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# THE FUTURE OF PARTNERSHIP TAXATION

EDWARD J. SCHNEE\*

## I. INTRODUCTION

The year 1986 was a landmark point in the history of United States income taxation. The Tax Reform Act of 1986<sup>1</sup> changed the topography as drastically as an earthquake.<sup>2</sup> Today's tax adviser is still sorting out many of the subtle changes in an attempt to properly advise clients.

Among the more prominent changes wrought by the 1986 Act were the following: a drastic lowering of the tax rates;<sup>3</sup> an inversion of the individual and corporate tax rates;<sup>4</sup> repeal of the tax break for long-term capital gains;<sup>5</sup> revision of the alternative minimum tax,<sup>6</sup> which, when coupled with decreased regular tax rates, resulted in expanded applicability; a frontal attack on tax shelters and losses;<sup>7</sup> and repeal of the *General Utilities* doctrine.<sup>8</sup> In effect the law broadened the tax base, reduced rates and assured the double taxation of corporate income. The short-term effect was to encourage the conversion of corporations into non-corporate, pass-through entities as well as a search for new sheltering opportunities.<sup>9</sup> The old rules and plans were either abandoned or drastically modified.

With the arrival of a new administration, 1993 is shaping up to be another monumental year for tax policy. Congress is currently debating President Clinton's budget and tax bills, which are likely to once again redesign the tax landscape. Among the more interesting proposals are the following: resurrection of the investment credit;<sup>10</sup> a significant increase in

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1. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

2. For an interesting discussion of the origins of the act, see JEFFREY H. BIRNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH* (1987).

3. I.R.C. § 1 (Supp. 1993).

4. I.R.C. §§ 1, 11 (Supp. 1993).

5. I.R.C. § 1202 (repealed).

6. I.R.C. §§ 55-59 (Supp. 1993).

7. I.R.C. § 469 (Supp. 1993) (providing passive activity loss rules); *id.* § 382 (imposing limitations on net operating loss usage after certain changes in ownership); *id.* § 465 (limiting losses to amount of investment "at risk").

8. I.R.C. §§ 311 (Supp. 1993), 331 (1988) & 336 (Supp. 1993) repeal the pre-1986 rule of *General Util. & Oper. Co. v. Helvering*, 296 U.S. 200 (1935), which allowed avoidance of the corporate level tax on distributions of property.

9. For example, S Corporation elections and corporate liquidations provided tax relief after the Tax Reform Act of 1986.

10. TREAS. DEP'T, SUMMARY OF THE ADMINISTRATION'S REVENUE PROPOSALS 5-8 (1993) [hereinafter ADMINISTRATION'S PROPOSALS].

tax rates;<sup>11</sup> potential inversion of the corporate and individual rates;<sup>12</sup> adoption of a substantial long-term capital gain benefit;<sup>13</sup> and severe restriction of certain business deductions.<sup>14</sup> These changes will almost certainly be exacerbated by the tax law changes necessary to fund health care reform.

The long-term direction of tax policy may be greatly affected by the potential adoption of two radical proposals. The first is the adoption of a value added tax (VAT). A VAT would operate, in all likelihood, as a national sales tax. The second proposal is the integration of the corporate and individual tax systems. This would eliminate the classical double taxation that we are currently operating under and put the United States in line with the rest of its major trading partners. Adoption of either or both proposals would lead the United States into uncharted territory.

Given the magnitude of the prior tax law changes and the almost certain adoption of significant future changes, it is almost impossible to predict the future of partnership taxation. That does not mean there will not be changes; it means that the scope and direction are unpredictable. This Essay discusses various aspects of partnership taxation that Congress should address and offers suggestions for improving the operation of Subchapter K. Specifically, this Essay addresses the need for congressional examination of the definition of partnerships, the dichotomy between the aggregate and entity theories of viewing partnerships, and several specific types of partnership transactions.

## II. DEFINITION<sup>15</sup>

Code section 761 defines a partnership as “. . . a syndicate group, pool, joint venture or other unincorporated organization . . . .”<sup>16</sup> This is not so much a definition as the statement of an antonym. A partnership is not a corporation. Given this approach, it is no wonder that the majority of the cases and rulings concentrate on the definition and classification of a corporation.

The Internal Revenue Code of 1986, as amended (Code), defines a corporation as including associations, joint-stock companies, and insurance companies.<sup>17</sup> The regulations focus on the term “association” and define this word based on the six corporate characteristics enumerated by the

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11. *Id.* at 32-35, 44.

12. *Compare id.* at 32-35 (proposing increase in top individual rate from 31% to 36%, and possibly 39.6%) *with id.* at 44 (increasing top corporate tax rate from 34% to 36%).

13. *Id.* at 11-12.

14. *Id.* at 40 (denying deduction for executive pay over \$1,000,000); *id.* at 45 (denying deduction for lobbying expenses).

15. Much of the discussion of the definitional problems is based on William B. Brannan, *Lingering Partnership Classification Issues (Just When You Thought It Was Safe To Go Back Into the Water)*, 4 FLA. TAX REV. 197 (1993).

16. This definition is repeated in I.R.C. § 7701(a)(2) (1988).

17. I.R.C. § 7701(a)(3) (Supp. 1993).

Supreme Court in *Morrissey v Commissioner*.<sup>18</sup> The six characteristics are: associates, profit motive, continuity of life, centralized management, limited liability, and free transferability of interest. To be classified as a corporation the entity must contain over one-half the corporate attributes.<sup>19</sup>

Within the definition and description of each of these characteristics, there is a bias against classifying a partnership as a corporation. This bias was included intentionally to restrict the pension benefits that the taxpayer obtained in *United States v. Kintner*.<sup>20</sup> In 1982, the pension law was changed to remove the reason for the bias.<sup>21</sup> The regulations, however, have not been changed.<sup>22</sup>

Although the regulations restrict the discussion to a resemblance test, the Internal Revenue Service (IRS) has attacked several entities based on the general definitional requirement that a partnership may not be incorporated.<sup>23</sup> For this purpose, the IRS has used the broad common-law definition of a corporation described in *Dartmouth College v. Woodward*.<sup>24</sup>

Even if the IRS is successful in proving that the entity is incorporated, it is still possible to obtain partnership tax treatment. In *Commissioner v. Bollinger*,<sup>25</sup> the Supreme Court refused to tax a corporation on its generated income where the taxpayer was able to show that the corporation was a dummy acting solely as the taxpayer's agent.<sup>26</sup>

As previously mentioned, the regulations, which were adopted in 1960, have a propartnership bias, and the general incorporation question, discussed above, is all but ignored. Therefore, a tax adviser should be in the position of being reasonably certain as to the classification of an entity as a partnership. Unfortunately there are still some lingering questions in relation to limited partnerships. These arise in cases in which the entity contains minimum equity, where the general partner is affiliated with the limited partners, and where the partnership can be reconstituted following dissolution.<sup>27</sup> As a result, a tax adviser must be willing either to meet the IRS's

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18. 296 U.S. 344 (1935).

19. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983). Because associates and profit motive are characteristics common to partnerships and corporations, an entity must have over one-half of the remaining corporate characteristics to be classified as a corporation. *Id.*

20. 216 F.2d 418 (9th Cir. 1954).

21. STAFF OF THE JOINT COMM. ON TAXATION, TAX TREATMENT OF MASTER LIMITED PARTNERSHIPS (1987), reprinted in DAILY TAX REP. (BNA), June 30, 1987, at J-1, J-3 [hereinafter MLPs].

22. In 1974, the Treasury issued proposed regulations reversing this bias. They were withdrawn the following day. See Terrill Ann Hyde, *Partnership-Statutory Outline and Definition*, 161-3rd TAX MGMT. PORT. 102-03 (1987).

23. See Brannan, *supra* note 15, at 204-05.

24. 17 U.S. (4 Wheat.) 518, 636 (1819) (defining corporation as artificial being, invisible, intangible, existing only in contemplation of law, and possessing only those properties which its charter confers expressly or which are incidental to its existence).

25. 485 U.S. 340 (1988).

26. For an expanded discussion of this issue, see BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.10, at 2-33 to 2-37 (5th ed. 1987).

27. For a complete discussion of those issues, see Brannan, *supra* note 15, at 207-08, 212-14, 238-39.

extremely stringent requirements for an advance ruling<sup>28</sup> or proceed without any assurances that the proposed classification will be honored.

### A. Publicly Traded Partnerships

A master limited partnership (MLP) is a limited partnership whose interests are traded on an exchange or over the counter.<sup>29</sup> They are also known as publicly traded partnerships to emphasize the trading of the interest, the attribute which removes one of the main deterrents to investing in any limited partnership—the illiquidity of ownership. The first MLP was organized in 1981.<sup>30</sup> By 1984, the number of MLPs had increased substantially. As a consequence, the Treasury offered a provision that would have classified limited partnerships with more than thirty-five partners as corporations.<sup>31</sup> However, this provision was not enacted.

One of the principle concerns generated by the rise in MLPs was the “disincorporation of America.”<sup>32</sup> The main fear was the erosion of the tax base as entities subject to double taxation were replaced with a form of pass-through entity subject to only one level of tax.<sup>33</sup> It is not surprising, therefore, that in 1987 Congress enacted Code section 7704, Certain Publicly Traded Partnerships Treated As Corporations.<sup>34</sup>

Code section 7704(a) provides that, unless excepted, a publicly traded partnership is treated as a corporation. This section defines a publicly traded partnership as one whose interests are traded on a securities market or are readily tradable on a secondary market or its equivalent.<sup>35</sup> The section attacks partnerships that are marketable rather than all large partnerships as in the original 1984 proposal. The reason for the change was that the trading of the interests, not just size, makes these entities almost indistinguishable from corporations. It is relatively easy to determine if the interests are traded on a securities market or secondary market. The real question is what are the equivalent transactions? The Treasury position is that the equivalent of a secondary market exists if a person is standing ready to make a market.<sup>36</sup> This can take the form of a general partner willing to either purchase the interest or provide a clearinghouse for trading information.

Excepted from corporate classification are partnerships with passive type income.<sup>37</sup> Passive type income is defined to include interest, dividends, real

28. Rev. Procs. 72-13, 1972-1 C.B. 735, 74-17, 1974-1 C.B. 438, 75-16, 1975-1 C.B. 696, and 89-12, 1989-1 C.B. 798.

29. MLPs, *supra* note 21, at J-6.

30. ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION 535.01, at 35-2 n.1 (4th ed. 1989).

31. I. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 120 (1984).

32. See Laura Saunders, *America Disincorporated*, FORBES, June 16, 1986, at 74.

33. MLPs, *supra* note 21, at J-7.

34. Revenue Act of 1987 § 10211(a), 26 U.S.C. § 7704 (1988).

35. I.R.C. § 7704(b) (1988).

36. I.R.C. Notice 88-75, 1988-2 C.B. 386.

37. I.R.C. § 7704(c) (1988).

property rents, income from natural resources, capital gains from property used to generate passive income, and certain commodity and futures transactions.<sup>38</sup> To be excepted, the partnership must receive ninety percent or more of its gross income from the types of income on the qualifying list.<sup>39</sup> In effect, the law exempts those MLPs that created the concerns.<sup>40</sup>

### B. Large Partnerships

The Tax Simplification Act of 1991<sup>41</sup> contained a number of provisions aimed directly at large partnerships. The stated reason for the proposal was to restrict the burden that normal partnership reporting placed on small investors. The burden results directly from the fact that a typical K-1 form from a large partnership may have over forty entries that each investor must decipher and report. The proposal was also designed to aid the IRS, which has substantial difficulty matching K-1 information to individual tax returns and then auditing these returns.

Although not mentioned, it is interesting to speculate concerning the extent that the required partnership tax year changes included in the 1986 and 1987 Tax Acts exacerbated the stated problems. These Acts changed the allowable tax years for partnerships such that most large partnerships are on a calendar year.<sup>42</sup> The result is that the K-1s are not due until April fifteenth, almost automatically guaranteeing that investors will file extended returns. This is difficult on the taxpayer, his or her adviser, as well as the IRS, which receives more returns in a shorter time period. Many practitioner groups objected to the tax year changes for these reasons. It is ironic and troublesome if the practitioners were accurate and Congress, rather than reversing itself, is planning on correcting the problem by adding additional rules and layers of complexity to an already complex subject.

One of the most significant changes to partnership taxation as applied to large partnerships proposed by the 1991 Act was to restrict the flow-through of income and deductions from the partnership to the partners.<sup>43</sup> Instead of all items flowing through, the only items that would have been reported on the partners' individual returns are passive income or loss, other income or loss, capital gains and losses, alternative minimum tax adjustments, and credits. In addition to restricting the reporting, the proposal would have limited charitable contributions at the partnership level and disallowed seventy percent of all items which qualified as miscellaneous itemized deductions.<sup>44</sup> Finally, the proposal would have made the deferred

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38. I.R.C. § 7704(d)(1) (1988).

