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From Allocations to Series LLCs: 2011's Partnership Tax Articles

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From Allocations to Series LLCs: 2011’s Partnership Tax Articles

By Bradley T. Borden

In 2011 several partnership tax articles appeared in student-edited journals. The articles covered a broad range of topics, many of which appeared to anticipate developments in the law or society that have since transpired. Not surprisingly, the allocation rules received the most attention. The topics of the other several articles included profits-only interests, the section 469 definition of limited partner, the 1982 Tax Equity and Fiscal Responsibility Act audit rules, the liability of general partners for partnership taxation, and LLCs. The breadth of topics is impressive, but the count is still relatively low considering the importance of partnership taxation.

The relative paucity of articles in this area suggests that the legal academy is far behind the curve on recognizing the presence and importance of tax partnerships. Perhaps the recent coverage of tax partnerships in the media (including a front-page story in The Wall Street Journal) will help generate more interest in this area of the law over the next several years. The significance of partnership taxation warrants that attention, but lay commentators may overlook many of the nuances and policy justifications for partnership taxation and recommend changes that are unfavorable. For example, lay criticism of partnership taxation often focuses on its weaknesses. Although partnership taxation is complex, it governs complex arrangements, so some of the complexity is necessary. This past year’s articles focus on discrete issues and generally recommend rather specific changes. Those recommendations can be helpful — at least they identify important issues. More work is needed to extol the virtues of pass-through taxation.

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This article reviews the partnership tax articles published in student-edited journals in 2011. The articles comprise a rich output on timely topics and demonstrate that partnership tax is primed for even more scholarly attention.

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1This article reviews partnership tax articles that were published in 2011 by student-edited law reviews. In two situations the articles are dated 2010 but published in 2011.
6A tax partnership’s employment taxes, the proper tax treatment of series limited liability companies, the use of tax partnerships as blockers and stoppers, and debt restructuring in tax partnerships and LLCs. The breadth of topics is impressive, but the count is still relatively low considering the importance of partnership taxation.


"William B. Taylor, “‘Blockers,’ ‘Stoppers,’ and the Entity Classification Rules,” 64 Tax Law. 1 (2010)."


"John D. McKinnon, “More Firms Enjoy Tax-Free Status,” The Wall Street Journal, Jan. 10, 2012, at A1. Although tax partnership tax commentators generally focus on its weaknesses, we also realize that pass-through taxation has strong policy justification, and with some tweaks it can serve its intended purposes. See Borden, “Three Cheers for Pass-through Taxation,” Tax Notes, June 27, 2011, p. 1353, Doc 2011-11596, or 2011 TNT 124-5. As tax partnership taxation continues to receive attention, commentators may have to do more to educate the public and lawmakers about the inherent value of tax partnership taxation and the changes that flaws in the law warrant."
and help improve it. It is a body of law that is not keeping up with the rapid changes in the business environment.

A. Allocations


The three articles on allocations all claim that the allocation rules are the heart and soul of partnership taxation, and they identify shortcomings in the current allocation rules. The three articles cover the main aspects of the allocation rules: the test for substantiality, the test for economic effect, and the definition of partners’ interests in a tax partnership. Naturally, the criticisms in the three articles overlap, and, not unexpectedly, their recommendations diverge. Two articles recognize that the ambiguous language used in the test for substantiality and the complexity of the test complicate its application. Undefined terms such as “strong likelihood” and “substantially diminished” make the rules difficult to understand and apply. The requirement to consider the after-tax economic consequence of allocations in present value terms also complicates the application of the test for substantiality.

Each of the articles acknowledges the purpose of the test for substantiality is to help prevent abusive tax-item allocations, but a close examination of the test raises serious questions about its effectiveness. In “Deterring Tax-Driven Tax Partnership Allocations,” professor Gregg Polsky uses a fairly sophisticated quantitative approach to analyze the tests for substantiality. He relies on the facts in Example 5 of the allocations regulations as the platform for his analysis. Using the facts of the example, Polsky demonstrates that the test for substantiality is difficult to apply, even to the relatively simple fact pattern.

In Example 5, Isabel and Juan (names have been changed slightly to preserve anonymity) made equal contributions to a tax partnership, and they agreed to share equally the gain or loss from the sale of the partnership’s property. The partnership owned tax-exempt and taxable securities. The partners agreed to allocate 80 percent of the tax-exempt interest to Isabel and 20 percent of it to Juan, and to allocate 100 percent of the taxable income to Juan. The example tests whether the economic effect of the allocation of the income is substantial. A fundamental part of the test for substantiality is identifying baseline allocations against which to measure the effect of the subject allocations. The rules provide that the baseline allocations are those that the tax partnership would make in accordance with the partners’ interests in the partnership without considering the subject allocations.

Example 5 treats the partners as having equal interests in the tax partnership for purposes of determining the baseline allocation. Consequently, it disregards the allocation of the income to determine the partners’ interests in the partnership. A significant assumption in the example is that the partners would have allocated the items equally if they had not used the allocation formula in the partnership agreement. Making that assumption in a self-created hypothetical (one that assumes the allocations would be equal but for the allocation formula in the agreement) is reasonable; making that assumption in a world filled with nuance and complexity may not be reasonable. Outside the context of the example, parties may not know what an arrangement would be like without the allocations in the partnership agreement. Using the assumed baseline, the example concludes that the economic effect of the allocation was not substantial.

After determining the economic effect of the allocations is not substantial, the example then reallocates the items in accordance with the partners’ interests in the tax partnership. To determine the partners’ interests for the purpose of reallocating the items, the example considers the income allocations and reallocates the items 36 percent to Isabel and 64 percent to Juan (the overall proportion of the allocations). Polsky’s discussion focuses on the appropriate proportion used for reallocating.

11Borden, supra note 2, at 1082 (“Allocating tax partnership income to the partners is the fundamental purpose and challenge of tax partnership taxation.”); Monroe, supra note 2, at 472 (“Tax partnership allocations are the hallmark of subchapter K.”); Polsky at 97 (“How to allocate a tax partnership’s tax items is the most fundamental issue in . . . the taxation of tax partnerships.”).

