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Handling the Problems of Forming a Partnership or Limited Liability Company

James W. Forsyth*

The formation of a partnership or limited liability company involves a variety of tax and nontax issues, including classification of the entity for tax purposes, the tax treatment of contributions and interests, and negotiation of the partnership or operating agreement. This article examines these matters and analyzes the effect of recent developments on partnership and LLC formation.

The tax and nontax issues in formation of partnership can range from the simple to the complex and uncertain, depending on the demands and negotiating strengths of the businesspersons involved. General partnership formation has a great tendency to fall on the straightforward side of the ledger. Therefore, this article focuses on the formation of limited partnerships and limited liability companies (LLCs) intended to be taxed as partnerships. The partnership agreement (or the operating agreement in the case of an LLC) is the keystone to partnership formation, and the drafting of it requires sensitivity to a wide range of tax and nontax issues.

Classification

Partnerships are governed by Subchapter K. Partnership formation, at first blush, would appear to be governed solely by Section 721(a), which provides that no gain or loss is recognized to a partnership or its partners in the case of a contribution of property in exchange for a partnership interest. The morass of Subchapter K quickly entwines the parties, however, with questions under Sections 704, 707, 731, 741, and 752. The complexity of these provisions is well

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recognized¹ and should not be tackled by the unfamiliar. Outside Subchapter K, partnership (and LLC) formation uniquely is concerned with Sections 7701(a)(2) and 7701(a)(3) and the corresponding Kintner Regulations.²

It is often unclear whether a partnership has been formed for federal income tax purposes. Co-ownership of property raises particularly interesting issues in light of Regulations Section 1.761-1, which states that a partnership, for federal income tax purposes, is broader in scope than the common law meaning of the term and may include groups not commonly called partnerships.³ An expense-sharing relationship is not a partnership, and "mere" co-ownership of leased property does not represent a partnership.⁴ Nevertheless, co-owners who lease property and provide services to tenants directly, or through an agent, have created a partnership under Regulations Section 1.761-1(a). Consequently, state law has little bearing on whether a partnership has been created.

This nettlesome issue, while problematic, ordinarily does not come into play when forming a limited partnership or LLC, because the intent to come together in a profit-seeking enterprise is usually unquestioned. The key question for limited partnerships and LLCs is whether the entity will be treated as a partnership or an association (corporation) for federal income tax purposes. Here, it is crucial for practitioners to participate in, if not control, the negotiation and drafting of the partnership agreement (or the operating agreement in the case of an LLC).

The Kintner Regulations state that an unincorporated entity is treated as an association rather than a partnership if "the organization more nearly resembles a corporation than a partnership. . . ."⁵ According to the regulations, the tax classification of a limited partnership (or an LLC) as an association depends on the presence or absence of four corporate characteristics—continuity of life, centralized manage-

¹ "The distressingly complex and confusing nature of the provisions of subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field." Foxman v. Comm'r, 41 T.C. 535, 551 n. 9 (1994) (Raum, J.).

² Reg. § 301.7701-2. These regulations were issued in response to the decision in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), *aff'g* 107 F. Supp. 976 (D. Mont. 1952). T.D. 6503, 1960-2 C.B. 409.

³ Reg. § 1.761-1(a).

⁴ *Id.*

⁵ Reg. § 301.7701-2(a)(1).

ment, limited liability, and free transferability of interests.⁶ Classification boils down to counting the number of characteristics present. If the entity has more than two of the four corporate characteristics, an association has been created for federal income tax purposes.⁷ The partnership (or operating) agreement and applicable state law determine whether these characteristics exist.

Despite the statement in the regulations that "other factors" may be found relevant in some instances,⁸ practitioners rely solely on the four enumerated characteristics in attempting to achieve partnership classification. The lack of case law and guidance from the Service do not allow advisors involved in structuring business formations to introduce any other concepts to the classification formula. The four cases that consider the phrase "other factors" acknowledge its presence in the regulations but provide no clue as to what these factors may be or how they are to be applied to the classification formula.⁹ Thus, it is prudent to rely solely on the four recognized characteristics.

Partnership classification is not a frequently litigated area. Practitioners are forced to rely primarily on the few decided cases, the Service's ruling guidelines, and private letter rulings. Reasoned conclusions and opinions must be drawn from these sometimes relatively gray authorities.

Recently, the Service issued Notice 95-14,¹⁰ which announced that consideration is being given to simplifying the classification process for domestic unincorporated entities. The Service is considering allowing unincorporated business organizations to choose partnership or corporate classification by filing the appropriate tax return (i.e., a "check the box" approach to classification). If adopted, this proposal would obviate the need to examine such an entity's characteristics.

⁶ Reg. § 301.7701-2(a)(2).

⁷ Reg. § 301.7701-2(a)(3).

⁸ Reg. § 301.7701-2(a)(1).

⁹ *Larson v. Comm'r*, 66 T.C. 159, 184 (1976), *acq.*; *Zuckman v. United States*, 524 F.2d 729, 744 (Ct. Cl. 1975); *Outlaw v. United States*, 494 F.2d 1376, 1385 (Ct. Cl. 1974), *cert. den.*; *Bush #1 c/o Stonestreet Lands Co. v. Comm'r*, 48 T.C. 218, 234 (1967), *acq.* In Revenue Ruling 79-106, 1979-1 C.B. 448, the Service published a list of seven factors that it will not consider as "other factors."

¹⁰ 1995-14 I.R.B. 7. The impetus behind this proposal seems to be two-fold. First, the Service devotes considerable resources to issuing revenue rulings and letter rulings relating to the classification of limited partnerships and LLCs (without an increase in tax revenues), and these resources could be better used elsewhere. Second, with the modernization of state partnership, limited liability partnership, and LLC laws, the distinctions between incorporated and unincorporated entities are becoming nonexistent.

Continuity of Life

The easiest corporate characteristic to avoid is continuity of life. The testing standard is contained in Regulations Section 301.7701-2(b)(1), which states that "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist."¹¹ Apparently, these are the only six dissolution events to be considered. Fairly clear guidance is provided by the statement in the regulations that limited partnerships organized under a statute corresponding to the Uniform Limited Partnership Act (Uniform Act) lack continuity of life. The Service has issued a revenue ruling finding that thirty-three states have partnership acts that correspond to the Uniform Act.¹² The partnership agreement should specify that the partnership is governed by one of these acts.¹³

For practitioners in the remaining seventeen states who wish to form a partnership under applicable state law, amendments to Regulations Section 301.7701-2(b) help define the rules to be observed. Because events happening to a limited partner do not affect the legal relationship of the partners, the focus is placed squarely on the general partner of the limited partnership. The regulations are written and interpreted¹⁴ in the disjunctive so that any of the six dissolution events can potentially be relied on to avoid continuity of life. Therefore, the partnership agreement must ensure that at least one of the six dissolution events (death, insanity, bankruptcy, retirement, resignation, or expulsion) causes a legal dissolution of the partnership.¹⁵

Limited partners often insist on having the ability to continue a partnership after a dissolution caused by the departure of the last

¹¹ The event of dissolution is tested by examining local law. See Reg. § 301.7701-2(b)(2).

