May 6, 2013

Notable Partnership Tax Articles of 2012

Bradley T. Borden, Brooklyn Law School

Available at: https://works.bepress.com/brad_borden/46/
Notable Partnership Tax Articles of 2012

By Bradley T. Borden

Bradley T. Borden is a professor at Brooklyn Law School.

Borden reviews several partnership tax articles published by academic journals in 2012. The subjects of the articles range from broad reform proposals to taxation of reorganizations to taxation of carried interest to issues affecting partnership liabilities.

The recent proposals by House Ways and Means Committee Chair Dave Camp, R-Mich., to change pass-through taxation is a reminder that reform in this area of the law is a real possibility.1 Camp is not the only person recommending changes to partnership taxation. Several articles published in academic journals this past year suggested changes to subchapter K. Other than one article that recommends a change to the allocation rules and another that calls for broader reform, the academic scholarship from 2012 did not address the areas in Camp’s proposals,2 and rightfully so. While the Camp proposals provide an immediate point of interest, they address a small portion of the many aspects of partnership taxation. The academic scholarship does an excellent job of addressing topics that are relevant and may remain so for years to come.

The authors include practitioners, law professors (from within and outside the United States), and law students. This potpourri of articles provides a rich review of central aspects and hot topics in partnership taxation. Most of the articles appear in specialty tax journals (that is, the Florida Tax Review and The Tax Lawyer), but a few are published in general law reviews. This phenomenon suggests that although business and tax lawyers realize the importance of partnership taxation, law schools and student editors of many law reviews still do not appreciate the central role that partnership taxation, and entities subject to partnership taxation, play in the economy and in the transaction setting. Perhaps that will change in the future.

Reform Proposals

Some aspects of partnership taxation appear to have no solution. That is no truer than with allocations of a tax partnership’s tax items. But the seeming impossibility of improving the tax allocation rules does not stop commentators (including me3) from proposing changes.

David Hasen, “Partnership Special Allocations Revisited,” 13 Fla. Tax Rev. 349 (2012). Hasen focuses on special allocation reform. He proposes that tax law require partnerships to allocate tax items in proportion to the partners’ capital account balances for any items that relate to the partnership’s property. The proposal would generally treat any allocation of those items that is not in proportion to capital account balances as a taxable transfer of capital. The following example illustrates the

1See Dave Camp’s discussion draft (Mar. 12, 2013). Option 1 of Camp’s proposals would modify subchapter S and repeal section 707(c), which governs guaranteed payments; require mandatory basis adjustments when a partnership distributes property or a member transfers an interest in the partnership; and make other modifications. Option 2 would eliminate subchapters K and S and adopt new, unified pass-through rules. It would limit the use of special allocations, require entity-level withholding of estimated taxes owed by members, extend the partnership liability rules to all pass-through entities, clarify the rules relating to employment taxes, and prevent shifting of gains and losses on the distribution of property. It would also maintain some rules that apply to tax partnerships, such as those that disallow pass-through losses to the extent they exceed members’ bases in their entity interests and the rules that require members to recognize gain on distributions that exceed their bases in their entity interests.

2This article defines the academic scholarship of 2012 to include articles published during 2012 (regardless of the date of the publication) in a student-edited journal.

3See Bradley T. Borden, “The Allure and Illusion of Partners’ Interest in a Partnership,” 79 U. Cin. L. Rev. 1077 (2011) (suggesting that the partnership allocation rules require tax items that correspond to an economic item to follow the allocation of the economic item and require tax items that do not correspond to an economic item to tie in with an economic aspect of the partnership that relates to the tax item).
proposal’s basic idea and how it might complicate the current rules without significantly improving them.

Assume that Margaret and Mikhail are partners in Marail LLC, a tax partnership. Margaret’s and Mikhail’s capital accounts are each $100,000. Marail LLC owns a single piece of depreciable property with an annual depreciation deduction of $5,000. According to the proposal, Marail LLC should allocate that $5,000 depreciation deduction equally to Margaret and Mikhail because they have equal capital account balances. An equal allocation will cause each partner’s capital account balance and outside basis to decrease by $2,500 to $97,500. Table 1 presents the partnership situation based on an equal allocation of the depreciation deduction.

Margaret and Mikhail might, however, agree to allocate all the depreciation deduction to Margaret, as allowed under the current rules. Under that arrangement, Marail LLC would allocate the $5,000 depreciation deduction to Margaret in full and none to Mikhail. The allocation would reduce Margaret’s capital account and outside basis but would not affect Mikhail’s capital account or outside basis. Table 2 presents Marail LLC’s situation following the special allocation of all the depreciation deduction to Margaret.