12See Monroe, supra note 2, at 496-504; Polsky, supra note 2, at 102-103.


14See reg. section 1.704-1(b)(2)(iii)(e).

15See Borden, supra note 2, at 1101; Monroe, supra note 2, at 496; Polsky, supra note 2, at 99.

16See reg. section 1.704-1(b)(5), Example (5).

17See reg. section 1.704-1(b)(5), Example (5)(i).


19See reg. section 1.704-1(b)(5), Example (5)(ii).
items that lack substantiality. He concludes that tax items should follow the economic arrangement, and if the partners allocate economic items 36 percent to Isabel and 64 percent to Juan, the tax items should follow in the same proportion. He also reasons that reallocating in accordance with the baseline 50/50 interests would not subject the partners to the risk that their original deal would be altered, even if substantiality fails. He does not question whether the example uses the appropriate baseline allocations, but the appropriateness of the baseline allocation was an important issue in “The Allure and Illusion of Partners’ Interests in a Partnership.”

That article illustrates that determining the partners’ interests in a tax partnership can be difficult in even simple tax partnerships. If an allocation affects the partners’ rights to distributions or obligations to make contributions, the allocation would appear to affect the partners’ interests in the tax partnership. In fact, the partners’ interests in the tax partnership’s economic profits and losses, cash flow, and nonliquidating distributions are factors the rules consider in determining the partners’ interests in the partnership. Therefore, the baseline allocations may have no connection to reality, if they disregard allocation provisions in a partnership agreement.

Revisiting Example 5 illustrates that the presumptive 50/50 baseline allocations could be problematic. Example 5 implies that the income allocations would be equal if the partners had not provided otherwise in the agreement. In the absence of facts that clearly provide for equal allocations, that conclusion is not obvious. In fact, outside the confines of the example, partners like Isabel and Juan may be able to produce facts that support the inclusion of the allocations in the baseline. For instance, they could divvy up the responsibility for the tax partnership property in such a way that Isabel is primarily responsible for managing the tax-exempt property and Juan is primarily responsible for managing the taxable assets. If that were the case, using the 50/50 baseline would not represent the parties’ economic arrangement. Instead, it would represent somewhat of a random guess of what the partners would have done in an alternate universe. This illustration shows that even in what otherwise may look like a simple tax partnership, determining the baseline allocation may be difficult because no one may know what the partners would do without the allocations provided for in the partnership agreement.

Polsky’s technical analysis of the language in the test for substantiality is the true value-add of the article. The test for substantiality provides that the economic effect of an allocation will not be substantial if at least one partner’s after-tax economic consequences will be enhanced and there is strong likelihood that no partner’s after-tax economic consequences will be substantially diminished. Polsky demonstrates that the simple facts in Example 5 present 10,201 possible outcomes (tax-exempt income between $450 and $550 and taxable income between $450 and $550). Based on the facts of the problem, Polsky concludes that in the worst case scenario ($450 of tax-exempt and $550 of taxable income), Isabel will be $2.50 worse off than she would be without the allocation. That worst case scenario has a 0.01 percent chance of occurring. Therefore, Isabel does not have a strong likelihood of substantial diminishment. Because Juan’s economic situation was enhanced, the economic effect of the allocation lacked substantiality. If the $2.50 is a substantial diminishment, Polsky wonders what constitutes a strong likelihood that a substantial diminishment will occur. After trying to rationalize the results in Polsky’s article and the regulations, the reader recognizes that Polsky’s greatest accomplishment may be demonstrating the extreme difficulty people face in dealing with the probability and diminishment language in the overall-tax-effects test for substantiality.

Polsky also discusses how the partners’ risk tolerance may affect their decision to include particular allocations in the partnership agreements. He concludes that partners would have to be exceptionally risk-averse to be deterred by the overall-tax-effects test. Polsky also notes that in theory, partners could affect their after-tax economic consequences by hedging the losses that could occur within the tax partnership, but the overall-tax-effects test considers only tax attributes (and not economic attributes) that are unrelated to the partnership. The cost of hedges will most likely deter most partners from purchasing hedges, so this issue is not that significant. Polsky considers other aspects of the tests for substantiality, including the

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20See Polsky, supra note 2, at 115.
21Id. at 115-116.
22See Borden, supra note 2, at 1101-1102.
23Id. at 1112-1127.
24Id. at 1098-1102.
25See reg. section 1.704-1(b)(3)(ii)(b), (c).
shifting and transitory tests (which he lumps into a single test) and then draws the following eight general conclusions about the tests:

1. The current rules deter tax item transactions within tax partnerships only for highly risk-averse partners.

2. Substantial diminishment should be determined by comparing the amount of potential diminishment to the expected maximum benefits. A diminishment of 10 percent of expected benefit and 5 percent of maximum benefit is not substantial based on the examples in the regulations.

3. The law appears to disregard hedges outside the tax partnership when applying the overall-tax-effects test, which appears to be appropriate if the transaction costs of hedges are high.

4. The IRS should be concerned about the possibility of tacit makeup agreements among the partners.

5. The two-tiered application of partners’ interests in the partnership is reasonable because it helps ensure that tax consequences follow economic results and it imposes additional risks on partners who engage in tax item transactions.

6. The three substantiality tests are duplicative unless one or more partners agree to an increased tax liability for no compensation, which should never happen in arm’s-length transactions.

7. The shifting-transitory tests must be a backstop for the overall-tax-effects test.

8. The shifting-transitory test should include present value concepts to be consistent with overall-tax-effects test.

In “Too Big to Fail: The Problem of Tax Partnership Allocations,” professor Andrea Monroe provides an engaging account of the history of the section 704(b) allocation rules. She describes the shortcomings of substantial economic effect and partners’ interests in a tax partnership. Monroe recognizes that the evolution of state law entities and tax entity classification rules has outpaced changes to the allocation rules, and the rules now lack effectiveness. Monroe claims that the one-size-fits-all approach in the allocation rules does not work for the different types of tax partnerships that now exist. She argues that the rules defining substantial economic effect are too complex for simple tax partnerships, which cannot afford the advice needed to comply with the rules. This claim is not wholly intuitive, because a standard-form tax partnership agreement should contain language that would help ensure that the agreement complies with the economic effect requirement. If the partners do not attempt to allocate items to obtain tax benefits (which would generally require sophisticated tax advice), the economic effect of the allocations of a simple tax partnership should be substantial. Further, allocations of simple tax partnerships that lack sophistication should, at a minimum, be in accordance with the partners’ interests in the tax partnership. Trouble arises when partners have the sophistication to structure allocations to obtain favorable tax results. Indeed, this is the more severe problem in the current rules — sophisticated tax partnerships probably structure allocations to the partners’ strategic advantage.