¹² Rev. Rul. 95-2, 1995-1 I.R.B. 7. Further, the Service will not issue private letter rulings on continuity of life if the partnership is organized in a state with a partnership act corresponding to the Uniform Act, because such a ruling would be a mere comfort ruling. Rev. Proc. 92-88, 1992-2 C.B. 496; Rev. Proc. 93-3A, 1993-1 C.B. 381.

¹³ Any amendments subsequent to the Service's rulings could cause the state partnership act no longer to correspond to the Uniform Act.

¹⁴ Reg. §§ 301.7701-2(b); 301.7701-2(g), *Example 2*; 301.7701-3(b)(2), *Examples (1), (2)*. See also *Glensder Textile Co. v. Comm'r*, 46 B.T.A. 176 (1942), *acq.*; *Larson v. Comm'r*, 66 T.C. 159, 173-176 (1976), *acq.*

¹⁵ Only dissolution events capable of legally occurring should be relied on. For instance, a limited partnership agreement should not provide that the only dissolution event is the death of the general partner when the only general partner is a corporation.

remaining general partner. Accordingly, the issue arises as to whether a dissolution takes place if the partners vote to continue the partnership. Previously, the Service demanded that the relevant state law provide for a legal dissolution upon the withdrawal of the remaining general partner unless *all* remaining partners agreed to continue the partnership. Otherwise, the Service would refuse to find that continuity of life was absent.

The first hint of a change in the Service's position is found in Revenue Procedure 92-35,¹⁶ in which the Service announced that it would not take the position that a partnership possessed continuity of life if at least 50 percent of the remaining members agreed to continue the partnership upon the bankruptcy or removal of the remaining general partner. In addition, Regulations Section 301.7701-2(b)(1) was amended to permit state law dissolutions to be avoided by fewer than all the remaining partners. On May 13, 1993, this regulation was issued in final form, making clear that upon the withdrawal of the remaining general partner, continuity of life does not exist even though a majority in interest of the remaining partners agree to continue the partnership.¹⁷ Thus, practitioners drafting agreements in states that do not have a statute corresponding to the Uniform Act may provide that dissolution may be avoided if a majority in interest of the remaining partners agree to continue the partnership.¹⁸

Centralized Management

The second relevant characteristic to examine in classifying an entity as a corporation or partnership is centralized management. The general rule is that if any group of persons, which does not include all the members, has continuing exclusive authority to make management decisions necessary to the conduct of the business, centralized management is present.¹⁹ At first blush, it would appear that a limited partnership would always possess centralized management because the limited partners are not supposed to have management responsibility. Management should be in the hands of the general partner.

¹⁶ 1992-1 C.B. 790.

¹⁷ Reg. § 301.7701-2(b)(1).

¹⁸ This does not mean a majority of the remaining partners, but a majority in interest of the remaining partners. Rev. Proc. 94-46, 1994-28 I.R.B. 129, specifies that the affirmative vote must represent a majority of the profits interests and a majority of the capital interests. This same rule also applies in the case of LLCs. Rev. Proc. 95-10, 1995-3 I.R.B. 20, at § 5.01(3).

¹⁹ Reg. § 301.7701-2(c)(1).

Nevertheless, Regulations Section 301.7701-2(c)(4) concludes that limited partnerships organized under a statute corresponding to the Uniform Act “generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners.” This regulation further provides that if the limited partners may remove the general partner, “all the facts and circumstances must be taken into account in determining whether the partnership possesses centralized management.” Perhaps the ability to remove the general partner means that the general partner manages the partnership’s assets in the best interests of the limited partners (to avoid being removed) instead of managing for the general partner’s own benefit. The removal provision of the regulation is unclear in this regard.

The regulation introduces two important concepts—(1) the size of the limited partners’ ownership interests and (2) removal rights. If the limited partners’ interests are sufficiently large, the regulation seems to deem the general partner as operating in a representative capacity for the limited partners. That is, the general partner acts as a board of directors acts for corporate shareholders. Indeed, limited partnership acts typically impose upon the general partner the fiduciary duty to manage the limited partnership in the best interests of all the partners.²⁰

Because of the absence of authority with respect to centralized management, practitioners approach this characteristic with much caution. The Service stated in Revenue Procedure 89-12²¹ that it will not rule that a partnership lacks centralized management unless the general partners own at least 20 percent of the total interests in the partnership (including any interests held as limited partners).²² This percentage has come to be the standard that practitioners use to

²⁰ See, e.g., Del. Code Ann. tit. 6 § 17-403(b).

²¹ 1989-1 C.B. 798, modified by Rev. Procs. 90-3, 1990-1 C.B. 402; 92-87, 1992-2 C.B. 496; 95-10, 1995-3 I.R.B. 20, supplemented by Rev. Proc. 92-33, 1992-1 C.B. 782.

²² Particular caution should be exercised when the general partner is affiliated with limited partners. Rev. Proc. 89-12, 1989-1 C.B. 798, modified by Rev. Procs. 90-3, 1990-1 C.B. 402; 92-87, 1992-2 C.B. 496; 95-10, 1995-3 I.R.B. 20, supplemented by Rev. Proc. 92-33, 1992-1 C.B. 782, states that the Service will consider all facts and circumstances, including limited partner control of the general partner (whether direct or indirect), in determining whether centralized management exists. Thus, a general partner with a 20 percent, or greater, interest may not defeat the presence of centralized management if an affiliated limited partner exists.

issue opinions relating to the presence or absence of centralized management. If the general partners do not own 20 percent of the total interests in the partnership, tax opinions find that centralized management exists.