Hasen views partnerships from a tax-centric aggregate perspective and takes the position that the special allocation represents a capital shift. Under that view, because both Margaret and Mikhail contributed equally to Marail LLC, they indirectly own half of Marail LLC’s property. Consequently, they should each be entitled to half the property’s depreciation deduction. Hasen concludes that because the allocation of all the depreciation deduction to Margaret causes her capital account to decrease disproportionately, a capital shift has occurred. He reasons that Mikhail could maintain his $100,000 capital account balance as an equal owner of depreciable property only if Margaret transferred $2,500 of capital to Mikhail. Thus, the law should deem that the partners allocate the depreciation deduction equally, and Margaret transfer $2,500 of capital to Mikhail, which would be ordinary income to Mikhail and deductible by Margaret. That deemed transfer of capital would restore Mikhail’s capital account balance to $100,000 (from the $97,500 following the depreciation deduction allocation) and reduce Margaret’s capital account balance to $95,000 (from the $97,500 following the depreciation deduction). The capital accounts following the depreciation deduction and deemed capital transfers would be the same as those in Table 2. Hasen’s aggregate view of special allocations is tax centric because it considers how the partners allocate tax items and then requires that the economic arrangement change to align with the tax arrangement.

An economic-centric aggregate view of partnerships would allow Margaret to deduct all $5,000 of the depreciation deduction only if she indirectly owned a disproportionate amount of Marail LLC’s assets. The economic-centric view would thus require Mikhail to transfer capital to Margaret. Assuming the deemed transfer was a $2,500 capital shift, that transfer would trigger $2,500 of ordinary result and Hasen’s later recommendation adopts the capital shift analysis, this article focuses solely on the capital shift analysis.

### Table 1. Marail LLC Situation With No Special Allocation

<table>
<thead>
<tr>
<th>Assets</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Capital Account</td>
</tr>
<tr>
<td>Book</td>
<td>Tax</td>
</tr>
<tr>
<td>Building</td>
<td>$195,000</td>
</tr>
<tr>
<td>Margaret</td>
<td>$97,500</td>
</tr>
<tr>
<td>Mikhail</td>
<td>$97,500</td>
</tr>
<tr>
<td>Total</td>
<td>$195,000</td>
</tr>
</tbody>
</table>

### Table 2. Marail LLC Situation With Special Allocation

<table>
<thead>
<tr>
<th>Assets</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Capital Account</td>
</tr>
<tr>
<td></td>
<td>Book</td>
</tr>
<tr>
<td>Building</td>
<td>$195,000</td>
</tr>
<tr>
<td>Margaret</td>
<td>$95,000</td>
</tr>
<tr>
<td>Mikhail</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$195,000</td>
</tr>
</tbody>
</table>
income for Margaret, and Mikhail should have a deduction on the transfer, assuming the purpose of the deemed transfer would give rise to a deduction. The $2,500 of income would be to offset the depreciation deduction allocated to Margaret (leaving her a net deduction of $2,500) and provide a $2,500 deduction for Mikhail. The net result is that the transfers put the partners in the same position they would have been in had they not made the allocations. Following the deemed transfer of capital and the allocation of the depreciation deduction, each partner would have a $97,500 capital account balance, so the partnership’s situation would be the one reflected in Table 1. The effect of the disproportionate allocation and the deemed transfer is an equal allocation of the depreciation deduction. Thus, if the law adopted this economic-centric view, it could simply disallow allocations that deviate from capital account balances and require reallocation of any items that are not in proportion to capital account balances.

In the end, both these methods are oversimplified. From an economic-centric aggregate view, a partner could take 100 percent of the depreciation deduction attributed to the partnership’s property only if the partner indirectly owned 100 percent of the property. Thus, to enable Margaret to deduct 100 percent of the depreciation deduction, the deemed transfer would not be for merely $2,500 of the property but for all $50,000 of Mikhail’s indirect ownership interest in the property. Margaret would therefore recognize income immediately on the deemed transfer and take the depreciation deductions over time, assuming the allocation of depreciation deductions for the property remains 100:0. The law would have to determine whether Mikhail should qualify for a $50,000 deduction at the time of the deemed transfer. Indeed, Hasen recognizes that disproportionate allocations of items related to the property require a deemed transfer of the property when the allocation becomes part of the partnership’s agreement, and he recommends a current deduction. The difference between the $2,500 deemed transfer at the time of the allocation and the $50,000 deemed transfer becomes one of timing for tax purposes. With the former, Mikhail would take deductions over time that add up to $50,000, and with the latter, he could qualify for a $50,000 current deduction. The law could rectify that timing difference by requiring Mikhail to take deductions only as Marail LLC takes depreciation deductions. The net effect of this reasoning is a requirement that allocations be made in proportion to capital account balances.

