.453-1(b)(3)(i).

[1109] Temp. Reg. § 15A.453-1(b)(3)(i).

[1110] Temp. Reg. § 15A.453-1(b)(3)(i).

(1) Obligations Payable on Demand. An obligation payable on demand is treated as a payment in the year received and not as an installment obligation payable in future years.[1111]

(2) Certain Readily-Tradable Obligations Treated as Payment. Certain readily-tradable obligations are treated as payment in the year the obligations are received.[1112]

(3) Computation of Amount Realized if Obligation Treated as Payment. If an obligation is treated as a payment in the year received, the amount realized by reason of such payment must be determined in accordance with the taxpayer's method of accounting. For a cash method taxpayer, the amount realized on such payment is the fair market value of the obligation. For an accrual method taxpayer, the amount realized on receipt of an obligation payable on demand is generally the face amount of the obligation.[1113] Special rules apply to readily tradeable obligations.[1114]

f. Treatment of Mortgages and Other Liabilities.

(1) Mortgage Assumed or Taken Subject to is Treated as Payment Only to the Extent it Exceeds Basis. A mortgage (or other qualifying indebtedness) assumed or taken subject to by the purchaser in an installment sale is treated as a payment in the year of sale only to the extent that the mortgage exceeds the basis of the property.[1115]

(2) Sales to Creditor. If a taxpayer sells property to a creditor and the taxpayer's debt is cancelled in consideration of the sale, such cancellation is treated as payment.[1116]

(3) Sales of Property Subject to Mortgage for Which Taxpayer Is Not Personally Liable. If the taxpayer sells property which is encumbered by a mortgage on which the taxpayer is not personally liable, and the person acquiring the property is the obligee, the taxpayer is treated as having received payment in the amount of such indebtedness.[1117]

(4) Wrap-around Mortgage. Special rules apply to wrap-around mortgages.

[1111] I.R.C. § 453(f)(4)(A). *See, e.g. Champy v. Commissioner*, 68 T.C.M. (CCH) 242 (1994).

[1112] I.R.C. § 453(f)(4)(B).

[1113] Temp. Reg. § 15A.453-1(e)(2).

[1114] *See* Temp. Reg. § 15A.453-1(e)(2).

[1115] Temp. Reg. § 15A.453-1(b)(3)(i).

[1116] Temp. Reg. § 15A.453-1(b)(3)(i).

[1117] Temp. Reg. § 15A.453-1(b)(3)(i).

D. Examples.

1. **Example 1.** Adam, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in Adam's hands, to Bob for $100,000: $10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. Adam's basis in Blackacre, exclusive of selling expenses, is $38,000. Adam pays selling expenses of $2,000.

a. **Computation of Gross Profit.** The gross profit derived by Adam on the sale is $60,000 [$100,000 (selling price) less $40,000 (basis inclusive of selling expenses)].

b. **Gross Profit Ratio.** Adam's gross profit ratio is 3/5, computed as follows:

$$\frac{\$60{,}000 \text{ (gross profit)}}{\$100{,}000 \text{ (contract price)}}$$

c. **Amount of Each Payment Includible in Income.** The portion of each annual $10,000 which is includible by Adam as gain on the sale is $6,000 (3/5 of $10,000). The portion of each $10,000 payment that is treated as recovery of basis is $4,000 ($10,000 less $6,000). The interest received in addition to principal is ordinary income to Adam.[1118]

2. **Example 2.** Carl sells Whiteacre to David for a selling price of $160,000. Whiteacre is encumbered by a mortgage in the principal amount of $60,000. David will assume or take subject to the $60,000 mortgage and pay the remaining $100,000 in 10 equal annual installments together with adequate stated interest. Carl's basis in Whiteacre is $90,000. There are no selling expenses.

a. **Gross Profit.** The gross profit derived by Carl on the sale is $70,000 [$160,000 (selling price) less $90,000 (Carl's basis in the property).

b. **Contract Price.** The contract price on the sale is $100,000, which is the $160,000 selling price less the mortgage of $60,000 assumed or taken subject to.

c. **Gross Profit Ratio.** Carl's gross profit ration is 7/10, computed as follows:

$$\frac{\$70{,}000 \text{ (gross profit)}}{\$100{,}000 \text{ (contract price)}}$$

d. **Amount of Each Payment Includible in Income.** The portion of each annual $10,000 which is includible by Carl as gain on the sale is $7,000 (7/10 of $10,000).

[1118] *See* Temp. Reg. § 15A.453-1(b)(5), Example 1.