While the regulations raise the wild card of removal rights, there is only sparse authority on the subject. *Larson v. Comm'r*²³ suggests that the ability of the limited partners to remove the general partner may make the general partner analogous to an agent of the limited partners. The general partner is presumed to manage the partnership's business solely for the benefit of the limited partners and, therefore, in a representative capacity. When a general partner has a back-end interest and the limited partners have an unfettered right to remove the general partner, this analysis is compelling.²⁴ In the case of a typical partnership, however, *Larson* will not be dispositive, because general partners usually insist that removal rights be restricted.²⁵

Limited Liability

The general rule for determining whether the characteristic of limited liability is present is simply stated: "An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization."²⁶ Consequently, general partnerships lack limited liability as do limited partnerships with individual general partners.²⁷ Limited partnerships, however, customarily have corporate general partners to achieve effective limited liability. As a result, corporate general partners muddy the waters with regard to limited liability.

²³ 66 T.C. 159, 178 (1976). See *Glensder Textile Co. v. Comm'r*, 46 B.T.A. 176, 185 (1942).

²⁴ The partnership agreements in *Larson* apparently gave the limited partners the unbridled right to remove the general partner. *Larson*, 66 T.C. at 166.

²⁵ An unrestricted right to remove a general partner may cause centralized management to exist even if the general partner has 20 percent of the interests in the partnership. McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, 2d ed. (Warren, Gorham & Lamont, 1990) ¶ 3.06[4][b] (hereinafter McKee). It would be unusual for such an unfettered right to be present. Typically, a general partner may be removed only for certain specified causes, such as willful misconduct or gross negligence.

²⁶ Reg. § 301.7701-2(d)(1).

²⁷ Rev. Proc. 92-88, 1992-2 C.B. 496, perhaps raises a minimum net worth requirement for individual general partners. In a limited partnership with a sole general partner who is an individual, limited liability will be lacking if the individual general partner's net worth exceeds the lesser of (1) 10 percent of the total capital contributions or (2) \$1 million.

The regulations contain a special two-part test for limited partnerships with corporate general partners.²⁸ Limited liability exists upon satisfaction of both parts of the test: (1) The general partner has no substantial assets (other than the partnership interest) that could be reached by a creditor of the organization and (2) The general partner is merely a "dummy" acting as the agent of the limited partners.²⁹ Because case law interpreting this characteristic is sparse, practitioners are forced to scrutinize ruling guidelines from the Service in formulating opinions.

Aggressive practitioners may ignore the uncertainty of trying to fund a corporate general partner with "substantial assets" and simply rely on the proposition that the general partner is not merely a "dummy" acting as the limited partner's agent. *Larson* supports this concept but offers little solid guidance for determining when the general partner is not a mere dummy. In *Larson*, the Tax Court stated that a "mere 'dummy' would be totally under the control of the limited partners."³⁰ This connotes an ownership affiliation between the general partner and the limited partners. Revenue Procedure 89-12 goes farther in providing that the Service generally will rule that limited liability does not exist if the general partner "will act independently of the limited partners."³¹

Tax practitioners who intend to rely on the fact that the corporate general partner is not a dummy will find great comfort in *Zuckman v. United States*.³² The bottom line of the Court of Claims' holding there was that limited liability would never be present in a limited partnership under the test of the regulations.³³ Most often, however, practitioners will find little solace in the terms "under the control," "independ-

²⁸ See Reg. § 301.7701-2(d)(1).

²⁹ Reg. § 301.7701-2(d)(2).

³⁰ *Larson*, 66 T.C. at 181.

³¹ Rev. Proc. 89-12, 1989-1 C.B. 798, at § 4.07. For ruling purposes, a showing of independence should typically involve (1) no more than insignificant influence by limited partners; (2) much larger contributions by the general partners to the partnership, including services, than would otherwise be required; (3) a much larger profits interest for the general partners than would otherwise be required; and (4) significant net worth of the general partners. If one or more of these factors are lacking, the remaining factors generally must be compelling to elicit a favorable ruling on limited liability. GCM 39798 (Oct. 18, 1989).

³² 524 F.2d 729 (Ct. Cl. 1975).

³³ If the general partner is not acting as a dummy, limited liability does not exist under Reg. § 301.7701-2(d)(2) (first sentence). If the general partner is acting as a dummy for the limited partners, the limited partners would have personal liability under Reg. § 301.7701-2(d)(2) (second sentence). *Zuckman*, 524 F.2d at 741.

dently," and "mere dummy." Accordingly, an attempt to fund the corporate general partner with "substantial assets" will be required.

The Service has indicated that it will generally rule that a limited partnership lacks limited liability if the net worth of the general partner (exclusive of the value of its partnership interest) equals at least 10 percent of the total capital contributions to the partnership.³⁴ Where a ruling is sought, Revenue Procedure 89-12 further states that if the corporate general partner does not meet the 10 percent net worth guideline, the Service may still rule that the partnership lacks limited liability, although "close scrutiny will be applied to the situation."³⁵ Most often, rulings are not sought, and practitioners have come to rely on the 10 percent test as a safe harbor despite the clear statement in Revenue Procedure 89-12 that the guidelines are not intended to be substantive rules for determining partnership status and are not to be applied upon audit of a taxpayer's return.³⁶

Typically, however, shareholders who do not wish to fund the corporate general partner sufficiently may try to circumvent even the 10 percent standard. A persistent (and nervous) practitioner will attempt to fund the corporate general partner with anything that comes to mind, which frequently is a promissory note from the shareholder to the corporate general partner.³⁷ One commonly used device is a demand note that allows the corporate general partner, on demand, to require the shareholder to pay immediately the principal and interest due under the note.

The Service has issued some guidance indicating that notes will be permitted to count toward the net worth of the corporate general partner, generally with conditions.³⁸ Demand notes are required by the Service to be negotiable, to be payable immediately upon demand, and to bear interest. In addition, the maker must have sufficient net worth to pay the note if demand is made.³⁹ In general, the practice

³⁴ Rev. Proc. 89-12, 1989-1 C.B. 798, at § 4.07. See also Rev. Proc. 92-88, 1992-2 C.B. 496.

³⁵ *Id.*

³⁶ *Id.* at § 1.03. See Rev. Proc. 92-88, 1992-2 C.B. 496, which states that the Service will treat a partnership as lacking limited liability if the corporate general partner satisfies the 10 percent net worth requirement in addition to other conditions.

³⁷ Partnership interests also are often the main source of providing the requisite net worth of a corporate general partner in cable television limited partnerships and home security service limited partnerships. GCM 39798 provides particular guidelines when partnership interests are used to satisfy the 10 percent net worth standard.

³⁸ GCM 39798; LTRs 9046015, 9021009, 8942085.