The economic-centric view of the transaction requires tax items to follow the perceived economic arrangement and puts the members in the position they would be in without the special allocation. Requiring tax items to follow economics is the typical tax treatment outside the partnership context, so it would be appropriate within partnerships. Even though the regulations deviate from the typical treatment, deviating further, as recommended in the Hasen proposal, would be unwise. That extension would impose unneeded complexity on an already complicated system. A law that simply requires the allocations to be in proportion to capital accounts may avoid some of the complexity and unjustifiably harsh results that arise from treating special allocations as a transfer of capital. (It could also open the door for tax abuse, but that is a topic for another day.)

In addition to taking a tax-centric perspective, the Hasen proposal relies on shaky assumptions, as he acknowledges. First, the proposal assumes that depreciation deductions affect partners’ interests in the partnership. Depreciation deductions are tax items that often do not correspond to properties’ changes in value, so they may not affect the partners’ economic interests in the partnership. Second, the proposal assumes that the book value of property equals its fair market value. Because the book value and FMV of property generally will be the same on just one day (the day of acquisition), relying on book value to determine the allocation of tax items can create inaccurate allocations.

Hasen defines special allocations as “allocations of specific items of partnership income, gain, loss, and deduction . . . that do not generally track properties’ changes in value, so they may not affect the partners’ economic interests in the partnership.” The problem with that definition, and almost any other attempt to define special allocations, is that it relies on the partners’ interests in the partnership. Unfortunately, identifying partners’ interests in a partnership, except in the simplest of arrangements, is probably impossible. The inability to identify special allocations will make applying special rules to them all the more difficult. As Hasen’s proposal illustrates, any of those rules will be complex and at the same time overinclusive.

---

8See Borden, “Partnership Tax Allocations and the Internalization of Tax-Item Transactions,” 59 S.C. L. Rev. 297, 334-338 (2008) (describing how the test for economic effect is a tax-centric test — i.e., the rules require the economic items to follow allocated tax items). In fact, I generally do not support allocations in proportion to capital accounts. In many situations, those allocations may not reflect the partners’ economic arrangement.

9See Borden, supra note 3, at 1088.


11See Borden, supra note 3, at 1105-1127 (illustrating the deficiencies of the definition of partners’ interests in a tax partnership in the section 704(b) regulations).
(altering allocations that reflect the partners’ economic arrangement) and underinclusive (failing to alter allocations that do not reflect the partners’ economic arrangement).

Andrea Monroe, “Integrity in Taxation: Rethinking Partnership Tax,” 64 Ala. L. Rev. 289 (2012). Monroe takes a broader approach to reform of partnership taxation. She draws on Ronald Dworkin’s “principle of integrity to develop a coherent vision of subchapter K” and to outline “an intellectual groundwork for the reform of partnership taxation.” Monroe’s article retracts the general history of partnership taxation, illustrating that it started as an eminently flexible body of law that granted great latitude to partnership members. Lawmakers realized that with that flexibility, partners could receive tax treatment that was unavailable to other taxpayers. Congress reacted by enacting rules to restrict the use of partnership taxation to obtain tax benefits that were unavailable outside partnerships. The result is a complex body of law that frustrates the values of partnership taxation: flexibility, efficiency, equity, and simplicity.

The complex rules do not curb abuse. They instead provide tax planning opportunities for partnerships that have the resources to hire sophisticated tax advisers, which causes inequity because smaller partnerships are unable to take advantage of those rules. The complex rules also increase tax administration costs and distort economic behavior because taxpayers arrange their affairs to take advantage of loopholes within the partnership tax rules. This complex body of law therefore creates the perception that partnership taxation is unfair and unprincipled, undermining its legitimacy.

Monroe argues that Dworkin’s principle of integrity as applied to partnership taxation requires simpler rules that would allow even small partnerships to competently navigate the rules without sophisticated tax advice. Simplicity would also make administration of partnership taxation less costly, help end abusive tax shelters, and promote equity. Otherwise, Monroe generally leaves to “Congress and to the partnership tax community of scholars, practitioners, and partners” the task of “determining the conceptual components of an integrity-based subchapter K.” Thus, the heavy lifting is left to be done.