Based on the conclusion that the rules are too complex for small tax partnerships and too prone to manipulation by complex tax partnerships, Monroe recommends a default rule subject to an election out. The default rule would require partners to allocate tax items in accordance with the partners’ interests in the tax partnership, and the partners’ relative capital accounts balances would represent their interests in the tax partnership. Consequently, the default rule would require partners to allocate tax items in accordance with the partners’ relative capital account balances. Tax partnerships that elect out of the default rule would be able to make allocations in accordance with a revised substantial economic effect safe harbor. The revised safe harbor would retain the current test for economic effect and reinstate a version of the earlier tax avoidance standard. Tax partnerships would reveal their departure from the default rules by electing to rely on substantial economic effect, so

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35See Monroe, supra note 2, at 504-505.
36Id. at 470.
37Id.
38Id.
39Id. at 510.
41See Monroe, supra note 2, at 511.
42Id. at 513-516.
In fact, allocating tax items in accordance with relative capital account balances could provide the partners significant tax avoidance opportunities. Assume for example that during year 1 Howard has a lot of ordinary loss outside Howyll PLLC. Howyll PLLC retains its profit-sharing arrangement, but Howard contributes $200,000 and Darryll contributes nothing to the tax partnership. The tax partnership allocates $600,000 of its income to Howard and $400,000 to Darryll, but it allocates $1 million of taxable income to Howard and $0 to Darryll in accordance with their relative capital account balances. The partners could manipulate their relative capital account balances as needed to improve their tax result. Thus, allocations in accordance with relative capital account balances may fail to match economic and tax items, and it may provide opportunities for abusive allocations.

“The Allure and Illusion of Partners’ Interests in a Partnership” not only exposes the deficiencies in the current definition of partners’ interests in a tax partnership, it also exposes deficiencies in the test for economic effect. The safe harbor and alternate test for economic effect both require tax item allocations to have legal and economic consequences. The problem with that requirement is that some tax items, such as depreciation, do not correspond to an economic item. The economic effect rules therefore require partners to forgo legal and economic rights in exchange for some tax item allocations. Forcing the partners to give up economic rights in exchange for an allocation that does not correspond to an economic item seems unfair. The article also examines the definition and application of partners’ interests in a partnership in depth and illustrates that the current definition of partners’ interests in a partnership is not sufficient to govern allocations. The multiple-factor definition in the regulations is so skeletal it lacks meaning. The article therefore recommends that changes to the rules must require partners to examine the flow of economic items and seek to match the allocation of tax items with that flow. Any effort to fit tax item allocations into a convenient, mandatory regime will fail because the nature of tax partnerships is too complicated for these restrictive rules.

(7/2) to Howard and approximately $416,667 (7/2) to Darryll. The tax item allocations would still differ from the allocations of economic items.

43Id. at 516.
44See section 1366(a)(1).
45See section 1361(b)(1)(D).
47If the default rule relied on after-allocation capital account balances, Howyll PLLC would allocate approximately $583,333.
48See Borden, supra note 2, at 1098-1101.
49Id. at 1098-1101.
50Id. at 1105-1127.
51Id. at 1127-1138.
B. Profits Interests

4. Note, “Taxing Partnership Profits Interests: The Carried Interest Problem,” 124 Harv. L. Rev. 1773 (2011). The disclosure of the Romneys’ tax returns rekindles the furor surrounding the favorable tax treatment available to service partners who receive profits-only interests tax free and then pay tax on income derived from that interest at lower rates.\(^{52}\)

The thought that a person can amass hundreds of millions of dollars of wealth from a service-oriented profession at low tax rates is disturbing. Witnessing that potential in the Romneys’ tax returns should remind us of the inequity that results from the favorable treatment granted compensation paid in the form of profits-only interests in a tax partnership. The elimination of the favorable tax treatment continues to be a favorite topic of the current administration,\(^{53}\) and the partnership tax community must recognize that change is inevitable (and needed) in this area of the law. The question becomes what that change will ultimately look like.

“Taxing Partnership Profits Interests: The Carried Interest Problem,” a student note, revisits the issue of taxing profits-only interests in tax partnerships.\(^{54}\) The note does a good job of presenting the issues that profits-only interests raise and provides a present-value analysis of several different tax alternatives, including the current system and the proposed section 710 treatment.\(^{55}\) The note concludes that the law should disaggregate profits-only interests and tax a portion of the income allocated to the profits-only partner as ordinary income and tax the remaining portion based on its character determined at the tax partnership level.\(^{56}\) The note recommends disaggregation because merely comparing the compensatory tax rate and the capital gains tax rate “ignores the increased risk of a profits interests compared to the relative safety of taking a salary.”\(^{57}\) This notion overestimates “the relative safety of taking a salary” and gives undue preference to the compensation structure of private equity managers. The risk associated with profits-only interests is the risk of nonpayment because of lack of performance of assets that the service provider manages. The risk exists because the service provider defers payment until some future date instead of demanding current payment. Instead of deferring payment, the manager could bargain for a different compensation structure or enter a different profession. The manager’s risk is not unlike the risk many professionals, such as an expert in partnership tax or a musician, face.

Consider a young attorney who decides to pursue a career as a partnership tax lawyer. The young attorney can make a nice salary. The salary of a young attorney does not, however, justify the effort, pain, discomfort, energy, and time required to master the intricacies of partnership taxation. Anyone willing to put themselves through the rigorous of learning a complex area of the law, such as partnership taxation, for other than academic reasons must realize that future compensation as an expert in the area justifies the present outlay of effort. And those who reach expert status and build a book of business can profit from their efforts, but tax law does not treat their income preferentially.