³⁹ GCM 39798; LTR 8942085.

among advisors seems to be to respect the above conditions articulated by the Service, except for the negotiability aspect of the demand note. Negotiability and the provision of interest bear directly on the value of the note but would not cause the net worth of the corporate general partner to fall below the 10 percent threshold if the face amount of the demand note is adequate.

Discussion of demand notes normally raises concerns about original issue discount. Ordinarily, interest is required to be paid currently to avoid imputed interest. A shareholder should be advised whether the failure to pay interest currently on this type of demand note will cause interest to be imputed. A demand note in this setting is essentially a promise to make a capital contribution to the corporation. The corporation has not loaned money to the shareholder with the expectation of being repaid on demand. Consequently, there should be no "issue price" or "original issue discount" as those terms are used in Section 1273 and no "loan" within the meaning of Section 7872. Therefore, imputed interest would be inappropriate.

Free Transferability of Interests

An organization has the characteristic of free transferability of interests if "those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization."⁴⁰ The power of substitution (not the power of assignment) is paramount. The mere ability to assign the economic right to profits, losses, and distributions is of no moment without the power of the transferee to participate in the management of the organization. The power of substitution requires that the transferee be able to exercise all the attributes of the transferred interest without the consent of the other members.⁴¹

The regulations require only that "substantially all" of the interests be freely transferable to find that this corporate characteristic exists. In a typical limited partnership, most of the interests are held by the limited partners and, hence, the question of whether there is free transferability requires an analysis of the limited partners' ability to transfer their interests. Moreover, it is common for a limited partnership agreement to freely permit transfers to existing partners,

⁴⁰ Reg. § 301.7701-2(e)(1).

⁴¹ *Id.*

but for purposes of this test, the ability to transfer a partnership interest to an existing member is disregarded.⁴²

Revenue Procedure 92-33⁴³ provides that the Service will rule privately that a partnership lacks free transferability if, throughout the life of the partnership, the partnership agreement expressly restricts the transferability of more than 20 percent of all interests in the partnership. Accordingly, if 79 percent of the partnership interests may be transferred without restriction but 21 percent of the interests may not be transferred, the partnership lacks free transferability. The usual caveat is present in Revenue Procedure 92-33 that this ruling position is not intended to represent substantive law.⁴⁴ Because the limited partners usually hold more than 80 percent of the interests in a partnership, the transferability of their interests must be restricted.

In negotiating the limited partnership agreement, the limited partners are usually quite unhappy when informed that to negate the characteristic of free transferability, limited partners may transfer only the economic attributes of their partnership interests (or may transfer their partnership interests only to another partner). Limited partners tend to fear that they will not be able to realize the full value of their interests if they cannot confer completely all their limited partner attributes upon a transferee as a substitute limited partner. Hence, some ability to transfer is often insisted upon by the limited partners.

The simplest form of counterattack for the drafter of the partnership agreement is to require all the other partners, or at least the general partner, to consent to a transfer. The pertinent regulation could be interpreted to require the consent of all other members to defeat the presence of free transferability, but other authorities support consent by fewer than all other members.⁴⁵ Most practitioners seem to think that consent of the general partner, which may be withheld in its sole discretion, is all that is necessary to defeat free transferability.⁴⁶

⁴² Reg. § 301.7701-2(e)(1).

⁴³ 1992-1 C.B. 782, at § 3.02.

⁴⁴ *Id.* at § 1.02.

⁴⁵ Reg. § 301.7701-3(b)(2), *Example (1)*, in which the requirement of consent of only the general partners negates free transferability; LTR 9239014, requiring only the general partner's consent; LTR 9218078, requiring only the consent of the manager or two-thirds in interest of the members in the case of an LLC.

⁴⁶ A detailed discussion of the effectiveness of general partner consent where some affiliation exists between the general and limited partners can be found in Brannan, "Lingering Partnership Classification Issues," 1 Fla. Tax Rev. 197, 227-232 (1993). See also Meyer, "Tax Classification of Partnerships Controlled by Affiliated or Related Taxpayers," 10 J. Partnership Tax'n 204 (1993).

Nevertheless, if consent may not be withheld unreasonably, free transferability will exist.⁴⁷ Often, the general partner's power to approve or disapprove transfers cannot be successfully negotiated and, therefore, practitioners will attempt to limit the universe of transferees.

Conventional wisdom would lead one to believe that by restricting transfers to affiliates, family members, and certain estates, the partnership agreement would not give rise to free transferability, because this limited group of transferees would suggest that the partners are not "free" to transfer their interests. A former representative of the Service's Chief Counsel's office stated at an LLC seminar that using even the foregoing restricted list of transferees may give rise to free transferability of interests.⁴⁸ Only limited transfer rights, such as at death, dissolution, divorce, and bankruptcy, have been permitted by the Service.⁴⁹ Thus, it would be wise not to permit lifetime transfers to family members or any other restricted class of transferees. While free transferability may be easy to avoid in theory, in practice it is often the subject of difficult negotiation.

Limited partnership agreements commonly provide for rights of first refusal to the general partner and/or the partnership in the event limited partners successfully negotiate transfer rights. While such a provision may effectively nullify the ability of the partners to transfer their interests to third parties, the regulations do not find that free transferability will be absent. Instead, "modified" free transferability exists if a right of first refusal is present.⁵⁰ The existence of modified free transferability signals the death knell for practitioners attempting to avoid this characteristic and corporate classification, because modified free transferability does not count toward lacking two of the four corporate characteristics.⁵¹ As a result, modified free transferability is effectively equivalent to free transferability.

Limited Liability Companies

The increase in the number of LLC statutes makes necessary an analysis of the classification of this fairly new form of unincorporated

⁴⁷ Larson, 66 T.C. at 183.

⁴⁸ Comment of Susan Pace Hamill, former Attorney/Advisor, Office of Chief Counsel, at the ALI-ABA seminar on LLCs, broadcast Mar. 17, 1994, by satellite.

⁴⁹ LTR9253013, regarding death; LTR 9243018, regarding death, dissolution, and bankruptcy; LTR 9210019, regarding death, dissolution, divorce, liquidation, and merger; LTR 9313009, regarding death, dissolution, liquidation, bankruptcy, or insolvency of a member.

⁵⁰ Reg. § 301.7701-2(e)(2).

⁵¹ See Reg. § 301.7701-2(a)(3).

entity. Revenue Ruling 88-76⁵² is primarily, if not solely, responsible for the LLC trend. In that ruling, the Service determined that LLCs, like all other unincorporated entities, would be classified as partnerships or associations by examining the four corporate characteristics discussed above. The Service has now issued Revenue Procedure 95-10,⁵³ which outlines the conditions for obtaining a ruling on an LLC's status as a partnership for tax purposes.