Hasen’s and Monroe’s proposals illustrate the tension that reform of partnership taxation presents. Both Hasen and Monroe recognize that the allocation rules facilitate abuse, and they recommend changes to the law that they believe would help curb that abuse. Nonetheless, Hasen’s proposal adds complexity to partnership taxation in an attempt to improve accuracy. Monroe argues that that complexity undermines the integrity of partnership taxation, and she advocates for a simpler system. Perhaps simplicity and accuracy cannot coexist in this area of the law.

Although partnership tax is complex and in need of improvement, simplification alone will not solve its problems. Arrangements that qualify for partnership taxation can vary from a simple ma and pa bodega to a consortium of multinational corporations. Despite the simple appearance of the bodega ownership structure, it actually could be more complicated in its sharing of control, profits, and other aspects of the business than the consortium. A simple tax regime may not be suited to govern the wide variety of arrangements that come within the definition of partnership. Further, tax law makes pass-through taxation available to simple business arrangements through subchapter S. Subchapter S is a simple law that applies to simple arrangements, but once arrangements take on even a modicum of economic complexity, subchapter S ceases to provide sufficient capabilities for handling the additional complexity. Subchapter K performs an important function by governing complex arrangements. Perhaps the law must leave simplicity to subchapter S and recognize that the law governing complex arrangements must be complex. Nonetheless, the complexity is a problem that the law must contain, assuming simplification is not possible.

Partnership Reorganization

The three articles on reorganizations are excellent. Two of them are not exclusively about tax partnerships, but they cover a considerable amount of partnership taxation.

John B. Truskowski, “Cross Species Conversions and Mergers,” 65 Tax Law. 591 (2012). Truskowski’s article covers conversions and mergers of limited liability companies and partnerships into corporations, and conversions and mergers of corporations into LLCs and partnerships. It details how the form of a transaction can affect the gain or loss recognized on the transaction, the basis the members take in new ownership interests, the basis the entity takes in assets, and the holding period of the assets and the interests. This article should become an indispensable source for anyone who does transactional work.

12At that time, which preceded the creation of limited liability companies, tax partnerships were in fact state law partnerships.

Cross-species conversions and mergers can take the assets-over, assets-up, or interests-over form.\textsuperscript{14} Tax law generally respects the form of the transaction, but if the transaction does not reflect one of the possible forms (such as a state law merger or conversion), tax law prescribes the form. For example, tax law deems an assets-over reorganization to occur if a merger or conversion transforms a partnership into a corporation, and it deems an assets-up reorganization if a merger or conversion transforms a corporation into a partnership.\textsuperscript{15} If the members of an entity would be unhappy with the default form of the transaction, they must plan to structure the transaction to come within one of the other possible forms.

One example illustrates how the form of the conversion or merger can affect the tax aspects of the transaction. If the reorganization transforms a partnership into a corporation and the members’ bases in their interests in the partnership are different from the partnership’s basis in its assets, the form of the reorganization can affect the basis the new entity will take in the assets. On liquidation of a partnership, the members take bases in the partnership’s assets that equal the bases they had in their respective interests in the partnership.\textsuperscript{16} If the aggregate basis of the members’ partnership interests is less than the bases the partnership had in the assets, the assets will lose basis on an assets-up reorganization. By contrast, the assets retain their bases if the transaction is an assets-over reorganization or an interests-over reorganization because the transferee takes the transferor’s basis on the contribution of assets.\textsuperscript{17} Thus, the assets would retain their bases if the reorganization were a state law conversion or merger, which tax law deems to be an assets-over reorganization.

Even though later transfers of the interests or assets equalize the result over time, the time value of money can make the timing disparity significant. This simple example illustrates how the form of the transaction can affect the tax consequences of the transaction. Partnership members who are contem-plotting a cross-species conversion or merger would have to study the specific aspects of the proposed reorganization to determine which form is best for their situation. That study adds complexity to the reorganization.