At the beginning of the journey to become an expert, the young attorney faces serious risks. Perhaps her skill set, interests, and aptitude do not match the requirements to be a top-flight partnership tax attorney, and after years of effort she must pursue a different course. Perhaps the young attorney ends up with a firm or partner who is neither a helpful mentor nor an effective promoter, and her career as a partnership tax attorney fizzes after a few years of extreme effort. Or perhaps the economy tanks as the young attorney builds momentum in the profession and the lost work sidelines his efforts. Finally, an attorney could work for several years, build a nice book of business, and be on the verge of arriving as one of the elite attorneys in the field only to have Congress repeal pass-through taxation and impose a universal entity-level business tax. Instead of capitalizing on the years of effort to build expertise in partnership taxation, the attorney becomes just another competent tax attorney. Thus, an attorney who wishes to become an expert in partnership taxation stands to earn the real payoff only after surviving the considerable risks that face all aspiring attorneys.

The largest portion of an attorney’s compensation comes only after overcoming all the risks. Thus, the attorney defers the compensation for a number of years (probably at least 10\(^{58}\)). A significant portion of the effort the attorney expends will be lost if she does not reach expert status and develop a book of business. Those risks are similar to the risks faced by private equity managers. Despite the significant


\(^{54}\)See Note, supra note 3.

\(^{55}\)Id. at 1783-1796.

\(^{56}\)Id. at 1795-1796.

\(^{57}\)Id. at 1780.

risks that an attorney faces, tax law does not (and should not) favor the income earned by an expert partnership tax attorney. Instead, tax law treats that compensation as ordinary income and subjects it to the law’s highest tax rates.

The plight is no different for an aspiring classical trumpeter. Imagine a young man who decides he wants to play fulltime for the Philadelphia Orchestra. At a young age, he believes that if he can obtain a fulltime position with the orchestra, he would be richly compensated for the extreme efforts he will have to expend to develop the world-class skill required of trumpeters in that elite organization. The risks the trumpeter faces are astronomical. Standing between him and the position on the orchestra are at least 10 years of deliberate practice, elite education, and the real possibility of changes to the classical music industry.59 When he signs on (in the form of personal resolve) to pursue the career, he has little statistical probability of ever landing a fulltime position and earning the dreamed-of compensation. In the unlikely event that the trumpeter overcomes the insurmountable odds, lands the position, and begins to earn the dreamed-of compensation, tax law does not reward the trumpeter for overcoming the high risks; it does not tax the virtuoso’s compensation at lower rates. Instead, the trumpeter pays the same ordinary rates that the rest of the working public pays.

Even aspiring academics face the risk that they will not earn their full potential. A person entering the legal academy without tenure runs the risk of never obtaining tenure. The skills required to be a successful academic are different from the skills required to be a successful practitioner or successful administrator (and rightfully so, some would argue). Consequently, a person who accepts a law teaching job forgoes opportunities to develop skills that have market value in other professions. The recent downturn in the legal market has put legal education in the crucible of public opinion.60 It is possible that some law schools will fail. A person who enters the legal academy therefore accepts risk relating to future compensation and forgoes opportunities to develop marketable skills. Any number of factors could affect the law teacher’s future compensation. Every future salary payment represents an instance of overcoming the risks associated with being in that job. Nonetheless, the legal academic does not benefit from a favorable capital gains rate on risk-associated compensation.

The law does not grant them preferential treatment merely because that income was at risk before receipt. Holders of profits-only interests in a tax partnership risk not being paid if the partnership is unprofitable. All employees face a similar risk. If the employer fails to earn profits on average over a period, the employees will not collect their compensation. All future compensation is at risk and all decisions regarding the employment of services involve risk, but the risk does not warrant favorable tax treatment. Granting favorable treatment to holders of profits-only interests creates inequity by treating them differently from other wage earners. The law could proceed in one of two ways to correct that inequity. It could provide favorable tax rates to everyone who earns risk-associated income. This, of course, is the wrong way to proceed. The law should instead subject all compensatory income to ordinary rates. Another unsavory argument in favor of granting preferential tax treatment to some profits-only interests is that they encourage specific types of socially valued activities. The social value of the type of work that Mitt Romney did with Bain Capital is not, however, above reproach.61 He made money buying businesses, firing employees, cutting benefits, leveraging the businesses, and at times, selling them and watching them go into bankruptcy.62 Extending favorable tax treatment to people who earn money through services in that industry makes no sense when people who do work that scores very high on the social value meter (such as educators, healthcare professionals, law enforcement agents, fire fighters, military personnel, and numerous others) pay tax on their compensation at ordinary rates. The rationales for favorably taxing profits-only interests in the financial industry bear no legitimate weight.

Revising the taxation of profits-only interests in tax partnerships may require a scalpel instead of a butcher knife. For example, lawmakers must question whether they would like to tax Mitt Romney in the same manner that they would tax the operator of a falafel cart in New York City. Imagine a scenario in which someone purchases a cart and obtains a license to sell falafels in downtown Brooklyn. That person could easily agree to pay someone a wage to operate the cart. If the owner and operator develop a good working relationship over the years, the owner could grant the operator a profits-only interest in the business, the cart, and the license. The

62Id.
person who works in that cart day in and day out during the hot and cold months in New York and deals with difficult customers on a daily basis is in a somewhat different situation from Romney. The operator's share of profits from operations will be taxed at ordinary rates. If the partnership were to sell the cart or the license, however, non-recapture gain on that sale could qualify for favorable capital gains rates.

Many people would not quibble over granting the cart operator favorable rates on that gain because of the severe hardship the person endured to earn that income and the social value of providing good, convenient falafels. Perhaps the law should distinguish between the treatment it provides Romney and the treatment it provides the operator of the falafel cart. Both on a social value scale and a sympathy scale, the operator of the falafel cart garners more points. If favorable tax treatment is appropriate at all for profits-only interests, it would be appropriate for the falafel cart operator.