With respect to continuity of life, the same general analysis set forth above applies to an LLC. One dissolution event suffices to defeat continuity of life, and a majority in interest of the remaining members may agree to continue the business without causing continuity of life to exist.⁵⁴ For ruling purposes, however, Revenue Procedure 95-10 states that the specified dissolution events must apply to all members of a member-managed LLC or, alternatively, to all member-managers in a manager-managed LLC. This condition clearly conflicts with Regulations Section 301.7701-2(b)(1), which indicates that a dissolution event occurring to any member should be sufficient. Despite the position of the revenue procedure, the most important consideration in avoiding continuity of life is the language of the pertinent LLC statute. For LLCs, this is a crucial characteristic to lack.

LLCs generally possess the characteristic of limited liability. A primary reason for using an LLC is to obtain limited liability for the members. Some LLC statutes, however, permit a member to become liable for all or part of the LLC's liabilities. Revenue Procedure 95-10 recognizes this possibility and provides guidelines for the issuance of a ruling finding that the LLC lacks limited liability.⁵⁵ Only in unusual cases will an LLC attempt to lack limited liability. Consequently, to be classified as a partnership, an LLC usually needs to lack (in addition to continuity of life) either free transferability of interests or centralized management. In most cases, an LLC will rely on the absence of free transferability to avoid classification as an association.

So-called bulletproof LLC statutes prohibit members from transferring their rights to vote and participate in the management of the

⁵² 1988-2 C.B. 360.

⁵³ 1995-3 I.R.B. 20. Rev. Proc. 89-12, 1989-1 C.B. 798, specifically does not apply to LLCs.

⁵⁴ Rev. Proc. 95-10, 1995-3 I.R.B. 20, §§ 5.01(3), 5.01(4), requires that the taxpayer demonstrate that the dissolution event selected provide a "meaningful possibility of dissolution." Rev. Proc. 94-46, 1994-28 I.R.B. 129, provides that a majority in interest means a majority of the profits interests and a majority of the capital interests owned by all the remaining partners.

⁵⁵ Rev. Proc. 95-10, 1995-3 I.R.B. 20, at § 5.04.

LLC without the unanimous consent of the other members. This prohibition, combined with statutory mandates concerning dissolution, causes an LLC to lack two of the four pertinent corporate characteristics and thereby escape being treated as an association. When these characteristics coexist, partnership tax treatment is impregnable (i.e., bulletproof). Because not all LLC statutes are bulletproof, though, drafters of LLC operating agreements should generally follow the guidelines in Revenue Procedure 95-10 to avoid free transferability. Requiring unanimous consent of the other members as a precondition to a transfer is not necessary to defeat free transferability.⁵⁶

Additionally, the Service's ruling guidelines provide that not all the members' interests must be burdened by transfer restrictions. As is the case for limited partnerships, the Service requires that only more than 20 percent of the LLC interests need be subject to limitations on transfer by virtue of a requirement that the members consent to a transfer.⁵⁷ Further, the power of a member to withhold consent must represent a meaningful restriction on the transfer of the interests. Revenue Procedure 95-10 does not address whether free transferability may be avoided by limiting the pool of potential transferees. The earlier discussion regarding partnerships should be reviewed if a practitioner seeks to avoid free transferability by narrowing the group of permissible transferees.

An entity possesses centralized management if exclusive authority to make management decisions is vested in a group of persons who are not required to consult with the business owners in the decision-making process. LLC statutes may provide that management of the business may be reserved to the members or placed in the hands of designated managers. An LLC risks possessing centralized management if state law vests management in elected managers. If the LLC elects managers, centralized management exists unless management includes members owning at least 20 percent of the total interests in

⁵⁶ In a manager-managed LLC (i.e., one in which only the managers have a voice in management), free transferability can be avoided by either (1) requiring the consent of at least a majority of the nontransferring member-managers or (2) requiring the consent of at least a majority of the nontransferring members. In a member-managed LLC (i.e., one in which all members have an equal voice in management), free transferability can be avoided by requiring the consent of at least a majority of the nontransferring members. Rev. Proc. 95-10, 1995-3 I.R.B. 20, at § 5.02. Consent of a majority for these purposes includes a majority in interest (profits and capital), a majority of either the profits or capital interests in the LLC, or a majority determined on a per capita basis.

⁵⁷ Rev. Proc. 95-10, 1995-3 I.R.B. 20, at § 5.02.

the LLC.⁵⁸ Caution should be exercised, however, because even if the 20 percent requirement is met, the Service will consider all the relevant facts and circumstances (such as whether the members can remove the member-managers). On the other hand, when state law and an operating agreement reserve management and control in the members, the Service will treat the LLC as lacking centralized management.⁵⁹

It is not practical for LLCs with a sizable number of members to require all the members to participate in management. Accordingly, practitioners seeking partnership tax treatment for such an LLC will be required to avoid continuity of life and free transferability of interests. Because free transferability of interests is often a significant issue for investors, it is likely to be insisted on by investors in business entities requiring substantial investor capital. Outside of relatively small private placements and closely held businesses, an LLC will likely not be a viable choice as a business entity simply because of the need to lack free transferability of interests to obtain pass-through tax treatment. Of course, if the Service adopts the "check the box" approach to the classification of unincorporated entities, LLCs will become the primary vehicle for conducting business.

Contributions and Interests

Having negotiated the partnership agreement to resolve the rights of the partners and ensure flow-through tax treatment, the partners may focus on beginning business and making contributions. The ease of partnership formation is a result of Section 721(a), which provides that no gain or loss arises to either the partner or the partnership if property is contributed in exchange for an interest in the partnership, irrespective of the size of the interest. Substituted basis is provided to the contributing partner,⁶⁰ and the partnership succeeds to a transferred basis in the contributed property.⁶¹ If the contributed property was a capital asset or Section 1231(b) property in the contributor's hands, tacking applies to the holding period of the contributor's partnership interest.⁶² The partnership's holding period always includes the contributing partner's holding period.⁶³

⁵⁸ *Id.* at § 5.03(2). This requirement is similar to the 20 percent rule found in Rev. Proc. 89-12, 1989-1 C.B. 798, relating to limited partnerships.

⁵⁹ *Id.* at § 5.03(1). A day-to-day manager does not create centralized management as long as management authority is truly vested in the members. LTR 9320019.

⁶⁰ I.R.C. § 722.

⁶¹ I.R.C. § 723.