39. I.R.C. § 7704(c)(2) (1988).

40. These partnerships, although outside I.R.C. § 7704, may be subject to special rules under I.R.C. § 469. This change was designed to prevent the MLP from functioning as a passive income generator.

41. H.R. 2777, 102d Cong., 1st Sess. (1991); S. 1394, 102d Cong., 1st Sess. (1991).

42. I.R.C. § 706 (Supp. 1993).

43. H.R. 2777, 102d Cong., 1st Sess. § 201 (1991).

44. *Id.*

sale method the mandatory method for purposes of the Code section 704(c) adjustment.<sup>45</sup>

The proposed change in the law was to apply solely to large partnerships, which the Act defined as a partnership with more than 250 partners.<sup>46</sup> Once classified as a large partnership, the entity would retain this classification unless the number of partners declined to fewer than 100. There was an exception for any partner who owned more than five percent of the partnership and materially participated in management.

The proposal, in effect, would elevate the entity and downplay the partners. It is very reminiscent of the rules that applied to S Corporations before the Subchapter S Revision Act of 1980.<sup>47</sup> The proposal has been criticized as restricting the application of good tax theory without substantially reducing the administrative burdens that the theory imposes.

The Tax Simplification Act of 1991 never became law. Instead these large partnership provisions were included in the 1992 Tax Act.<sup>48</sup> This act was vetoed, preventing the proposals from becoming law. However, it is reasonable to assume that we will see these proposals again.

### C. *Limited Liability Companies*

A partnership, even a limited partnership, suffers from a serious drawback in the minds of investors and owners—unlimited liability. As court judgments and settlements have reached stratospheric heights followed closely by insurance premiums, many partners have sought limitation of these risks. For many, the bright star on the horizon is the limited liability company (LLC). For those parties forming LLCs, the hope is that these entities will provide limited liability while still providing partnership tax treatment for the income.

To obtain the expected tax treatment, the LLC must meet the tax definition of a partnership. Based on the resemblance test from the regulations, the entity may not have more than one-half of the four relevant characteristics—limited liability, centralized management, free transferability of interest, and continuity of life.<sup>49</sup> Because the entity has limited liability by definition, it cannot have two of the other three corporate characteristics. Most commentators assume that it is relatively straightforward to accomplish this structure.<sup>50</sup> However, it may not be as simple as it seems. As Brannan points out, to lack centralized management the entity must be organized

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45. See I.R.C. § 704(c) (Supp. 1993) (requiring contributing partner to recognize pre-contribution gain on partnership's disposal of property).

46. H.R. 2777, 102d Cong., 1st Sess. § 201 (1991).

47. Pub. L. No. 97-354, 96 Stat. 1669 (1982).

48. Tax Fairness and Economic Growth Act of 1992, H.R. 4210, 102d Cong., 2d Sess. subtitle C (1992).

49. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983).

50. See, e.g., Charles E. Price, *Tax Aspects of Limited Liability Companies*, 174 J. Acct. 48 (1992).

under a Discretionary Delegation Statute.<sup>51</sup> If this is not available or unacceptable to the owners, the owners must be willing to give up free transferability and be willing to allow the entity to dissolve on the death or bankruptcy of any of the owners. Even if the LLC lacks centralized management, it must also lack one of the other two attributes. These choices may not be palatable to many owners.

Based on the above, Brannan concludes that the problems will “. . . confine the use of limited liability companies to the closely held and personal service business contexts.”<sup>52</sup> I am not certain that either of these problems is insurmountable or that limiting the LLC's use to closely held and personal service businesses is much of a restriction. At the present time, the uncertainty of liability in states that do not have an LLC statute and the state tax results are much more of an impediment to increased use of LLCs.

#### D. *The Future*

The preceding discussion has highlighted the need for a clarification of the definition of a partnership. I expect it to be forthcoming. The exact form of the clarification is harder to predict.

Given the stringent restriction currently in force against tax shelters, the reasons for restricting the definition of a partnership have been reduced. Therefore, I think that there should be a liberalization of the definition of a partnership. The one exception should be the large partnership. These entities should be treated more like corporations than partnerships. They should have a limitation on the passthrough of income. In addition, transactions between a partner and a large partnership should be treated as occurring between unrelated parties. The rules that are finally adopted should treat large partnerships similar to the old Subchapter S corporations. As for the LLCs, the Code should allow full partnership benefits. This will allow business persons to shield themselves from unlimited liability without paying a second level of federal tax for the privilege. The result would be that LLCs will be the fastest growing segment of the partnership market absent significant tax reform legislation. Accordingly, tax advisers would have to grapple with the aggregate-entity dichotomy (as modified by the relevant LLC statute).

### III. AGGREGATE VS. ENTITY THEORY

#### A. *Background*

For partnerships, early English common law adopted the aggregate theory of viewing this type of business entity.<sup>53</sup> Under this approach each

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51. See Brannan, *supra* note 15, at 252-53.

52. *Id.* at 255.

53. See WILLIAM L. CARY & MELVIN ARON EISENBERG, CORPORATIONS 31-33 (6th ed. 1988) (discussing history of aggregate-entity dichotomy in partnership law).



partner is treated as owning his or her individual share of each of the partnership's assets. Transactions with the partnership are treated as transactions with each of the individual partners. This approach is very cumbersome.

Alternatively, a partnership may be viewed under the entity theory, which treats the partnership as an entity separate and distinct from its owners. When applied, this theory treats transactions with a partnership as involving a separate legal entity without reference to the effect or classification that would result if the transaction was with any or all of the partners.

The original Uniform Partnership Act generally adopted the old English common law aggregate approach with the entity concept restricted to a limited number of areas.<sup>54</sup> By using both theories, a conflict arose. Which theory should be applied in the absence of specific guidance in the law?

The Internal Revenue Code of 1954 incorporated both theories within Subchapter K. The adoption of both was considered necessary to prevent tax avoidance or inequitable tax treatment among the partners.<sup>55</sup>

### B. *Specific Items*

Code sections 701 through 703 illustrate the adoption of both theories. Section 703 treats the partnership as an entity by requiring the partnership to compute its income as if it were an individual. Sections 701 and 702 apply the aggregate approach by exempting the partnership from taxation and then requiring each partner to report his or her individual share of the partnership's income, loss, and deductions.