Some commentators may claim that the difficulty of valuing profits-only interests justifies not taxing them like other compensatory transfers of property. A thought experiment helps test that argument. Discussions of profits-only interests in tax partnerships generally do not require any qualifications, because discussants generally assume that a person who receives a profits-only interest in a tax partnership receives that interest in exchange for services. After all, by definition, a profits-only interest grants the recipient a right only to the tax partnership's future profits. It does not grant the recipient a right to a capital distribution on liquidation immediately following the grant of the interest. But consider whether a rational person would ever contribute capital to a tax partnership in exchange for a profits-only interest. A person who made a capital contribution in exchange for a profits-only interest would lose all rights to the capital contribution. This may lead some to conclude that only an irrational person would ever make a capital contribution in exchange for a profits-only interest in a tax partnership.

Those who insist that profits-only interests in tax partnerships have value on the date of grant recognize, however, that rational investors would undoubtedly contribute capital in exchange for profits-only interests. In fact, contributing capital in exchange for a profits-only interest is the economic equivalent of paying money to purchase that interest. The measure of fair market value is what a willing buyer would pay a willing seller for that interest, so those who insist that profits-only interests have value recognize that investors would happily contribute capital in exchange for those interests. Indeed, if the present value of the profits-only interest exceeded the next best investment opportunity, a rational investor would contribute capital in exchange for profits-only interests in tax partnerships.

Naysayers may claim that even if profits-only interests have value, the value depends on future performance and it is therefore too speculative. Those who have looked at the Romneys' tax returns recognize that a significant portion of the couple's current income is from profits-only interests in private equity funds. It is difficult to imagine that reasonable minds would claim that the interests the Romneys hold have no value. Part of the interests' value is in liquidation rights, but a significant portion of the value is also in future profits. In fact, after reviewing the Romneys' tax returns, a reasonable person would likely pay hundreds of millions of dollars for the rights to the couple's future income — and the Romneys would undoubtedly sell the rights to that future income for the right price. If in the end, however, valuing profits-only interests remains a problem, the law could tax income allocated to the income holder as the tax partnership recognizes it.

One of tax law's important responsibilities is to identify and tax financial and economic phenomena. In this area, the analyses work from the wrong end of the spectrum. Instead of placing the burden on the government to determine how much of the income from a profits-only interest should be subject to ordinary income rates, the onus should be on the recipient of the profits-only interests to justify taxing any portion of the income from the interest at other than ordinary income rates. The law should recognize compensatory profits-only interests as nothing more than disguised compensation arrangements and tax them as such. Perhaps the law should apply a version of Monroe's default rule and treat all income from a profits-only interest as compensation by default. If the law waits to tax the income until the partnerships recognize it, the law could impose an additional interest component to account for the time that passed between the date of grant until the date of recognition. A partner who

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64See Reg. section 20.2031-1(b).
wishes any other treatment would have the burden of demonstrating the source of income was not services.

C. Definition of Limited Partner

5. Kristin Balding Gutting, “Keeping Pace With the Times: Exploring the Meaning of ‘Limited Partner for Purposes of the Internal Revenue Code,”’ 60 U. Kan. L. Rev. 101 (2011). In this article, professor Kristin Balding Gutting addresses the anomalous per se rule in section 469(h)(2). Under that rule, generally, “no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.” Gutting notes that Congress enacted the section 469 passive activity loss rules and the section 469(h)(2) per se rule in 1986. The purpose of section 469 is to allow deductions and losses from an activity only to persons who materially participate in the activity. Gutting reminds readers that in 1986 most states prohibited limited partners from participating in the management of limited partnerships through limited partner interests. The section 469(h)(2) per se rule recognized that phenomenon and provided that losses allocated to a limited partner were per se to someone who by operation of state law did not participate in the management of the limited partnership. The rule made sense on the date of enactment: Because limited partners generally could not participate in management, why go through the hassle of asking if they materially participated in management?

State law regarding limited liability entities, including limited partnerships, has changed significantly since Congress enacted section 469. All states have adopted LLC statutes. Those statutes provide limited liability to all members and allow all members to participate in management. The inconsistency of providing limited liability to members of LLCs who participate in management while restricting limited partners’ rights to participate in management becomes apparent. Consequently, all states, except Louisiana, have adopted some form of the 1985 or 2001 Uniform Limited Partnership Act, which allow limited partners to participate in management to varying degrees. As a result, limited partners may now participate in management and the section 469(h)(2) per se rule has lost its relevance.

Despite the obvious anachronism of the section 469(h)(2) per se rule, professor Gutting kindly reviews cases that have held that the rule does not apply to members of LLCs and limited liability partnerships. The Tax Court maintained that section 469(h)(2) required both a limited partnership and an interest in the limited partnership as a limited partner. The court was then able to hold that members of LLCs and LLPs come within the regulatory general-partner exception to the per se rule. As a result, the court held that the section 469(h)(2) per se rule does not apply to members of LLCs or LLPs. Instead, the material-participation test applies to determine whether these members actively participate in the management of the entity. The Court of Federal Claims, on the other hand, held that an LLC is not a limited partnership and, therefore, the section 469(h)(2) per se rule does not apply to members of LLCs. The court’s rationale was simple: The plain language of the statute and the regulations limit the application of the per se rule to interests in limited partnerships. The rule does not apply to members of entities that are not limited partnerships.

Professor Gutting reviews the history and evolution of the various relevant forms of limited liability entities and correctly establishes that the world has changed significantly since Congress enacted the section 469(h)(2) per se rule. Although the regulations appear to emphasize limited liability as the basis for the per se rule, Congress enacted the per se rule because, at the time of enactment, limited partners did not participate in management of limited partnerships. Gutting therefore not only questions the validity of the regulations that apply

Footnote continued on next page.
the per se rule based on limited liability, but she also recommends that Congress amend section 469 to eliminate the section 469(h)(2) per se rule.