⁶² I.R.C. § 1223(1).

⁶³ I.R.C. § 1223(2).

Application of these rules necessarily assumes that "property" is contributed to the partnership, but neither Section 721 nor the accompanying regulations defines the term "property." The regulations simply indicate that an installment obligation is property.⁶⁴ The term "property" is used throughout the Code, and compelling analogies may be drawn from the use of such term in Section 351. The regulations merely identify one item that is not property—services.

Services

The receipt of a partnership interest in exchange for the performance of services is not within the nonrecognition mandate of Section 721. Taxability of a partnership interest received for services depends on the type of interest received. A partnership interest may represent an interest in partnership profits and capital or merely an interest in partnership profits. The former is addressed by the regulations and the latter has been the subject of a number of cases.

Regulations Section 1.721-1(b)(1) provides:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services . . . , section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.⁶⁵

The quoted language relates to the receipt of an interest in partnership profits and capital. This occurs when a partner receives an interest in exchange for services and, if the partnership liquidated immediately, the "service" partner would be entitled to receive some partnership property, notwithstanding the fact that the partnership earned no income. Thus, the service partner has an immediate interest in the partnership's capital. Other partners have given up some of their right to be repaid their contributions. The value of such an interest constitutes income.⁶⁶

If the service partner receives only an interest in partnership profits, no other partner has given up his right to be repaid his

⁶⁴ Reg. § 1.721-1(a).

⁶⁵ See *McDougal v. Comm'r*, 62 T.C. 720 (1974).

⁶⁶ Reg. § 1.721-1(b)(1). For a subtle distinction between the language of this regulation and the receipt of an interest in partnership capital, see *McKee*, *supra* note 25, at ¶ 5.01. The contradictory language of the regulation is not significant with respect to the issuance of partnership interests at the time of formation.

contributions and Regulations Section 1.721-1(b)(1) does not apply. While Section 721 does not clothe a service partner with nonrecognition treatment, Sections 61 and 83 both clearly provide that the receipt of property as compensation for services represents income.⁶⁷ In the first significant decision directly on point, *Diamond v. Comm'r*,⁶⁸ the Seventh Circuit held that the receipt of a profits interest was a taxable event. Subsequent to *Diamond*, a General Counsel Memorandum was issued by the IRS Chief Counsel, suggesting that the Service not follow *Diamond* "to the extent it holds that the receipt of an interest in future profits as compensation results in taxable income," provided that the recipient is a partner, not an employee or independent contractor.⁶⁹

The long dormant issue of the taxability of the receipt of a profits interest came to a head again in *Campbell v. Comm'r*.⁷⁰ To the chagrin of tax practitioners, the Eighth Circuit failed to state unequivocally that the receipt of a profits interest was not a taxable event under the Code. The Eighth Circuit did, however, reverse the Tax Court's holding that *Campbell* was taxable on the receipt of the profits interest. The appellate court ruled that the interests had no fair market value due to the speculative nature of the partnership's profits and, therefore, the interests should not have been included in income.

The Service in *Campbell* went so far as to concede that the receipt of a profits interest in exchange for services to the partnership was not a taxable event. The court, however, did not accept the concession and decided the case on the grounds discussed above. Thus, immediately after *Campbell*, a partner with a profits interest could still be taxable upon receipt of the interest if the value was ascertainable.⁷¹

⁶⁷ Reg. § 1.61-2(d); I.R.C. § 83(a). With respect to Section 83, the receipt of property generally must be in an employment setting.

⁶⁸ 492 F.2d 286 (7th Cir. 1974), *aff'g* 56 T.C. 530 (1971).

⁶⁹ GCM 36346 (Jul. 25, 1977).

⁷⁰ 943 F.2d 815 (8th Cir. 1991). For background, see Ruffer, "Eighth Circuit's Decision in *Campbell* Clarifies the Limited Scope of *Diamond*," 9 J. Partnership Tax'n 3 (1992).

⁷¹ *Diamond* agreed to obtain financing in exchange for a profits interest. The financing was obtained, and *Diamond* was given an interest in the partnership. Within three weeks, he sold the interest for \$40,000, thereby establishing the value of the profits interest at the time of receipt. *Mark IV Pictures, Inc. v. Comm'r*, T.C. Memo. 1990-571, *aff'd*, 969 F.2d 669 (8th Cir. 1992), was decided shortly after *Campbell* and may contradict the Eighth Circuit's own decision in *Campbell*. A good argument, however, can be made that both *Diamond* and *Campbell* are distinguishable from *Mark IV* on the ground that *Mark IV* involved a grant of an interest in partnership capital in exchange for services. For an analysis of *Mark IV*, see Lockhart, "Partnership Capital Interests Were Received for Services, Rules CA-8 in *Mark IV Pictures*," 10 J. Partnership Tax'n 131 (1993).

Revenue Procedure 93-27⁷² conceded that the receipt of a profits interest in exchange for providing services to or for the benefit of a partnership is not a taxable event. The Service concluded there that nontaxability will be the rule, unless:

1. The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
2. Within two years of receipt, the partner disposes of the profits interest; or
3. The profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b).⁷³

If the service provider receives an interest in partnership capital and so is required to recognize income, the partnership is generally entitled to a compensation deduction.⁷⁴ The partnership may even incur a gain on the transfer of the partnership interest in satisfaction of the compensation obligation.⁷⁵ If a profits interest is received without the recognition of income, neither the partner nor the partnership should have any tax consequences. If, however, the receipt of a profits interest is outside Revenue Procedure 93-27, the tax consequences should be similar to those arising on the issuance of an interest in partnership capital in exchange for services.⁷⁶

Investment Company

Section 721(a) also does not protect a partner from nonrecognition of gain if the partnership constitutes an investment company.⁷⁷ Under Section 721(b), a transfer of property in exchange for a partnership interest may result in gain recognition if the partnership "would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated." A definition of an "investment

⁷² 1993-2 C.B. 343. For a discussion of the revenue procedure, see Lockhart, "IRS Concedes Tax Treatment of a Partnership Profits Interest Received for Services," 10 J. Partnership Tax'n 283 (1994).

⁷³ Rev. Proc. 93-27, 1993-2 C.B. 343, at § 4.

⁷⁴ I.R.C. § 83(h). But see Reg. § 1.83-6(a)(4) in the case of a transfer of property constituting a capital expenditure.

⁷⁵ Reg. § 1.83-6(b). See McKee, *supra* note 25, at ¶ 5.08[2][a].

⁷⁶ McKee, *supra* note 25, at ¶ 5.08A[2].