The portion of each $10,000 payment that is treated as recovery of basis is $3,000 ($10,000 less $7,000). The interest received in addition to principal is ordinary income to Carl.[1119]

3. **Example 3.** The facts are the same as in Example 2, except that Carl's basis in the land is $40,000.

a. **Amount of mortgage assumed or taken subject to by David exceeds Carl's basis in the property.** Since mortgage assumed or taken subject to by David ($60,000) exceeds Carl's tax basis in the property ($40,000), Carl is deemed to have received a payment in an amount equal to the excess of $20,000.

b. **Amount Includible as Income.** Since Carl fully recovers his basis in the year of sale, the gross profit ratio is 1 ($120,000/$120,000) and Carl will include as gain the entire $20,000 deemed payment in the year of sale and each $10,000 annual payment.[1120]

E. **Treatment of Contingent Payment Sales.** Special rules apply to contingent payment sales.[1121]

F. **Resales by Related Persons.**

1. **Gain Recognized on Resales by Related Persons.** Section 453(e) provides a special rule applicable to sales of property to a related person using the installment method. Under Section 453(e), if:

a. A taxpayer ("first seller") disposes of property to a related person ("related purchaser"); and

b. Before the first seller receives all payments relating to the sale, the related purchaser disposes of the property, the first seller will be treated as receiving the total payments received by the related purchaser on the resale. The first seller will recognize gain, based upon his gross profit ratio, but only, in general, to the extent the amount realized[1122] from the second disposition exceeds actual payments made under the first sale.[1123]

[1119] *See* Temp. Reg. § 15A.453-1(b)(5), Example 2.

[1120] *See* Temp. Reg. § 15A.453-1(b)(5), Example 3.

[1121] Temp. Reg. § 15A.453-1(c)(1); *see, e.g.*, 200004009 (Jan. 28, 2000) ("The sale occurring in Year 1 in the present case would be a contingent payment sale because of the payments contingent on the net income of Corp. B.").

[1122] In the case of a second disposition which is not a sale or exchange, the fair market value of the property disposed of is treated as the amount realized for this purpose. I.R.C. § 453(e)(4).

[1123] I.R.C. §§ 453(e)(1) & (e)(3); *see also* I.R.C. §§ 453(e)(6) & 453(e)(7) (providing exceptions to resale rule); *Shelton v. Commissioner*, 105 T.C. 114, 122 (1995) (liquidation treated as disposition of property). The term "related person" is broadly defined to include most relationships under Sections 318(a) and 267(b) of the Code. I.R.C. § 453(f)(1).

2. Treatment of Later Payments. If a resale by a related person results in the recognition of gain to the first seller, subsequent payments received by that seller are recovered tax-free until the total of such payments equals the amount realized from the resale which resulted in gain.[1124]

3. 2-year Cutoff Period. The resale rule applies only with respect to resales of property (other than marketable securities) occurring within 2 years after the initial installment sale.[1125]

G. Installment Sales of Depreciable Property Between Certain Related Persons.

1. Installment Method Does Not Apply. Section 453(g) provides a special rule for sales of depreciable property between certain "related persons" (defined in Section 453(g)(3)). Under Section 453(g)(1), the installment method does not apply to a sale of depreciable property between related persons. Rather, all non-contingent payments to be received are treated as received in the year of disposition.[1126] The purchaser cannot increase the basis of the property acquired by any amount before the time such amount is includible in the seller's gross income.[1127]

2. Exception Applies If Tax Avoidance Not a Principal Purpose. The rule denying installment sale treatment to a sale of depreciable property between related persons does not apply if the taxpayer can establish that tax avoidance was not a principal purpose for the disposition.[1128]

H. Recapture of Income on Installment Sale. The depreciation recapture rules of Sections 1245 and 1250 of the Code override the installment sale rules. Thus, depreciation recapture income with respect to any property will be recognized in full in the year of an installment sale of such property, even if no principal payments are received in that year.[1129]

I. Electing Out of the Installment Method.

1. General Rule. Unless otherwise elected, an installment sale must be reported on the installment method.[1130] The Treasury Regulations prescribe the time and manner for electing out of the installment method.

[1124] I.R.C. § 453(e)(5).

[1125] I.R.C. § 453(e)(2).

[1126] I.R.C. § 453(g)(1)(i).

[1127] I.R.C. § 453(g)(1)(C).

[1128] I.R.C. § 453(g)(2).

[1129] I.R.C. § 453(i).

[1130] Temp. Reg. § 15A.453-1(d)(1).