Although Truskowski’s article is largely descriptive, his description of these types of reorganizations illuminates the complexity that the multiple forms create. The rules governing mergers and divisions of partnerships are useful because they provide bright-line guidance.\textsuperscript{18} Those rules allow sophisticated property and business owners to plan their affairs to minimize the tax consequences of a conversion, merger, or division. As with any complex body of law, however, the complexity and potential for different outcomes based on the form of the transaction can become a trap for the unwary, which generally includes partnerships that lack the resources to hire sophisticated tax counsel. To help alleviate that problem, it may behoove Treasury and the partnership tax bar to consider the possibility of a uniform set of rules that would apply to mergers and divisions of partnerships regardless of the form of the transaction.

Martin J. McMahon Jr., “Now You See It, Now You Don’t: The Comings and Goings of Disregarded Entities,” 65 Tax Law. 259 (2012). McMahon’s article includes extensive discussion of the tax consequences of a partnership becoming a disregarded entity and a disregarded entity becoming a partnership. This article, like Truskowski’s, should become a crucial part of any transactional attorney’s library.

The transfer of an interest in a disregarded single-member LLC will convert the LLC to a partnership, and the acquisition by one member of all the other interests in a multiple-member LLC (taxed as a partnership) will convert it to a disregarded entity.\textsuperscript{19} The interesting thing about those transactions is that they may be asymmetrical — tax law treats the buyer and seller differently. For instance, if an LLC member purchases all the other interests in the LLC from the other members, tax law treats the acquiring member as purchasing a proportionate share of the assets from the other members and receiving a distribution of the remaining portion of the assets. Tax law treats the other

\textsuperscript{14}Under the assets-up form, the terminating partnership distributes its assets to its members who then contribute them to the continuing entity. Under the assets-over form, the terminating partnership contributes its assets to the continuing entity in exchange for interests in that entity. The terminating partnership then distributes the interests to its members in liquidation. Under the interests-over form, the members of the terminating partnership transfer their interests to the continuing entity in exchange for interests in that entity. The continuing entity can then either liquidate the partnership or retain it as a single-member disregarded entity.

\textsuperscript{15}See reg. section 301.7701-3(g)(1)(i).

\textsuperscript{16}See section 732(b).

\textsuperscript{17}See section 723.

\textsuperscript{18}See reg. section 1.708-1(c) and (d); Borden, “What You Should Know About Mergers and Divisions of Partnerships,” 17 Prac. Tax Law. 45 (Winter 2003).

\textsuperscript{19}See Rev. Rul. 99-5, 1999-1 C.B. 434 (governing the sale of a membership interest in a single-member LLC); Rev. Rul. 99-6, 1999-1 C.B. 432 (governing the acquisition of all LLC membership interests by a single member of an LLC).
members as selling their interests in the partnership. If the single member of an LLC transfers an LLC interest to another person, tax law treats the single member as selling a portion of the LLC’s assets to the new member, and both the new member and the single member are treated as transferring assets to a new partnership. These transactions give an old basis to the portion of the assets that the single member is deemed to contribute. The partnership takes a new cost basis in the assets that are deemed sold prior to the contribution and restarts the depreciation on the portion of the assets’ basis that is new.

Hendrick Jacobsen, “The Taxation of Partnership Terminations in the U.S., the U.K., and Germany — Same Issues, Different Solutions,” 65 Tax Law. 15 (2011). The final article in the reorg trifecta considers the tax treatment of partnership terminations in the United States, the United Kingdom, and Germany. The article may be a harbinger of the type of scholarship that will find its way into academic journals in the future. As lawmakers and commentators in the United States struggle to come to grips with passthrough taxation, they may gain insight into the source of the complexity of U.S. partnership taxation by looking to other jurisdictions. Those studies may provide an understanding of mechanisms that other countries use to address passthrough entities. They also may reveal that passthrough taxation’s complexity is merely a symptom of other problems with the tax system. For example, both the attraction and complexity of passthrough taxation may result from the lack of an integrated corporate tax system. The administration of double taxation in the corporate context would make passthrough taxation less enticing.

Taxation of Hedge Funds

David S. Miller and Jean Bertrand, “Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers,” 65 Tax Law. 309 (2012). Miller and Bertrand’s review of the federal tax treatment of hedge funds is an important source of information. The article begins with a description of the various structures that hedge funds use and presents the reasons for those structures, and it includes an extensive choice-of-entity discussion. The article provides an in-depth examination of the tax issues facing taxable U.S. investors, tax-exempt investors, and foreign investors. It demonstrates how funds use blocker entities to shield the respective investors from specific types of taxes. For example, foreign feeder funds may shield a foreign investor from income effectively connected with a U.S. trade or business. Tax-exempt investors buy interests in foreign feeder funds to avoid unrelated business taxable income that would otherwise arise if they invested directly in a U.S. partnership that borrows to make investments. Even taxable U.S. investors may find reason to invest in a foreign blocker entity. Even though talk of reforming the taxation of carried interest is frequent, fund managers still benefit from the favorable passthrough treatment of income earned by hedge funds, as Miller and Bertrand describe in detail.