⁷⁷ I.R.C. § 721(b).

company" is not contained in Section 351 but rather, is found in Regulations Section 1.351-1(c)(1).

A corporation (and, through Section 721(b), a partnership) is an investment company if immediately after the exchange of securities for an interest in the corporation, more than 80 percent of the value of the corporation's assets (excluding cash and nonconvertible debt obligations) is held for investment and consists of readily marketable stocks or securities (or interests in regulated investment companies or real estate investment trusts).⁷⁸

According to this regulation, there also must be a direct or indirect diversification of the transferor's interests to support a finding that an investment company exists. Neither Section 721(b) nor Section 351(e)(1) specifies that diversification must occur; this requirement is set forth only in the regulations. The diversification requirement originated in the Senate Report, which clearly states that no gain is recognized under Section 721(b) unless a contribution results, "directly or indirectly, in the diversification of the transferor's interests."⁷⁹ Diversification ordinarily occurs if two or more persons transfer nonidentical assets in the formation of the partnership.⁸⁰ In short, Section 721(b) is designed to prevent tax-free diversification of securities portfolios. To escape the grasp of this provision, partners must contribute a sufficient amount of nonsecurity assets (i.e., more than 20 percent) to the partnership.

Boot at Formation

When a partner contributes property to a partnership in exchange for an interest, the partner may receive boot in two ways. First, the partnership may be deemed to make a cash distribution to the partner as a result of the partnership's assumption of the partner's liability.⁸¹ Second, the partnership may make an actual transfer of money or property to or for the benefit of the contributing partner. The receipt of an actual or deemed distribution of boot is taxed under Section 731(a) unless the "disguised sale" rules of Section 707(a)(2)(B) apply.

If the boot distribution results from the partnership's assumption of certain liabilities (which do not invoke Section 707) of the contributing partner, any tax consequences result solely from Section 731(a).

⁷⁸ Reg. § 1.351-1(c)(1)(ii).

⁷⁹ S. Rep. No. 938, 94th Cong., 2d Sess., Pt. 2, at 483, 484 (1976).

⁸⁰ Reg. § 1.351-1(c)(5).

⁸¹ I.R.C. § 752(b).

A decrease in a partner's individual liabilities by reason of the partnership's assumption of the liabilities and a decrease in a partner's share of partnership liabilities are treated as a distribution of money to the partner.⁸² Not all transfers of property with liabilities result in a taxable event.

If the contributing partner's basis in the contributed property exceeds the liability assumed by the partnership, the deemed cash distribution under Section 752(b) merely reduces the contributor's basis in his partnership interest.⁸³ Even if a contribution of property involves a liability assumption greater than the contributing partner's basis in the asset, taxable gain may still not arise.⁸⁴ A contributing partner may be treated as having some continuing share of his former liabilities under Section 752 despite the partnership's assumption of the obligation. Hence, his deemed cash distribution may ultimately be less than the basis of the contributed property, thereby preventing gain recognition.

Immediately after the partnership's formation, a contributing partner must determine his share of partnership liabilities.⁸⁵ Generally, liabilities are shared based on a partner's economic risk of loss.⁸⁶ Because limited partners have no economic risk of loss for recourse liabilities of the partnership, such partners generally receive no increase in basis for these liabilities. No partner bears the economic risk of loss for a nonrecourse liability and, thus, under Section 752(a) all partners are considered as contributing money to the partnership for their shares of any nonrecourse liabilities of the partnership.⁸⁷ In the case of an LLC, all the liabilities of the entity ought to be nonrecourse because no member bears the economic risk of loss.

The application of the Section 752 regulations should be carefully reviewed to avoid gain recognition upon formation of a partnership. Recognition of gain may be avoided to the extent the contributing partner increases what would otherwise have been his share of partner-

⁸² *Id.*

⁸³ I.R.C. § 731(a)(1).

⁸⁴ A liability to which property is subject is treated as a liability of the owner of the property, under Section 752(c), only to the extent of the fair market value of the property.

⁸⁵ Reg. § 1.752-1(f).

⁸⁶ Reg. § 1.752-2(a).

⁸⁷ Reg. § 1.752-1(a)(2). A partner's share of nonrecourse liabilities of the partnership is determined under a three-part allocation rule. A nonrecourse liability is allocated according to a partner's share of partnership minimum gain, the amount of any taxable gain that would be allocated to a partner under Section 704(c), and the partner's share of excess nonrecourse liabilities. Reg. § 1.752-3(a)(1).

ship liabilities. The regulations contain an example in which a contributor of property encumbered by a recourse debt remained personally liable to the creditor so that no other partner was exposed to any economic risk of loss for the debt. The contributor's continued exposure for the transferred debt obligation offset the deemed cash distribution from the partnership.⁸⁸ The net effect of the contribution was that no deemed cash distribution occurred.

A contributing partner may consider executing a guarantee of a debt assumed by the partnership to produce an increase in his share of partnership liabilities. A guarantee of a partnership nonrecourse debt should increase the guarantor's share of partnership liabilities because the guarantor should not have recourse against the other partners in the event of a partnership default. In the case of a partnership recourse liability, a guarantee executed by a partner increases his share of the partnership liabilities if the guarantor is not subrogated to the creditor's rights against the other partners. Subrogation rights vary by state and should be reviewed before a guarantee is executed.

Disguised Sale Rules

Actual cash or property distributions to or for the benefit of a contributing partner can be tax-free reductions in basis under Section 731(a). It is more likely, however, that such distributions will cause a contribution of property in exchange for a partnership interest to be recharacterized as part contribution, part sale.⁸⁹ Section 707(a) casts a wide net to capture every transaction between a partnership and a partner who is not acting in his capacity as a partner. The substance, not the form, of a transaction determines whether Section 707(a) applies.⁹⁰

Section 707(a)(2)(B) was added to the Code in 1984 generally to treat certain transactions as disguised sales. A disguised sale results when a partner contributes property to a partnership; a related distribution of money or property occurs; and the two transfers, when viewed together, are properly characterized as a sale. Legislative regulations are authorized by Section 707(a)(2). The final regulations under this section contain safe harbors that practitioners should analyze carefully before property transfers occur. Otherwise, the contributing partner

⁸⁸ Reg. § 1.752-1(g).

⁸⁹ I.R.C. § 707(a); see Reg. § 1.731-1(c)(3).