As Gutting points out, the current section 469(h)(2) per se rule is anachronistic. Congress enacted it in an environment that no longer exists. Its continued existence creates inequity. The per se rule treats a limited partner, who participates in management of a limited partnership, differently from a member of an LLC or LLP who also participates in management. The members of the several entities can all enjoy limited liability and participate in management, but only the limited partner is subject to the per se rule. Congress could solve the inequity by extending the per se rule to members of LLCs and LLPs, but that would overextend the passive activity loss rules to taxpayers who may materially participate in management under the material participation test and undermine Congress’s original intent. Thus, to remedy the inequity and avoid making the passive activity loss rules broader than their intended purpose, Congress should follow Gutting’s recommendation and simply repeal section 469(h)(2).

Despite the eminent rationality of the proposal, hoping for congressional action may be a complete pipe dream. An administrative fix is perhaps more grounded in reality. In fact, Treasury published proposed regulations on November 28, 2011, adopting a participation test for members of all types of limited liability entities, including limited partners. The proposed regulations incorporate the participation test by changing the definition of interest in a limited partnership to include only an interest in a tax partnership that does not grant rights to manage the entity under state law and the governing agreement. Under that definition, a member of an LLC who does not have management rights would be subject to the section 469(h)(2) per se rule, but a limited partner who does have management right would not be. The rules also treat an individual as not holding an interest in a limited partnership if the person also holds an interest that is not in a limited partnership. Consequently, a person who holds both a limited partner interest and general partner interest would not hold a limited partner interest for purposes of the rules. The proposed rules take management participation into consideration, so they are a definite improvement over the current regime.

D. TEFRA Rules

6. Peter A. Prescott, “Jumping the Shark: The Case for Repealing the TEFRA Tax Partnership Audit Rules,” 11 Fla. Tax Rev. 503 (2011). By now, the reader should recognize that criticizing partnership rules is a favorite passtime of academics. Professor Peter Prescott’s “Jumping the Shark: The Case for Repealing the TEFRA Partnership Audit Rules” is further evidence of that tendency. Prescott provides a nice review of the history, policy justification (fairness/equity, simplicity/ease of administration, and economic efficiency), and basics of the TEFRA rules. He then proceeds to suggest that the rules do not sufficiently accomplish their stated purposes. First, he considers how the rules tend to shift complexity more than eliminate it. For instance, the TEFRA entity-level audit simplifies IRS administration, but it shifts administrative complexity to the partnership and partners. Before TEFRA, the IRS communicated directly with partners regarding matters related to partnership audit items, but now the tax matters partner (TMP) often bears the burden of that communication. Prescott is critical of the shift of that burden because a TMP will have less experience with audits than the IRS and may fail to adequately perform all the required audit responsibilities because of incompetence or intentionally misleading the other partners. TEFRA also added more text to the tax code and more regulations, creating more complexity, and partners must now contend with two sets of audit rules and deal with the ambiguous definition of partnership item to determine whether TEFRA or the main audit regime applies.

Second, Prescott also questions the fairness of the TEFRA rules by looking at both the fairness to and fairness among the partners. When considering fairness to the partners, he focuses on the treatment afforded to small partners (those owning less than 1 percent of the partnership). Small partners do not receive notice from the IRS about an audit’s

status, the committee believes it should not be necessary to examine general facts and circumstances regarding material participation in this context”).

See Gutting, supra note 4, at 135.

Id. at 147.


See prop. reg. section 1.469-5(e)(3)(ii). A tax partnership is any arrangement that comes within the reg. section 301.7701-3 definition of partnership.

beginning and end but instead must rely on communication from the TMP.\textsuperscript{92} The TMP can bind small partners under a settlement agreement with the IRS.\textsuperscript{93} Prescott recognizes that the TEFRA rules therefore shift traditional audit functions from small partners to the TMP. He is concerned not only about the small partners giving up procedural due process but also about potential conflicts of interests between the small partners and the TMP,\textsuperscript{94} which appears to be unfair to small partners. Prescott identifies two primary ways in which TEFRA creates inequity among partners. If a single partner’s statute of limitations extends beyond the partnership’s statute of limitations, that partner, but no other partner, is exposed to audit of partnership items.\textsuperscript{95} Also, TEFRA treats small partners and other partners differently.\textsuperscript{96} That different treatment creates inequity among the partners.

Third, Prescott also identifies two issues related to the economic efficiency of the TEFRA rules. He questions whether the rules have had the intended result of reducing tax shelters.\textsuperscript{97} He also wonders whether the TMP can use the tax-related powers bestowed by TEFRA to influence nontax business decisions.\textsuperscript{98} Those shortcomings could negatively affect the economic efficiency of the rules.

After discussing the unfairness, complexity, and economic inefficiency of the TEFRA rules, Prescott turns to the rules’ operational shortcomings. He is particularly concerned about their limited scope.\textsuperscript{99} For example, the rules do not apply to qualified tax partnerships that make the section 761 election,\textsuperscript{100} to small partnerships,\textsuperscript{101} to electing large partnerships,\textsuperscript{102} or to some publicly traded partnerships.\textsuperscript{103} That leaves a fairly small percentage of tax partnerships subject to the TEFRA and its rules.\textsuperscript{104} By illustrating that the small partnership exception significantly limits the scope of the TEFRA rules and that large partnerships, including publicly traded partnerships, are not subject to TEFRA, Prescott undermines his earlier criticisms. If TEFRA does not apply to large and publicly traded partnerships, it may apply mainly to tax partnerships that do not have small partners. A significant part of Prescott’s inequity arguments focus on small partners. If the TEFRA rules generally do not apply to partnerships with small partners, the rules will be less inequitable than Prescott claims.

Finally, Prescott argues that times have changed and no longer warrant the TEFRA rules (if they ever did). The passive activity loss rules have done more to eliminate tax shelters than the TEFRA rules, and technology would enable the IRS to better manage partnership audits.\textsuperscript{105} He therefore recommends complete repeal of the rules.\textsuperscript{106} After his convincing argument that the TEFRA rules have a fairly limited scope, the reader is left wondering whether the perceived hardships they create warrant any changes. If the rules affect only a small percentage of partnerships, should Congress invest the effort to consider their repeal? However, if the effect of repeal would be negligible, should Congress hesitate to eliminate a set of rules that add complexity and unfairness to some situations? With or without the rule, audits of tax partnerships will remain complicated. Perhaps there are ways to keep the good aspects of the rules and look to fix the problematic parts.