These sections also demonstrate that the partnership will be considered an entity for computational purposes.<sup>56</sup> There is no indication that this will change.<sup>57</sup> In fact, this aspect of the entity theory of partnerships is being reinforced. For example, Code section 6698 imposes a fine for failure to file a partnership return on time. Code section 6221 provides that the treatment of all partnership items will be determined at the partnership level, and Code section 6223 provides that a tax matters partner will receive notice for the entire group.

It is even possible for both theories to exist within the same Code section. For example, Code section 743(a) provides that a partnership's basis in its assets will not change following the sale or exchange of a partnership interest—entity theory—while section 743(b) provides an optional basis adjustment to modify the partnership's basis in its assets such that they equal the partner's basis in his or her interest—aggregate theory. Another example is Code section 707(c), which provides that payments to

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54. *Id.* at 32. However, the REVISED UNIFORM PARTNERSHIP ACT (1992) moves closer to the entity concept.

55. PAUL LITTLE, *FEDERAL INCOME TAXATION OF PARTNERSHIPS* (Supp. 1957).

56. Michael Pusey, *The Partnership as an "Entity": Implications of Basye*, 54 *TAXES* 143, 147 (1976).

57. ARTHUR B. WILLIS ET AL., *PARTNERSHIP TAXATION* § 4.06, 4-7 (4th ed. 1989).

a partner for services or capital will be treated as to an unrelated party, but solely for purposes of sections 61 and 162—entity approach. Apparently, a taxpayer is required to treat these payments under the aggregate approach for all other purposes.

This duality of theory also applies outside of Subchapter K for transactions that affect partnerships. For example, if a partnership debt is forgiven, the partnership will compute the amount of forgiveness of indebtedness at the entity level.<sup>58</sup> However, the exception to recognition of cancellation of indebtedness income based on bankruptcy or insolvency as well as the attribute reduction is determined at the partner level, evidencing the aggregate approach.<sup>59</sup>

Recent legislative and administrative decisions appear to be adopting the entity approach to prevent tax avoidance. For example, there is the enactment of Code section 707(a)(2)(A) and (B).

Section 707(a)(2)(B) provides that in those cases in which there is a transfer of property to a partnership and a related distribution of cash to the contributing partner, the transaction will be treated as occurring between a partnership and an unrelated party. In other words, the contributing partner will be treated as if he or she sold the property to the partnership with full recognition of the realized gain. This is a very clear example of the entity approach.

This change was designed to prevent sales from escaping taxation by masquerading as a contribution of property followed by a distribution of cash, which is nontaxable under Code sections 721 and 731. Specifically, section 707(a)(2)(B) was designed to overrule the results in the *Otey v. Commissioner*,<sup>60</sup> *Communications Satellite Corp. v. United States*,<sup>61</sup> and *Jupiter Corp. v. United States*<sup>62</sup> cases.<sup>63</sup>

Code section 707(a)(2)(A) requires the partnership to treat the performance of services by a partner and a related allocation and distribution to such partner as a transaction between the partnership and a nonpartner. Once again the partnership is treated as an entity separate and distinct from its partners.

The enactment of Code section 707(a)(2)(A) was designed to prevent taxpayers from circumventing the capitalization requirement. For example, a payment made to a general partner for organization and syndication activities would generate a nondeductible expenditure at the partnership level.<sup>64</sup> However, if the general partner received a special allocation of income and a related distribution of cash, the income reported by the other

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58. I.R.C. § 61 (Supp. 1993).

59. I.R.C. § 108(d)(6) (Supp. 1993).

60. 70 T.C. 312 (1978), *aff'd per curiam*, 634 F.2d 1046 (6th Cir. 1980).

61. 625 F.2d 997 (Ct. Cl. 1980).

62. 2 Cl. Ct. 58 (1983).

63. STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984 225-26 (1984).

64. See I.R.C. § 709 (1988) (providing for treatment of partnership syndication expenses).

partners would be reduced, resulting in the functional equivalent of a deduction for the organization and syndication costs. By treating the transactions as occurring between an individual and a separate entity, the expenditure would be capitalized. The tax avoidance potential inherent in the aggregate approach was nullified by section 707(a)(2)(A)'s entity approach.

Another example involves the contribution of property. Code section 721 provides that no gain or loss will be recognized when a partner contributes property to a partnership in exchange for an interest. Code section 723 mandates that the partnership take a carryover basis in the contributed property. If a partner contributes an appreciated asset to a partnership, then the unrealized appreciation will be shifted in part to the noncontributing partners. To prevent this shifting of the gain to noncontributing partners, section 704(c)(1)(A) requires that income, gain, loss and deductions from contributed property be allocated to take into account the difference between fair market value and basis at time of contribution. In other words, the Code appears to adopt a pure aggregate approach to contributed property to prevent tax avoidance accomplished by the shift of unrealized gains, losses and deductions.

However, the Treasury recently issued proposed regulations under section 704(c).<sup>65</sup> One of the options available to taxpayers under these proposed regulations is the deferred sale method. Under this method the taxpayer will be treated as having sold the property to the partnership for its fair market value. The partnership's basis will be cost, and gain, loss, and depreciation will be calculated based on this cost. From the partnership's side, the transaction will be taxed under the entity method.<sup>66</sup> The entity approach prevents tax avoidance by using fair market value as the basis for the partnership and the noncontributing partners. Therefore, there is no potential to shift either income or deductions.

Not all of the recent decisions have adopted the entity approach. As previously discussed, cancellation of indebtedness income is determined at the entity level. The exceptions contained in Code section 108 are applied at the partner level. An exception, not previously discussed, is section 108(e)(5) which permits nonrecognition of the income provided the basis of the property is reduced. This is known as the purchase price reduction exception. According to section 108(e)(5)(B), this exception does not apply if the taxpayer is insolvent or in bankruptcy. In Revenue Procedure 92-92, the Treasury concluded that a partnership can avail itself of the purchase

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65. Prop. Treas. Reg. § 1.704-3, 57 Fed. Reg. 61,345 (1992).

66. The contributing partner will continue to use the aggregate approach. His or her basis in the partnership interest will still be substituted basis under Code section 722. The gain or loss generated by the hypothetical sale to the partnership is deferred until the asset is disposed or it is depreciated, thereby generating an increased deduction for the noncontributors. In effect, the proposed regulations permit a combined entity/aggregate approach to a single transaction.

price reduction exception regardless of its insolvency or bankruptcy.<sup>67</sup> The only restriction is that the partners cannot take inconsistent positions on their individual returns. Although it is not a perfect example, the revenue procedure adopts a form of the aggregate approach. It disregards the financial position of the entity. It is likely that it did not adopt a pure aggregate approach because of the administrative complexities of having the partnership treat segments of the cancellation of debt income as purchase price reductions based on the financial position of each individual partner. The procedure rejects the entity approach by ignoring the position of the partnership. The result is a procedure which reaches its conclusion from an aggregate approach perspective.