⁹⁰ Reg. § 1.707-1(a).

may be treated as undertaking a sale transaction as of the date the partnership becomes the owner of the property.⁹¹

Regulations Section 1.707-3(b)(1) states that a contribution by a partner and a distribution to that partner constitute a disguised sale of the contributed property only if, based on all the facts and circumstances, (1) the distribution would not have been made but for the transfer of property and (2) in the case of non-simultaneous transfers, the subsequent distribution does not depend on the entrepreneurial risks of partnership operations.⁹² Entrepreneurial risks would not exist in the case of a partner acting in the capacity of a seller. Despite the facts and circumstances test, a contribution and distribution are presumed to be a disguised sale if they occur within two years of each other and are presumed not to be a disguised sale if they occur more than two years apart.⁹³ Both presumptions are rebuttable.

The assumption of a liability or taking property subject to a liability represents a distribution under the regulations.⁹⁴ The regulations establish two sets of rules, depending on whether or not the liabilities are "qualified liabilities."⁹⁵ In general, the assumption of qualified liabilities results in more favorable tax treatment to the contributing partner.

Special safe harbors are provided for distributions of guaranteed payments for capital, reasonable preferred returns, operating cash flow distributions and reimbursement of preformation expenditures.⁹⁶ These safe harbors reflect the fact that the disguised sale rules were not intended to prevent partners from receiving priority or preferential distributions in return for their capital contributions.⁹⁷ Reasonable guaranteed payments for capital and reasonable preferred returns are

⁹¹ Reg. § 1.707-3(a)(2).

⁹² For a noninclusive list of facts and circumstances, see Reg. § 1.707-3(b)(2).

⁹³ Reg. §§ 1.707-3(c), 1.707-3(d).

⁹⁴ Reg. § 1.707-3(b)(1).

⁹⁵ Reg. § 1.707-5(a)(1). A liability assumed by a partnership in connection with a transfer of property to the partnership by a partner is a qualified liability of the partner only to the extent the liability is (1) a liability that was incurred by the partner more than two years prior to the transfer; (2) a liability that was not incurred in anticipation of the transfer, but was incurred within two years prior to the transfer and has continuously encumbered the property; (3) a liability allocable under Temp. Reg. § 1.163-8T to capital expenditures with respect to the property; or (4) a liability representing an ordinary account payable if substantially all the assets of the business were also transferred to the partnership.

⁹⁶ Reg. § 1.707-4.

⁹⁷ H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. at 1221 (1984); S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess. at 231 (1984).

presumed to be payments other than in exchange for property.⁹⁸ Such distributions are reasonable in amount if the sum of any preferred return and any guaranteed payment for capital does not exceed the amount determined by multiplying (1) either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year, by (2) the safe harbor interest rate for that year.⁹⁹ If the guaranteed payments and preferred returns exceed the sum determined by applying the regulations, no part of the payment is reasonable and the entire distribution is presumed to be part of a disguised sale.¹⁰⁰

Generally, operating cash flow distributions do not represent disguised sale proceeds if such distributions do not exceed the partner's share of the partnership's net cash flow from operations. The regulations provide for specific adjustments in determining the net cash flow of the partnership.¹⁰¹ Additionally, transfers made by a partnership to reimburse a partner for certain capital expenditures incurred within two years prior to a contribution by the partner to the partnership are excepted from disguised sale treatment as long as the reimbursement does not exceed 20 percent of the fair market value of the property when contributed.¹⁰² If operating cash flow distributions or reimbursements of preformation expenditures exceed the above amounts, the distributions qualify for the safe harbor presumption up to the amount allowed under the regulations, and any excess distributions must be tested under the general facts and circumstances test.¹⁰³

It is conceivable that a partnership's distribution to a partner would consist of property that had been contributed to the partnership at formation by a different partner. Prior to the enactment of Section 704(c)(1)(B) in 1989, a contributing partner and her partnership could circumvent Section 704(c) in this fashion. Now, however, if previously contributed property is distributed to a partner (other than the contributing partner) within five years of the contribution, the contribution and distribution are treated as a sale.¹⁰⁴ The contributing partner must

⁹⁸ Reg. §§ 1.707-4(a)(1)(ii), 1.707-4(a)(2).

⁹⁹ Reg. § 1.707-4(a)(3).

¹⁰⁰ Reg. § 1.707-4(a)(1)(iii).

¹⁰¹ Reg. § 1.707-4(b)(2)(i).

¹⁰² Reg. § 1.707-4(d).

¹⁰³ See Reg. §§ 1.707-4(b)(2)(i), 1.707-4(d).

¹⁰⁴ I.R.C. § 704(c)(1)(B). See also Prop. Reg. § 1.704-4, PS-76-92, PS-51-93, 60 Fed. Reg. 2352 (proposed Jan. 6, 1995). For an analysis of these regulations, see Schmalz & Edquist, "Proposed Regulations Give Some Guidance on Partnership Mixing Bowl Transactions," 12 J. Partnership Tax'n 133 (1995).

recognize gain or loss equal to the gain or loss that would have been allocated to such partner if the property had been sold at its fair market value at the time of the distribution. The legislative history and the proposed regulations under Section 704(c)(1)(B) indicate that appropriate adjustments are to be made to the basis of the contributing partner's partnership interest and the basis of the distributed property to reflect recognized gain or loss.¹⁰⁵ The partnership's adjustment to the property's basis is made prior to the distribution of the property to the distributee.¹⁰⁶

If the contributing partner later receives a distribution of property from the partnership that results in the original contribution and the later distribution being properly characterized as a disguised sale under Section 707(a)(2)(B), the original characterization of the contributed property as subject to Section 704(c) and any gain previously recognized must be revised. Regulations Section 1.707-3(a)(2) overrides Section 704(c)(1)(B) by finding that the contributing partner initially received a right to money or other consideration from the partnership at the time of such partner's contribution, rather than contributing property in exchange for a partnership interest. The partnership's subsequent distribution of cash or property to the contributing (i.e., selling) partner simply represents satisfaction of the partnership's obligation and is not a distribution under Section 731.

Conclusion

The formation of a partnership is a complex and dynamic process that involves substantial tax and nontax law. Investors will have many demands, including pass-through tax treatment and maximum control over their investments. Despite the ease of partnership formation, practitioners must take care to avoid gain recognition to the partners making contributions in exchange for partnership interests. The rules of Subchapter K can give rise to immediate taxation in a variety of ways. Practitioners must look to both current and future events to minimize the tax consequences to the partners when a partnership is formed.

¹⁰⁵ S. Rep. No. 101, 101st Cong., 1st Sess. 197 (1989); Prop. Reg. § 1.704-4(e).

¹⁰⁶ *Id.*