E. Liability of General Partners

7. Venessa Haberbush, “Be Careful What You Wish For: The Unforeseen Repercussions of the IRS’ Desired Outcome in United States v. Galletti on the IRS’ Ability to Collect Tax Partnership Taxes Against General Partners,” 32 Whittier L. Rev. 533 (2011). IRS collection actions are closely related to IRS audit procedures. “Be Careful What You Wish For: The Unforeseen Repercussions of the IRS’ Desired Outcome in United States v. Galletti on the IRS’ Ability to Collect Partnership Taxes Against General Partners,” another student article, considers IRS collection action.\textsuperscript{107} This article considered the somewhat dated Supreme Court case of United States v. Galletti.\textsuperscript{108} The issue in the case was whether the IRS could enforce the tax partnership’s employment tax liability against the general partners, even though it had assessed the tax only against the partnership before the end of the statute of limitations.\textsuperscript{109} The Supreme Court held that the IRS could because the general partners are liable for the partnership’s liability under state law.\textsuperscript{110} The author claims that the IRS may have gained the

\hspace{1cm} \textsuperscript{92}See section 6223(b)(1), (g); reg. section 301.6223(g)-1(a)(1), (2).
\hspace{1cm} \textsuperscript{99}See section 6224(c)(3)(A).
\hspace{1cm} \textsuperscript{94}See Prescott, supra note 5, at 542-546.
\hspace{1cm} \textsuperscript{95}Id. at 550.
\hspace{1cm} \textsuperscript{96}Id. at 551.
\hspace{1cm} \textsuperscript{97}Id. at 553.
\hspace{1cm} \textsuperscript{98}Id. at 554.
\hspace{1cm} \textsuperscript{99}Id. at 556-560.
\hspace{1cm} \textsuperscript{100}See section 761(a).
\hspace{1cm} \textsuperscript{101}See section 6231(a)(1)(B)(i).
\hspace{1cm} \textsuperscript{102}See section 6240.
\hspace{1cm} \textsuperscript{103}See section 7704 (treating publicly traded partnership as corporations in general).
\hspace{1cm} \textsuperscript{104}See Prescott, supra note 5, at 559-560.
\hspace{1cm} \textsuperscript{105}Id. at 560-564.
\hspace{1cm} \textsuperscript{106}Id. at 564.
\hspace{1cm} \textsuperscript{107}See Haberbush, supra note 6.
\hspace{1cm} \textsuperscript{108}541 U.S. 114 (2004), Doc 2004-6422, 2004 TNT 57-17.
\hspace{1cm} \textsuperscript{109}Id. at 116-118.
\hspace{1cm} \textsuperscript{110}Id. at 123.
opportunity to proceed against general partners under state law, but in doing so, it may have closed the door of opportunity to bring similar actions against general partners under federal tax law.\footnote{See Haberbush, supra note 6, at 572-574.} Apparently that thesis has not yet been considered by a court. It will be interesting to see if a court would accept the thesis. In \textit{Galletti} the Court appeared to expand the potential liability of partners. Some courts would undoubtedly have difficulty reading the case as being restrictive.

\section*{F. Series LLCs}

8. Bradley T. Borden and Mathews Vattamala, \textit{“Series LLCs in Real Estate Transactions,”} 46 \textit{Real Prop., Trust & Est. L.J.} 255 (2011). The advent of series LLCs ostensibly raises tax entity classification questions. The IRS responded to those questions by publishing proposed classification regulations on September 14, 2010.\footnote{See prop. reg. section 301.7701-1(a)(3); REG-119921-09, Doc 2010-19982, 2010 TNT 177-12.} \textit{“Series LLCs in Real Estate Transactions”} reviews the mounting popularity of series LLCs, showing that each year property and business owners form thousands of series LLCs and that tens of thousands of series LLCs now appear to be in existence.\footnote{See Borden and Vattamala, supra note 7, at 259.} It also examines the legal aspects and tax entity classification of series LLCs.\footnote{Id. at 260-275.} The article concludes that under current rules, a series could be a separate entity.\footnote{Id. at 270-273.} As such, if it had a single member, it would be a disregarded entity by default but could elect to be a tax corporation.\footnote{See reg. section 301.7701-3(a), (b).} A series with more than one member would be a tax partnership by default but could elect to be a tax corporation.\footnote{Id. at 274-275.}

The article suggests that the proposed regulations would not add significantly to the current classification rules.\footnote{See Borden and Vattamala, supra note 7, at 274-275.} They would recognize a series as a separate entity if state law recognizes the entity as formed under state law.\footnote{See prop. reg. section 301.7701-1(a)(3).} Thus, if the series does not lack a separate business purpose nor has any business activity other than tax avoidance, it will be a separate entity.\footnote{See REG-119921-09.} Under the proposed regulations, a series with a single member will be disregarded unless it elects to be a tax corporation, and a series with multiple members will be a tax partnership unless it elects to be a tax corporation.\footnote{See prop. reg. section 301.7701-1(a)(3)(x), Example (1)(ii).}

Finally, the article offers a few ways in which property and business owners may use series LLCs in tax planning. First, property owners may use series LLCs in place of the traditional multiple-LLC structure common in many Bramblett arrangements. Recall that \textit{Bramblett v. Commissioner} sanctioned capital gain lock-in structures.\footnote{See Borden and Vattamala, supra note 7, at 277-278.} Those structures generally include one or more LLCs that own investment property and one S corporation that develops and sells the property. All the entities may be under common ownership. The \textit{Bramblett} court held that gain recognized by an investment entity on sale of the property to the developer entity may qualify for favorable capital gains rates (assuming the property otherwise qualifies for favorable rates).\footnote{Id. at 529.} Any gain the developer recognizes would be subject to ordinary rates. The article posits that series LLCs would allow property owners to accomplish the same tax objectives using series instead of separate entities.\footnote{Id. at 278-280.} The article also suggests that series LLCs may help simplify exchange accommodation titleholder arrangements.\footnote{See supra note 7, at 277-278.}

Although series LLCs have enjoyed considerable popularity over the last several years, time will tell whether they continue to enjoy that popularity. To date, eight states have enacted series LLC statutes.\footnote{Id. at 529.} If series LLCs are to become mainstream, other states must adopt series LLC statutes, and their use will have to continue to increase.