A more obvious example of the adoption of the aggregate approach to partnership taxation appears in Proposed Regulation 1.1374-4(h)(5). Under this regulation, a corporation that owns an interest in a partnership at the time it becomes an S corporation will be treated as owning a proportionate share of each of the partnership's assets. The built-in gains (BIG) tax will be assessed against the S corporation on each sale or exchange of an asset by the partnership. To have treated the partnership as an entity would result in the imposition of the BIG tax in the above case solely upon the S corporation's sale of its interest. By adopting the aggregate approach, the regulations prevent avoidance of the BIG tax.<sup>68</sup>

### C. *The Future*

Both the aggregate and entity theories were incorporated into partnership taxation from the very beginning. Both should be there at the end. In the future we should receive continued guidance on which theory to apply to which transaction. It would be intellectually soothing to advocate the adoption of one theory over the other. However, I believe a mixture of theories will continue to be necessary to achieve fair and consistent results with respect to partnership transactions. As McKee states:

Unfortunately, it is far easier to criticize the mixture of these theories in the existing statute than to envision an acceptable statutory alternative to avoid the blending of these incompatible concepts. Neither a pure entity nor a pure aggregate approach seems appropriate for the taxation of partners and partnerships because in fact, a partnership is a hybrid creature under state law, neither entirely fish nor entirely fowl. Rather, what seems needed in the statutory scheme is a clear indication as to which of these theories controls the resolution of doubtful questions with respect to certain broad categories of transactions.<sup>69</sup>

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67. 1992-46 I.R.B. 34.

68. For similar rules if the partnership is created after the S election is made, see Prop. Treas. Reg. § 1.1374-4(h)(7), 57 Fed. Reg. 57,971, 57,976 (1992).

69. WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.02, at 1-8 (2d ed. 1990).

## IV. PARTNERSHIP TRANSACTIONS

While Congress should not attempt a major overhaul of the theoretical underpinnings of Subchapter K, there are numerous discrete partnership issues that call for resolution. With time, many of these questions will be resolved. Rather than trying to identify each of them, I will cover the basic questions under the broad general headings of formation, losses and shelters, and sales and distribution.

## A. Formation

As previously discussed, the transfer of property to a partnership in exchange for an interest is nontaxable.<sup>70</sup> The partnership takes a carryover basis in the assets<sup>71</sup> and the partner uses a substituted basis for his or her interest in the partnership.<sup>72</sup> This relatively straightforward rule has been complicated by a very ambiguous regulation which states:

To the extent that any of the partners gives up any part of his right to be repaid his contribution (*as distinguished from a share in partnership profits*) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply.<sup>73</sup>

At the time the regulation was written, most commentators assumed it meant that the receipt of a capital interest for services was a taxable transaction, whereas the receipt of a profits interest was not. This assumption was challenged in *Diamond v. Commissioner*.<sup>74</sup> In this case the courts held that Sol Diamond had ordinary income upon receipt of the profits interest. The facts are somewhat unique and therefore distinguishable.

The Treasury did not lessen the confusion created by *Diamond* by issuing proposed regulations in 1971. These regulations repeat the above quoted sentence.<sup>75</sup> They then state that if the partner receives a *capital* interest for services, the transfer shall be treated as a transfer of property under Code section 83. The regulations do not mention a profits interest except in the quoted parenthetical phase. These regulations have never been finalized.

Recently, the Tax Court again addressed the issue in the extremely interesting case of *Campbell v. Commissioner*.<sup>76</sup> First, it should never have been litigated since the Treasury had previously indicated that it would not

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70. I.R.C. § 721 (1988). There is an exception for investment partnerships under I.R.C. § 721(b).

71. I.R.C. § 723 (1988).

72. I.R.C. § 722 (1988).

73. Treas. Reg. § 1.721-1(b)(1) (1956).

74. 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).

75. Prop. Treas. Reg. § 1.721-1, 36 Fed. Reg. 10,987 (1971).

76. 59 T.C.M. (CCH) 236 (1990), *rev'd in part and aff'd in part*, 943 F.2d 815 (8th Cir. 1991).

litigate this issue.<sup>77</sup> Second, after winning in the Tax Court, the government requested that the Court of Appeals reverse its victory. The Court refused to honor this request. It held that the receipt of a profits interest is taxable but because the interest in *Campbell* was speculative it had a zero value.<sup>78</sup>

*Campbell* does not resolve the issue. Recently, the Treasury issued Revenue Procedure 93-27,<sup>79</sup> which should end the majority of the controversy. This procedure holds that the receipt of a profits interest for services as a partner or in anticipation of being a partner will not be treated as a taxable event. The three exceptions are (1) if the profits interest is received in a partnership with a substantially certain and predictable income stream, (2) if the interest is sold within two years of receipt, and (3) if the interest is a limited partnership interest in a publicly traded partnership.<sup>80</sup> Given a reasonable interpretation of this revenue procedure, the issue should disappear.

The quoted regulation contains two parenthetical phrases. The first addresses the profits interest. The second has received significantly less attention. However, it is equally important. The question raised in the second parenthetical is the tax result of the receipt of a partnership interest in exchange for the cancellation of a partnership debt.

It has been suggested that the regulation should be interpreted to mean that the receipt of an interest in exchange for the cancellation of a debt arising from a property transfer is nontaxable, whereas a debt arising from the performance of services is taxable.<sup>81</sup> This is not the only interpretation. It is possible to read the regulation to mean all cancellations are taxable.

Section 108(e)(7)(E) provides support for the position that a creditor is entitled to a bad debt deduction upon receipt of a partnership interest worth less than a forgiven debt. In these cases, it is logical to assume that the partnership has forgiveness of indebtedness income.

The entire question of forgiveness of debt needs to be resolved. Given the current economic downturn, the question will certainly continue to arise. It is reasonable to expect that the Treasury will address this issue and provide guidance in the near future.