The article draws attention to the absurdity of tax law. In some contexts, tax law deviates from its general preference for substance over form. That deviation is apparent in reorganizations, as discussed above, and it is apparent in the hedge fund context. By using blocker and stopper entities, hedge funds can transform the character of income for investors. The substance of the investment goes largely unchanged with those arrangements, but the change in form transforms the tax treatment. Any effort to simplify tax law should consider whether the outcome from changed form is desirable. If so, tax law should grant the form and require taxpayers to pay tax according to the transaction’s economic substance.

Heather M. Field, “The Return-Reducing Ripple Effects of the ‘Carried Interest’ Tax Proposal,” 13 Fla. Tax Rev. 1 (2012). Field also makes a considerable contribution to the commentary on carried interest by examining the possible effects that changes to carried interest taxation would have on investors. She illustrates how a higher tax rate on fund managers could create incentives that are not in line with investor incentives. For example, if a fund pays the management to carry on one investment but has other investments under management, the manager may take risks that provide little upside potential but significant downside risk for investors, but some upside potential and no downside risk for the manager. Clawback provisions in fund agreements help mitigate that risk, but higher tax rates on fund manager fees could also change the effect that clawback provisions have on managers and investors. If clawback provisions require repayment of prior distributions net of taxes, the investors would bear the cost of the higher taxes paid on any amounts required to be returned to the fund. Finally, higher tax rates for fund managers

20 See Rev. Rul. 99-6, id.
22 See section 168(i)(7).

23 See also section 1031 and its accompanying regulations and case law, which embrace form over substance.
may create an incentive to increase a fund’s cash flow to cover the manager’s tax liability, even if increased cash flow is not in the best interest of investors.

Field acknowledges that investors can minimize the effect that higher tax rates will have on them by modifying the agreements they enter into with managers. For instance, investors can avoid the problem of divergent interests by basing fees on true net performance of the fund, making the fees contingent on total profits, and including clawback provisions in the fund agreement. Investors can avoid the inherent problems with after-tax clawback payments by ensuring that the amount returned to the fund is not net of the higher tax rate, so that the manager rather than the investors bears the cost of the increased taxes. Investors can avoid the problems of tax distributions by negotiating the distribution terms of the fund agreement to help align the manager’s interests with the investors’ interests. Thus, as Field acknowledges, over time (perhaps a short period) the ripple effects of an increased tax on carried interest likely would fade and managers and investors would figure out how to efficiently deal with the effects of the increased taxes.

**Jason A. Sacks, Note, “Effective Taxation of Carried Interest: A Comprehensive Pass-Through Approach,” 89 Wash. U. L. Rev. 449 (2011).** Sacks accepts the notion that carried interest should generally be taxed at ordinary rates, and he uses proposed section 710 as the foundation for his recommended changes. He proposes exempting C corporations from the additional tax; allowing managers to deduct losses from one fund against income from other funds; prohibiting investors from deducting the carry against ordinary income; limiting the tax to managers of investment services partnerships; and affirmatively addressing international tax concerns.

Although each of those recommendations is worthy of further discussion, a more interesting aspect of the article is its proposal that the law treat managers of various types of funds differently. Sacks suggests that the carried interest of private equity fund managers — but not venture capital fund managers — generally should be subject to higher tax rates. The rationale for that distinction is that tax law should encourage venture capital because it helps new ideas and technologies find life and that venture capitalists generally do not purchase entire start-up companies. According to the article, private equity, on the other hand, may be unworthy of that treatment because private equity investors tend to purchase entire companies and then cut costs and eliminate jobs. This unique idea is interesting, and undoubtedly the private equity industry would have a different take on the utility of its actions.

Another interesting aspect of the article is its confidence that Congress and Treasury can determine the most desirable types of investments. The success rates of fund investors and managers (both venture capital and private equity) are not high, and they are arguably the people most knowledgeable about potential investments. If fund investors and managers are unable to determine what ideas and companies can develop and provide products and services that are best for the economy and society, how will Congress or Treasury be able to make informed decisions regarding those matters?