\section*{G. Blockers and Stoppers}

9. Willard B. Taylor, \textit{“Blockers, ‘Stoppers,’ and the Entity Classification Rules,”} 64 \textit{Tax Law.} 1 (2010). In this article, Willard Taylor describes how the use of different tax entities can help taxpayers obtain preferential tax treatment for some types of income. A portion of the article discusses blockers and stoppers generally and includes discussions of tax partnerships only to demonstrate that they may not be as effective as tax corporations to stop undesirable tax results. For example, foreign investors may use a tax partnership to hold shares in real estate investment trusts that borrow from the tax partnership. If the interest paid to the partnership is portfolio interest, it is exempt from withholding.\footnote{See Bramblett v. Commissioner, supra note 7, at 277-278.} Interest paid to a shareholder owning 10 percent or more of the voting power of the corporation paying interest does not qualify for the portfolio interest exemption.\footnote{Id. at 256, n.1.} The rules adopt a look-through rule
to determine a partner’s percentage ownership of REIT stock owned by a tax partnership, but they do not apply a similar rule to shareholders of a corporation that owns the REIT stock. Consequently, the law inexplicably treats partners differently from shareholders.\(^\text{130}\)

More significantly (to partnership tax, at least), Taylor devotes considerable discussion to the use of blockers and stoppers in the burgeoning realm of publicly traded partnerships.\(^\text{131}\) For example, publicly traded partnerships use blockers to block income that if received directly, would cause the partnership to lose its favored status.\(^\text{132}\) Parties may also use blockers to block trading in the partnership’s interests.\(^\text{133}\) Taylor uses UpREITs to illustrate that use.\(^\text{134}\) With such a structure, the REIT becomes the general partner of a partnership with other limited partners. The REIT can be publicly traded and the investors can make contributions of property to the partnership without triggering section 351 gain, which would happen if the partnership were either a REIT or publicly traded. He also illustrates the point with an example of a tax partnership that invests in the shares of a corporation to avoid having too much non-passive-type income.\(^\text{135}\)

Taylor provides several other examples of blockers and stoppers. The article does an excellent job of reminding the profession that the tax entity classification rules may deserve renewed attention. The different treatment afforded taxpayers simply by altering the tax entity that owns property or a business creates complexity and inequity. The legal academy has been slow to recognize the existence of tax entities other than disregarded entities, tax partnerships, S corporations, and C corporations.\(^\text{136}\) In the future, academic analyses must begin to consider the other entity types that Taylor discusses.

H. Financially Troubled Tax Partnerships

10. David B. Newman, “Tax Aspects of Financially Troubled Tax Partnerships and LLCs (With a Few Thoughts on Subchapter S Corporations),” 5 Charleston L. Rev. 229 (2011). Finally, “Tax Aspects of Restructuring Financially Troubled Partnerships and LLCs (With a Few Thoughts on Subchapter S Corporations)” describes the rules governing modification of debt instruments and how some of those rules apply to tax partnerships.\(^\text{137}\) David Newman discusses how modifications can result in cancellation of indebtedness (COD) income, which triggers income allocation for the partners but also could be a deemed distribution resulting from a decrease in the partners’ shares of the tax partnership’s liabilities.\(^\text{138}\) He also discusses the different treatment afforded publicly traded and non-publicly traded debt and the treatment of contingent debt payments.\(^\text{139}\)

The most significant portion of the article discusses the tax treatment of a transfer of an interest in a tax partnership in satisfaction of a partnership’s liability.\(^\text{140}\) A tax partnership that satisfies all or a part of a liability with an interest in the partnership is treated as satisfying the liability with an amount of money equal to the value of the transferred interest.\(^\text{141}\) If the value of the interest is less than the amount of discharged liability, the partnership has COD income equal to the difference between the amount of discharged liability and the value of the interest. The partnership allocates that gain to the taxpayers who were partners immediately before the liability discharge.\(^\text{142}\) The partners must also account for any deemed distributions that result from the decrease in the tax partnership’s liabilities.\(^\text{143}\) Newman points out that the basis increase from the COD income should generally offset any deemed distribution from the decrease in shares of liabilities.\(^\text{144}\) He also recognizes that if the converted liability is a nonrecourse liability, the admission of the creditor in partial satisfaction of the liability may result in a reallocation of the partners’ shares of that liability to the lender.\(^\text{145}\) Other parts of the discussion address fairly routine transactions, such as the tax effects of transfers of property subject to liabilities.\(^\text{146}\) Nonetheless, the article provides a good review of these important rules.

\(^{129}\) See reg. section 1.871-14(b)(3).

\(^{130}\) See Taylor, supra note 8, at 11.

\(^{131}\) Id. at 18-24.

\(^{132}\) Id. at 19. A publicly traded partnership qualifies for subchapter K only if at least 90 percent of its income is from passive-type income. See section 7704(c), (d).

\(^{133}\) See Taylor, supra note 8, at 19.

\(^{134}\) Id.

\(^{135}\) Id. at 21.

I. Future Scholarships

The academic work in this area of the law must continue. In fact, as tax partnerships become more popular and draw additional attention from lawmakers and the public, the demand for scholarly work in this area of the law will increase. The partnership tax rules are complex, and scholarship that further explores any aspect of them and recommends improvements is welcome. Also, scholars must begin to grapple with the complexity that tax partnerships create because of the overlap of state law, tax law, accounting, and finance. Without that work, the nature of tax partnerships and the proper tax treatment of them will continue to stymie important developments in this area. In short, more sophisticated work can be done in this area to help explain the nature of tax partnerships, and the times demand such work.