One issue appears close to resolution. As previously mentioned, Code section 704(c) requires a partnership to allocate income, deductions, and so on, to take into account the difference between the value of contributed property and its basis at time of contribution. The methodology for handling this difference was open to question. The recently issued proposed regulations give taxpayers several options.<sup>82</sup> The difference can be eliminated through the traditional method with the ceiling rule, the traditional method

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77. Gen. Couns. Mem. 36,346 (July 23, 1975).

78. *Campbell v. Commissioner*, 942 F.2d 815 (1991).

79. Rev. Proc. 93-27, 1993-24 I.R.B. —.

80. *Id.*

81. W. Eugene Seago & Caroline D. Strobel, *Cancellation of Indebtedness in Exchange for a Partnership Interest*, 19 TAX ADVISER 443 (1988).

82. Prop. Treas. Reg. § 1.704-3(a)(1), 57 Fed. Reg. 61,348 (1992).

with curative allocations to offset the ceiling rule, or under the deferred sale method. This flexibility will aid taxpayers and is a very promising sign that the Treasury will avoid issuing regulations that act as a straitjacket in the future.

The proposed regulations provide that in addition to applying to the contribution of property, the rules apply in cases of capital account revaluation under Code section 704(b), also known as "reverse 704(c)" allocations. According to the section 704(b) regulations, these revaluations occur when a new partner contributes cash to a partnership that owns appreciated or depreciated property.<sup>83</sup> It can be argued that the "reverse (c)" allocations are beyond the scope of the Code section. Their inclusion may be defensible on the grounds that they prevent significant tax avoidance potential. Regardless of the final decision relating to the "reverse (c)" allocations, the Treasury should be commended for issuing readable and reasonable regulations.

### B. Losses and Shelters

Each partner reports his or her share of partnership income or loss on his or her individual tax return.<sup>84</sup> If it is a loss, the deductible amount is limited to the partner's outside basis.<sup>85</sup> Any excess is carried forward.

This simple rule provided the mechanism for the tax shelter industry. Although losses are limited to basis, this basis amount is increased by a partner's share of the partnership liabilities.<sup>86</sup> For recourse liabilities the reason is easily defensible. However, the increase for nonrecourse liabilities provided current deductions without the offsetting personal risk.<sup>87</sup> It was these deductions without risk that drew taxpayers seeking to shelter other income from taxation.<sup>88</sup>

If it were possible to eliminate these nonrecourse liabilities from outside basis, the general rule would work reasonably well. However, given the Supreme Court's decision in *Crane v. Commissioner*,<sup>89</sup> this is not likely to happen.

The problem was exacerbated by a simple rule in the regulations that authorized allocation of the nonrecourse debt based on the partners' profit shares.<sup>90</sup> This simple rule was subject to manipulation, as evidenced by *Raphan v. United States*.<sup>91</sup> Congress' response was section 79 of the 1984 Deficit Reduction Act which charged Treasury with issuing new section 752

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83. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (as amended in 1991). There are other transactions that trigger revaluations as well as stated restrictions.

84. I.R.C. § 701 (1988).

85. I.R.C. § 704(d) (1988).

86. I.R.C. § 752(a) (1988).

87. The present value of the phantom income recognized upon the reduction of these liabilities, while substantial, may not fully offset the present value of the current deductions.

88. See Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 TAX LAW. 693, 694 (1990) (describing tax shelter incentives).

89. 331 U.S. 1 (1947).

90. Treas. Reg. § 1.752-1(e) (1956) (allocating recourse partnership liabilities to general

regulations to override *Raphan*.<sup>92</sup> In the interim Congress enacted Code sections 465 and 469.

Code section 465 was designed to eliminate the deduction of artificial losses. It limits a taxpayer's deduction to the amount he or she has at risk in the activity.<sup>93</sup> This limit is in addition to the basis limit of Code section 704(d).

A taxpayer's amount at risk is equal to the money and adjusted basis of property contributed plus amounts borrowed for which taxpayer is personally liable or for which property outside the activity has been pledged.<sup>94</sup> In effect, nonrecourse loans do not generate amounts at risk and, therefore, do not generate artificial losses.<sup>95</sup>

In spite of Code sections 704(d) and 465, Congress decided that taxpayers were still deducting tax shelter losses. Therefore, in 1986 they enacted Code section 469 which limits the amount of passive activity losses that are deductible against nonpassive income. This limit applies to those losses which survive the limitations of section 704(d) and 465.

A passive activity is defined as an activity involving an active business in which the partner does not materially participate.<sup>96</sup> In other words, the definition looks at both the partnership and the partner. The partnership must be actively conducting a trade or business. An investment partnership would generate portfolio income and be outside the scope of Section 469. If the partnership is engaged in an active business, the inquiry switches to the partner. Does the partner materially participate in the activity? To be a material participant, the taxpayer must be involved in the operations of the business on a regular, continuous and substantial basis.<sup>97</sup> A limited partner would not be a material participant except as necessary to prevent tax avoidance.<sup>98</sup> Because the definition includes both the activities of the partnership and the partner, it is possible that section 469 will apply to some but not all of the partners.

Losses derived from a passive activity are deductible only to the extent of taxpayer's passive activity income for the year.<sup>99</sup> Excess losses are carried forward and treated as a passive loss in the following year.<sup>100</sup>

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partners based on their loss sharing percentages, and nonrecourse partnership liabilities to both limited and general partners based on their profit sharing percentage).

91. 3 Cl. Ct. 457 (1983) (allowing allocation of guaranteed nonrecourse debt to limited partners even though debt was, in substance, recourse due to guarantee), *aff'd in part and rev'd in part*, 759 F.2d 879 (Fed. Cir. 1985).

92. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 597 (1984).

93. I.R.C. § 465(a) (Supp. 1993).

94. I.R.C. § 465(b) (1988).

95. There is an important exception for qualified nonrecourse financing issued in real estate activities. I.R.C. § 465(b)(6) (1988).

96. I.R.C. § 469(c) (Supp. 1993). A passive activity is not limited to activities conducted in partnership form.

97. I.R.C. § 469(h)(1) (1988).

98. I.R.C. § 469(h)(2) (1988).

99. I.R.C. § 469(a)(1) (1988).

100. Temp. Treas. Reg. § 1.469-1T(f)(4)(B) (as amended in 1992).



There are exceptions to this limitation. A partner who actively participates in a rental real estate activity may deduct up to \$25,000 of the passive loss.<sup>101</sup> The amount is reduced by one-half of taxpayer's adjusted gross income in excess of \$100,000.<sup>102</sup> Thus, for taxpayers with adjusted gross incomes greater than \$150,000, this exception disappears.