**Partnership Liabilities**

Thomas D. Greenaway and Michelle L. Marion, “A Simpler Debt-Equity Test,” 66 Tax Law. 73 (2012). Greenaway and Marion take on an extremely difficult topic — the distinction between debt and equity. The article does not focus exclusively on the debt-equity question in the partnership context, but its review of the history of this issue and the recent case law in this area invariably lead to partnership taxation. Greenaway and Marion observe that recent courts have moved to a simple question for analyzing whether a financing arrangement is debt or equity: Did the parties to the transaction reasonably expect the funds would be repaid in full? They argue that the question does not simply reflect the current practice of the IRS and courts but represents a better approach than using the Mixon multifactor test. They note that multifactor tests are unpredictable and simply provide a judge (and the IRS) with sufficient resources to support an initial determination of an arrangement’s classification.

---

24See Deborah Gage, “The Venture Capital Secret: 3 Out of 4 Start-Ups Fail,” The Wall Street Journal, Sept. 9, 2012 (reporting on a study by Shikhar Ghosh, which found that “about three-quarters of venture-backed firms in the U.S. don’t return investors’ capital”); Mark Maremont, “Romney at Bain: Big Gains, Some Busts,” The Wall Street Journal, Jan. 9, 2012 (reporting that 22 percent of the companies that Bain Capital purchased under Mitt Romney’s direction filed for bankruptcy reorganization or closed their doors within eight years after Bain first invested in them, and that out of 77 businesses Bain invested in during that period, 10 produced more than 70 percent of the dollar gains from the investments).

25The Mixon factors are (1) the name of the instrument, (2) the presence or absence of a fixed maturity date, (3) the source of the principal payments, (4) the right to enforce payment, (5) the right to participate in management, (6) the status of the advance in relation to other debt, (7) the intent of the parties, (8) “thin” capitalization, (9) identity of interest between creditor and stockholder, (10) the source of “interest” payments, (11) creditworthiness, (12) the use of the advance to buy capital assets, and (13) payment history. See Estate of Mixon v. United States, 464 F.2d 394, 402 (5th Cir. 1972).
Greenaway and Marion recognize that after a decade-long lull in activity at the turn of the century, the IRS appears to have found a new appetite for debt-equity cases. They attribute that new appetite to the increase in cross-border financing and the ability to challenge the classification of cross-border financing without involving policymakers who encourage foreign direct investment in the United States. The authors then review the recent cases, many of which invoke the debt-equity question in the partnership context.26 They conclude that the courts decide these cases by asking whether the parties reasonably expect repayment. Greenaway and Marion posit that “reasonably” tests the parties’ intent against an arm’s-length standard. For instance, lenders do not expect to be repaid from undercapitalized borrowers with no cash flow and poor credit, and equity holders do not expect to be repaid in full.

Obviously any test that relies on reasonable expectations of the parties is not a bright-line, unambiguous test. Reasonableness tests suffer from the same afflictions that plague multifactor tests. They provide sufficient room for judges to support initial impressions, but they do not provide much predictability. Greenaway and Marion recognize that courts help support their conclusions by relying on expert testimony in these types of cases. With experts on both sides of the issue, the expert testimony may not prove definitive. Nonetheless, the search for reasonable expectations and expert testimony will provide a court sufficient material to find that an arrangement should be treated as equity (or debt) if the court senses an abusive transaction.

Tom King, Note, “The Tax Court Capsizes a Leveraged Partnership in Canal Corp.,” 65 Tax Law. 713 (2012). King’s article joins the chorus of other articles that criticize the Tax Court’s holding in Canal27 that the transfer of assets to a leveraged partnership and a proximate leveraged distribution from the tax partnership was a disguised sale.28 Reports that the case ultimately settled for pennies on the dollar29 suggest that the Tax Court decision was a Pyrrhic victory for the IRS. In his article, King draws particular attention to the court’s conclusion that Chesapeake Corp. and its subsidiary were unlikely to ever bear the risk of the liability. He prefers that courts instead consider whether a partner’s obligation to satisfy a partnership’s liability is a possibility. In this respect, King’s position is consistent with that of other commentators who insist that the remoteness of a partner’s obligation to satisfy a partnership’s liability is irrelevant.30 From a technical standpoint, King and commentators may have found a correct reading of the rules governing the allocation of a partnership’s liabilities. Still, that reading raises concerns.

