# Partnership Taxation

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FIFTH EDITION

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To Wally Blum, Cynthia Holcomb Hall, and Sharon King, who taught me how to be a tax lawyer. And to my wonderful wife and family, who have come to understand and cope with my love of tax law and golf (not necessarily in that order).

— Richard M. Lipton

To my loving wife and daughters, who wisely discourage me from talking about tax at home.

— Paul Carman

To Chuck Fassler, whose mentoring and guidance have been invaluable to the development of my career as a tax attorney. And to my wonderful wife, Shannon, and our two sweet girls, Elin and Mallory, for their love and support and for putting up with my long working hours, particularly while at home during a pandemic year.

— Ross Cohen

Dedicated to the memory of Walter H. and Augusta J. Schwidetzky.

I wish to acknowledge my indebtedness to Professors Stephen Lind, Stephen Schwarz, Daniel Lathrope, and Joshua Rosenberg, authors of *Fundamentals of Partnership Taxation*. I taught from their text for many years and it influenced my own approach to this effort.

— Walter D. Schwidetzky

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## Introduction

# The Spirit of Partnerships and Partnership Taxation

Most of this textbook focuses on the rules concerning partnership taxation—when a partnership exists, the tax treatment of contributions to a partnership, the basis of partnership assets and interests in a partnership, how income is allocated to the partners, the tax treatment of distributions, the consequences of partnership liabilities, partnership mergers, the retirement of a partner, and dissolution of the partnership. There also is significant attention paid to the numerous "anti-abuse" rules that have been adopted by Congress and the Internal Revenue Service ("IRS") over the past several decades, including the disguised sale rules, the treatment of "mixing-bowl" transactions, the complex rules to prevent basis abuse, and the overriding "partnership anti-abuse regulations" adopted by the IRS. These rules are embodied in the Code,[1] the Regulations, rulings from the IRS and numerous precedents, all of which are explored and discussed below. Put simply, this textbook contains a thorough discussion of the rules of partnership taxation.

In addition, this textbook explores one of the fundamental questions which always arises in partnership taxation: is a partnership to be treated as a separate taxable entity or an aggregate of its partners? The tension between entity and aggregate treatment of a partnership is one of the recurring issues in determining the tax consequences of partnership transactions. Indeed, it can be argued that Congress created perpetual uncertainty when it decided in 1954 that for tax purposes, a partnership was not solely an aggregation of its partners or a separate legal entity, but at times one and at times the other. Many of the questions addressed in this textbook arise, at their heart, because of the bifurcated nature of a partnership as both a separate entity and an aggregate of its partners. Some of the more complex areas in partnership taxation (like the IRS audit rules governing partnership controversies) arise because of Congress' unwillingness to draw the line between treating a partnership as a separate entity versus an aggregation of its partners.

However, this introduction focuses on a third aspect of partnership taxation—the spirit of partnerships and partnership taxation. The concept that individuals and corporations will, in the furtherance of legitimate business enterprise, want to

1. References to the "Code" and "I.R.C." are references to the Internal Revenue Code of 1986, as amended.

enter into partnerships is one of the unspoken axioms of the tax law. The practical consequences of people coming together is the focus of the complex rules governing partnership taxation, but the underlying reason why people want to combine their efforts is not addressed frequently. People coming together to promote their individual and collective self-interests is what underlies every partnership.

In order to understand partnership taxation, you need to take into account the fact that partnerships are one of the fundamental building blocks of human economic interaction. Partnerships have long existed, and they will continue to exist, although the success of partnerships may depend upon the tax rules applicable to them. The rules concerning partnership taxation need to be judged by whether they further or inhibit this basic goal. In other words, as you read each of the chapters below, you should consider not only the technical partnership tax issues that are discussed, but also whether the rules are consistent with the undiscussed spirit of partnerships and partnership taxation. If the rules further these goals without fostering abuse, then the rules may be considered to be "spiritually" appropriate. On the other hand, if, out of a desire to prevent some perceived abuse, the rules make it harder for people to combine their resources and energy, or result in uncertain or disproportionately inappropriate tax consequences, then the wisdom of the rules need to be carefully considered.