A taxpayer is permitted to deduct the aggregate amount of prior undeducted passive losses upon the taxable disposition of the entire interest in the activity.<sup>103</sup> The amount deductible is limited to the amount of loss generated by the activity. This requires the taxpayer to keep track of all passive activity loss carry-forwards separately for each activity. This exception was enacted based on the theory that it is possible to compute real economic gains and losses upon disposition of the complete investment in a passive activity.

If the passive activity loss is generated by a publicly traded partnership that is not treated as a corporation because of its qualifying income, the loss can only offset passive income from the same partnership.<sup>104</sup> In effect, losses from publicly traded partnerships are nondeductible.

Following the enactment of the limitations under Code section 469, the Treasury issued final revised regulations under Code section 752 in 1991.<sup>105</sup> The philosophy behind these regulations is that liabilities should be allocated to the partner who will ultimately bear the economic burden of repaying the liability. As a result, the misallocations that occurred in *Raphan* are avoided. Although the current regulations are much more complicated than the ones they replaced, they reflect the economic realities of the partnership more accurately.

It was hoped that these new regulations would remove the need for special limitations on the deductibility of partnership losses beyond that contained in Code section 704(d). The hope was naive. As long as nonrecourse debt generates basis, changing its allocation will not prevent someone from deducting losses in excess of economic risk. The question now becomes, are there excess losses of such magnitude to justify the extreme complexity involved in sections 465 and 469 and their interrelationship?<sup>106</sup> The answer is no. Over the past seven years numerous layers of complexity have been enacted to prevent avoidance through tax shelters. These provisions included but are not limited to extended depreciation lives,<sup>107</sup> a significantly strengthened alternative minimum tax,<sup>108</sup> and an economic performance requirement

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101. I.R.C. § 469(i) (1988).

102. I.R.C. § 469(i)(3) (1988).

103. I.R.C. § 469(g) (1988).

104. I.R.C. § 469(k) (1988).

105. Treas. Reg. §§ 1.752-0 to -5 (1991).

106. There is also a question about the effect of these provisions on different industries. Congress is currently considering repealing Code section 469 as it relates to real estate either as a stimulus or to correct an excess burden placed on this industry. ADMINISTRATION'S PROPOSALS, *supra* note 10, at 21-22.

107. I.R.C. § 168 (Supp. 1993).

108. I.R.C. §§ 55-58 (1988).

to accrued expenses.<sup>109</sup> Although these provisions do not eliminate all tax shelter benefits, they do restrict them severely. Congress could probably repeal Code section 465 without affecting government revenue significantly because of the existence of Code section 469. Alternatively, Congress could repeal Code section 469. However, it is unrealistic to expect a repeal of either section 465 or section 469 in the short run. Any loss of revenue is by definition significant to a Congress trying desperately to reduce the deficit without drastically cutting spending.

### C. Distributions and Dispositions

Generally, the sale or exchange of a partnership interest is governed by the entity concept. The seller recognizes capital gain or loss<sup>110</sup> and the purchaser has a cost basis in the acquired interest.<sup>111</sup> This approach to dispositions provides a tax avoidance potential. To the extent that the appreciation in the value of the interest is attributable to unrealized ordinary income within the partnership, the selling partner has converted ordinary income into capital gains. To prevent this abuse, Congress enacted Code section 751(a).

Code section 751(a) provides that to the extent the proceeds from the sale or exchange of a partnership interest are attributable to either unrealized receivables or substantially appreciated inventory, the transaction shall be treated as the sale of a noncapital asset. The seller will recognize ordinary income. The remainder of the transaction will be governed by the general rule providing capital gains and losses. In other words, section 751(a) bifurcates the transaction into a part sale of ordinary income property and a part sale of a capital asset.

An unrealized receivable is any amount due from the sale of goods or performance of services that has been earned but not yet recognized by the partnership under its accounting method.<sup>112</sup> Normally this refers to the accounts receivable of a cash method partnership. Unrealized receivables also include recaptures of amounts taxable under provisions such as Code sections 1245 and 1250.<sup>113</sup>

Inventory includes items for sale in the ordinary course of the partnership's business.<sup>114</sup> Any other item which would generate ordinary income if sold by the partnership<sup>115</sup> and any item that would generate ordinary income if sold by the partner<sup>116</sup> are also included in the definition of inventory.

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109. I.R.C. §§ 461(h) (Supp. 1993).

110. I.R.C. § 741 (1988). It is important to remember that the sale price includes the reduction in liabilities under *Crane v. Commissioner*, 331 U.S. 1 (1947).

111. I.R.C. § 742 (1988).

112. I.R.C. § 751(c) (1988).

113. I.R.C. § 751(c)(2) (1988).

114. I.R.C. § 751(d)(2)(A) (1988).

115. I.R.C. § 751(d)(2)(B) (1988).

116. I.R.C. § 751(d)(2)(D) (1988).

To be substantially appreciated, the inventory must meet two tests. First, the fair market value of the inventory must exceed 120% of the adjusted basis of the property.<sup>117</sup> In addition, the value of the inventory must exceed 10% of the value of all of the partnership's assets except cash.<sup>118</sup> Cash was omitted from this second test to prevent avoidance of the application of the section 751 rules by stuffing the partnership with cash immediately before the transaction. This cash could then be withdrawn after the transaction without recognizing any income under section 731.

Viewed solely from the perspective of the selling partner, the rules are logical. They replace the entity concept with the aggregate concept. The vendor is treated as selling his or her share of each partnership asset. This preserves the tax character of each asset. It prevents conversion of ordinary income into capital gains. It nullifies any potential benefit that could be derived from contributing property in anticipation of the sale of the interest.

Viewed from the perspective of the purchaser, the rules break down. Although the purchaser has paid fair market value for his or her share of the assets, the inside basis does not change. Therefore, upon the subsequent sale or disposition of the assets by the partnership, the appreciation which was already taxed to the seller will be taxed again to the purchaser. Granted, the purchaser will receive an increase in outside basis for this income.<sup>119</sup> However, this will not benefit the purchaser until a subsequent disposition of the interest. The reduced gain on this second sale of the interest, or the realized loss, cannot offset the prior excess income because of the absence of any present value computation to take into account the time value of money. In addition, the double counted income is likely to be reported as ordinary income, whereas the later offset is likely to be a reduced capital gain or capital loss. Given the rate differentials, these will not balance.