That reading may signal to Treasury that it should reconsider the rules. As Canal illustrates, the value of a share of a partnership’s liabilities can be significant in terms of tax dollars saved. If the likelihood of repayment of that liability is remote, partners can enjoy the benefit of tax savings with a small corresponding cost of assuming a greater share of the partnership’s liabilities.31 Perhaps Treasury should consider imposing a rule that requires the cost of a tax-planned shift of partnership liabilities to equal or exceed the tax benefit that that shift provides. The rule could require a definition of the cost of a shift to include the likelihood that a partner will have to satisfy the obligation. The existence of tools that help with those measurements may warrant a fresh look at Canal and the rules for allocating liabilities.

Series LLCs and TEFRA Statute of Limitations

The final two articles were also written by students. They both reflect thoughtful work and deserve attention.

James Howard, “Where Do We Go From Here? A Survey of Series LLCs in Texas in Light of the Proposed Federal Tax Classification for the Organization,” 63 Baylor L. Rev. 850 (2011). Howard provides an extensive review of series LLCs in Texas, which became a part of Texas law in 2009.32 He discusses various forms of series ownership and

Footnote continued in next column.


27Canal Corp. v. Commissioner, 135 T.C. 199 (2010).


30See Lipton and Golub, supra note 28, at 351 (citing reg. section 1.752-1(a) for the proposition that “what matters is which party would bear the loss in the most extreme situations, without regard to the likelihood of that situation arising”).

31See Borden et al., “A Model for Measuring the Expected Value of Assuming Tax-Partnership Liability,” 7 Brook. J. Corp. Fin. & Com. L. (forthcoming 2013) (illustrating that even if the likelihood of being obligated to satisfy a partnership liability is relatively high, the time value of money coupled with that likelihood may make the cost of assuming the greater share of the liability lower than the tax benefit that derives from the assumption).

considers how those various forms may affect the members’ liability protection. Howard also discusses the proposed regulations governing the tax classification of series LLCs. He concludes that the tax classification of series LLCs will legitimize them and lead to more being formed in jurisdictions that have series LLC statutes. He also predicts that other states will enact legislation to create series LLCs. Time will ultimately tell whether series LLCs become that popular. Several thousand have been formed already, and property and business owners are likely still forming them. If the formation of series LLCs continues, many of the legal questions that Howard identifies will get answered through litigation or new legislation.

Anisa Afshar, Comment, “Statute of Limitations for the TEFRA Partnership Proceedings: The Interplay Between Section 6229 and Section 6501,” 64 Tax Law. 701 (2011). Afshar argues that the courts should not apply both the section 6229 1982 Tax Equity and Fiscal Responsibility Act statute of limitations and the section 6501 general statute of limitations to items of a tax partnership. Afshar concludes that Congress intended only section 6229 to apply to items at the partnership level. If this issue moves to the Supreme Court to resolve the split among circuit courts, Afshar’s compelling argument should be relevant to the Court’s decision.

Conclusion
The 2012 academic articles on partnership taxation provide an eclectic collection of ideas and concerns about partnerships. The authors, editors, and publishers of these articles have done a great service to the tax bar, the legal academy, and the legal process. As long as we have passsthrough taxation, we will have tax problems to consider and resolve. Commentators, lawmakers, and the passthrough bar will undoubtedly have much to dispute as they bring different views, perspectives, interests, experiences, and objectives to the table. Undoubtedly 2013 will bring another wave of academic scholarship, and perhaps significant legislation, that will further the understanding of this critical area of tax law and the economy.

1Professor Bridget J. Crawford initiated this project three years ago with a survey of estate and gift tax articles of 2009, published under the title “Law Review Articles You Should’ve Read (but Probably Didn’t) in 2009,” Tax Notes, Jan. 18, 2010, p. 397.

2For example, one issue of the Tax Law Review alone — a symposium issue in spring 2012 on international taxation and competitiveness — includes 10 noteworthy international tax articles (the Tax Law Review is faculty-edited).

3Included several international tax articles that were published in general law reviews in 2012, because they were included in last year’s list based on working paper versions that were posted on the Social Science Research Network in 2011. Those include Allison Christians, “How Nations Share,” 87 Ind. L.J. 1407 (2012); Ruth Mason and Michael S. Knoll, “What Is Tax Discrimination?” 121 Yale L.J. 1014 (2012); and Michael J. Graetz and Alvin C. Warren Jr., “Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility,” 121 Yale L.J. 1118 (2012).

4There are several good ways to keep up with tax scholarship on SSRN. One is to subscribe to one or more of SSRN’s Tax Law (Footnote continued on next page.)