2. Time and Manner for Making Election. An election out of the installment method must be made on or before the due date (including extensions) for filing the taxpayer's return for the tax year in which the installment sale occurs. A taxpayer is generally permitted to make the election by reporting the full amount of gain on the sale on the tax return filed for the tax year in which the installment sale occurs.[1131] The election may be revoked only with the consent of the Service.[1132]

3. Treatment of an Installment Sale When a Taxpayer Elects Not To Report on the Installment Method. A taxpayer who elects out of the installment method must recognize gain on the sale in accordance with its accounting method.[1133] Special rules apply to contingent payment obligations.[1134]

J. Interest Charge Imposed on Tax Deferred in Certain Installment Sales.

1. Overview of Interest Charge. For certain installment sales, Section 453A of the Code imposes an interest charge on the income tax that is deferred under the installment method. The interest charge applies to an installment sale only if (1) the sale price with respect to such sale exceeds $150,000; and (2) the aggregate face amount of all installment obligations arising during the year and held by the taxpayer exceeds $5,000,000.[1135]

a. Sales Price Must Exceed $150,000. Section 453A applies to installment obligations arising from the sale of any property with a sales price exceeding $150,000, other than personal use property belonging to an individual, property used or produced in the trade or business of farming and certain timeshares and residential lots.[1136]

b. Aggregate Face Amount of Obligations Arising During Year Exceed $5,000,000. The interest charge under Section 453A applies to an obligation arising in a tax year (the "Sale Year") only if:

(1) The obligation is outstanding at the end of the Sale Year in which it arose; and

(2) The face amount of all installment obligations arising during such Sale Year and outstanding at year-end exceeds $5,000,000.[1137]

[1131] Temp. Reg. § 15A.453-1(d)(3)(i).

[1132] Temp. Reg. § 15A.453-1(d)(4).

[1133] Temp. Reg. § 15A.453-1(d)(2)(i).

[1134] Temp. Reg. § 15A.453-1(d)(2)(iii).

[1135] I.R.C. §§ 453A(b)(1)(b)(2).

[1136] I.R.C. § 453A(b).

[1137] I.R.C. §§ 453A(a) & (b)(2); *see* Notice 88-81, 1988-2 C.B. 399 (For partnerships and S corporations, the $5 million threshold is applied, and interest calculations are made, at the partner and shareholder level); cf.

2. **Computation of Interest Charge.**

a. **In General.** If Section 453A applies to an installment obligation, the tax deferred under the installment method is subject to an interest charge determined under Section 453A.[1138]

b. **Determining the Amount of the Interest Charge.** The amount of interest payable with respect to an obligation equals the "applicable percentage" of the "deferred tax liability" with respect to such obligation multiplied by the underpayment rate under Section 6621 in effect for the month within which the tax year ends.[1139]

c. **Deferred Tax Liability.** The deferred tax liability with respect to an installment obligation is the amount of gain under the obligation that has not been recognized as of year-end multiplied by the maximum tax rate in effect for the tax year.[1140] This rate will vary depending on whether the taxpayer is a corporation or is an individual, estate, or trust.[1141]

d. **Applicable Percentage.** The applicable percentage of an installment obligation is the percentage determined by dividing:

(1) The portion of the aggregate face amount of all installment obligations outstanding as of the end of the Sale Year in excess of $5 million, by

(2) The aggregate face amount of the installment obligations outstanding as of the end of the Sale Year.[1142]

Once determined, the applicable percentage does not change as payments on the obligation are made in subsequent tax years.[1143]

3. **Treatment in Subsequent Years.** Once Section 453A applies to an installment obligation, interest must be paid for any subsequent tax year if the installment obligation is outstanding at the end of that year.[1144]

I.L.M. ILM 201021020 (May 28, 2010) (addressing issues concerning the computation of interest on the deferred tax liability under § 453A of the Internal Revenue Code on Taxpayer's installment sales contract.).

[1138] I.R.C. § 453A(c).

[1139] I.R.C. § 453A(c)(2).

[1140] I.R.C. § 453A(c)(3).

[1141] I.R.C. § 453A(c)(3).

[1142] I.R.C. § 453A(c)(4).

[1143] H.R. Rep. No. 495, 100th Cong., 1st Sess. 930 (1987).

[1144] I.R.C. § 453A(c)(1).

K. Pledge of Certain Installment Obligations Treated as Receipt of Payment. Section 453A also imposes special rules generally applicable to pledges of installment obligations arising from the sale of property for a price exceeding $150,000. If such an installment obligation is pledged as security for a debt, the net loan proceeds are treated as the receipt of payment on such installment obligation on the later of the date that the debt is secured or the date that the net proceeds are received by the taxpayer.[1145] The amount of gain recognized is equal to the product of the net loan proceeds received and the gross profit ratio applicable to the installment obligation.[1146]

[1145]I.R.C. § 453A(d)(1); *see also* I.R.C. 453A(d)(2)(amount treated as received subject to limitation based upon total contract price).

[1146]H.R. Rept. No. 495, 100th Cong., 1st Sess. 930 (1987).