Congress recognized the inequity of this situation by providing the Code section 754 election to the partnership.<sup>120</sup> If the partnership so elects, it can adjust the inside basis of its assets. The adjustment will increase or decrease the basis of the asset by the difference between what the purchaser paid for his or her share of the asset and the existing basis of that share.<sup>121</sup> The adjustment is solely for the benefit of the purchasing partner.<sup>122</sup> The result is that each partnership asset has two bases—one for the continuing partners and one for the purchasing partner. In the extreme, each asset could have as many different bases as the partnership has partners.<sup>123</sup> The recordkeeping requirements in this situation are a nightmare.

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117. I.R.C. § 751(d)(1)(A) (1988).

118. I.R.C. § 751(d)(1)(B) (1988).

119. I.R.C. § 705 (1988).

120. I.R.C. § 754 (1988).

121. I.R.C. § 743 (1988).

122. I.R.C. § 743(b) (1988).

123. This would only occur if the sales of the interest were structured such that none of them terminated the partnership under Code section 708.

The section 754 election is made at the partnership's level, not the partner's level. In addition it can only be revoked with permission of the IRS. As a consequence, not all partnerships wish to make the election, nor can a purchasing partner require that it be made. The result is an inequity between the selling and purchasing partners.

Distributions from a partnership are even more complex. The general rules are that no gain or loss is recognized by either the partnership<sup>124</sup> or the partner<sup>125</sup> as a result of the distribution, and that the recipients take a carryover basis in the assets.<sup>126</sup> These general rules have exceptions for the recognition of gain if excess cash is distributed,<sup>127</sup> for the recognition of loss if the distribution terminates the partner's interest,<sup>128</sup> and for substituted basis.<sup>129</sup> In cases of distributions that terminate the partner's interest, the rules are further complicated by the requirement that the distribution be divided between the amount received in exchange for the partner's interest and the amount received as taxable ordinary income.<sup>130</sup>

Congress was concerned that the rules did not prevent the shifting of income among partners and the conversion of ordinary income into capital gains. Therefore, they enacted a provision that reclassifies a disproportionate distribution into a part distribution-part sale.<sup>131</sup> These rules border on the unintelligible. Worse, they fail to prevent the types of abuses that Congress sought to eliminate.<sup>132</sup> Even in those cases in which the rules work, there are likely to be inequities because of gain or loss recognition or basis limitation. In these cases, the partnership can elect to make an adjustment to the inside basis of its asset similar to the adjustment in the case of a sale.<sup>133</sup> This adjustment is difficult and in certain cases inaccurate.<sup>134</sup> The combination of all these rules creates a situation in which it is almost impossible to correctly report the tax result of a distribution.

Both the disposition and distribution rules could stand improvement. However, it is not likely that the disposition rules will be changed. They work reasonably well as is. They minimize the shifting of income or the conversion of ordinary income into capital gains.

Distributions are different. The rules do not work. Therefore, they should be changed to make them more manageable and consistent. The real question is how. A simple solution is to repeal the anti-abuse provisions of Code section 751(b). There is likely to be objection to this suggestion on

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124. I.R.C. § 731(b) (Supp. 1993).

125. I.R.C. § 731(a) (1988).

126. I.R.C. § 732 (1988).

127. I.R.C. § 731(a)(1) (1988).

128. I.R.C. § 731(b) (Supp. 1993).

129. I.R.C. § 732(a)(2) and (b) (1988).

130. I.R.C. § 736 (1988).

131. I.R.C. § 751(b) (1988).

132. For a complete discussion of the purpose of the anti-abuse rules and why they do not work, see MCKEE ET AL., *supra* note 69, at ¶ 21.01 [2], 21-4 to 21-8.

133. I.R.C. §§ 754, 734 (1988).

134. See MCKEE ET AL., *supra* note 69, at ¶ 25.02, 25-11 to 25-12.

the grounds that this will open too wide a loophole. I disagree. First, the current rules do not prevent the abuses; therefore, there is no reason to maintain them. Second, and more importantly, there are other safeguards in place. For example, the new section 704(c) regulations prevent the shifting of income both on contribution of property and, under the "reverse (c)" rules, on the contribution of cash. The revision of Code section 707(a)(2)(B) and the enactment of Code section 737 prevent distribution as well as possible disguised sales from avoiding taxation as a contribution. Code sections 724 and 735 prevent both contributions and distributions from converting ordinary income property into capital assets. Given all of these other rules there is very little need for a rule such as section 751(b). Its repeal will go a long way to returning rationality into partnership taxation.

There are other ways to change the distribution provisions.<sup>135</sup> Many of them would replace the existing rules with other highly complex rules.<sup>136</sup> Given the restricted abuse potential, these proposals should be analyzed with the view to preventing the creation of cures which are worse than the disease.

#### D. The Future

The Treasury should be reasonable in its interpretation of Revenue Procedure 93-27 and thereby eliminate the questions surrounding the receipt of a profits interest for services. Further, Congress should repeal the complex at-risk rules of Code section 469—the other layers of loss limitations are enough. Moreover, Congress should mandate Code section 754 treatment to alleviate the inequity between sellers and purchasing partners. Finally, Congress should repeal Code section 751(b) to allow consistent and rational treatment of distributions.

#### CONCLUSION

Recently, there has been renewed interest in partnership taxation. It has taken the form of a review of existing rules as well as suggestions for improvement and change.<sup>137</sup> As with all suggestions, it has proved impossible to meet the conflicting policy goals of simplicity, equity, neutrality and revenue protection. There have been trade-offs, which has been the history of taxation.

From the very beginning, partnership taxation has been unique in trying to blend the alternative concepts of the entity and aggregate theories. As a consequence, there is no one theory that can be applied to reason out an

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135. See Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173 (1991).

136. See John P. Steines, Jr., *Commentary—Unneeded Reform*, 47 TAX L. REV. 239 (1991).

137. See, e.g., *Partnership Taxation Symposium*, 47 TAX LAW REV. (1991); Sheldon I. Banoff, *Guaranteed Payments for the Use of Capital: Schizophrenia in Subchapter K*, 70 TAXES 820 (1992).

answer. This conflict will not be resolved. What we can reasonably expect is a continuing determination of the taxation of individual transactions.

The two possibilities that will have the most beneficial effect on future partnership taxation are outside Subchapter K. They are the expansion of Subchapter S and the integration of corporate and individual taxation. Both will reduce the pressure on business to operate in partnership form when the corporate structure is better suited. In the present environment of tax change, Congress should not ignore Subchapter K, but should revise the tax treatment of partnerships in a manner that advances the policy goals of easing complexity and promoting operational rationality.