**Why Are There Partnerships?** Anyone who wants to consider the origin of partnerships (and partnership taxation) needs to go no further than prehistoric times, as men banded together to hunt. The cave drawings found in Southern France all illustrate groups of men joining together to slay beasts, whether for food or protection. The proceeds of these efforts were shared by the hunters (partners), although a written agreement was not needed to determine how a slaughtered animal would be divided.

Indeed, it can be argued that the entire impetus of the change in civilization from a hunter/gatherer society to one in which people primarily lived in cities was a result of partnerships being formed. Although cities furthered economic growth and development by allowing individuals to exchange their efforts and goods, the impact of this interchange was greatly magnified as people joined together to increase the impact of their efforts. Partnerships provided the means for people to work together, and the law quickly developed to address the legal relationship of partners.

A survey of the laws of antiquity indicates that partnerships have been present for a long, long time. Dating back to the time of Sumer, there was a complex commercial system that included business partnerships. The transactions of these partnerships were recorded on clay tablets, some of which have been found in temple complexes.[2]

In his book on Mesopotamian contracts, Paul Halsell highlighted two contracts from the reign of Nebuchadnezzar II (c. 568–564 BC). In the first contract, Nabu-adki-iddin was an investor — a member of the great Egibi family. He contributed

2. Paul Guisepi & F. Roy Willis, History-World.org/sumeria, 2003.

four manas of capital to a partnership, while Bel-shunu, who was to carry on the business, contributed one half mana and seven shekels, whatever property he might have, and his time. Any expenses in excess of four shekels was considered to be extravagant and had to be paid by Bel-shunu from his own pocket. The contract was witnessed by three men and a scribe. In another partnership, entered into four years later, there were no initial contributions, but each of the partners drew 20 shekels of income one year later, and additional funds were used by the partnership to pay its obligations.[3]

This business model was carried over to ancient Greece and Rome. In Rome, in particular, "associations" were formed which functioned as partnerships. Partnerships were used, especially for transmarine transactions in which risk sharing was necessary in an age before insurance. Cato advised a capitalist not to fit out a single ship but, in concert with 49 other capitalists, to send out 50 ships and to take an interest in each to the extent of a fiftieth part.[4]

When Rome fell, and "darkness" spread upon the West, partnerships continued in the thriving intellectual climate of the Arab world. Indeed, partnerships were the primary form of business enterprise, because interest is forbidden in the Koran. Partnerships were regularly used to compensate the party who provided money to a venture, using a variable rather than a fixed rate of return. Indeed, there were different types of partnerships for the situation where one person contributed money and another contributed labor (Mudararah) and the situation in which both persons contributed capital (Musharakah).[5]

Even in the so-called Dark and Middle Ages, partnerships were the primary vehicle of commerce. For example, in 1235, a Jew (Saltell) and a Christian (Berenguer) formed a partnership to operate a mill. They originally agreed that Saltell would have one quarter of the income and bear one quarter of the losses. Seven years later, a dispute arose, with Saltell claiming he was owed money as a result of a premature disposition of the mill, and Berenguer claiming that there was a loss for which he was entitled to compensation. The matter was submitted to jointly accepted arbitrators, who found in favor of Saltell and awarded him monetary damages.[6]

The emergence of the West from the Dark Ages was accompanied by the growth of mercantile partnerships. Indeed, on his voyage of discovery, Christopher Columbus formed a partnership with the Spanish crown and Italian investors, in which

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3. Paul Halsall, Ancient History Sourcebook: A Collection of Contracts from Mesopotamia, c. 2300–428 BCE, in Internet Ancient History Sourcebook (1999), http://www.fordham.edu/halsall/ancient/mesopotamia-contracts.html.

4. Theodor Mommsen, The History of Rome, Book III.

5. M.A. Mannan, Economic Development and Social Peace in Islam (1989); M.U. Chapra, Towards a Just Monetary System (1986).

6. Medieval Sourcebook: A Business Partnership Between a Jew and a Christian in Barcelona, 1235–1242, based on Arxiu Capitular de Barcelona 1-6-3475.

he shared the proceeds from his discoveries.[7] The explorations by Sir Francis Drake were supported by partnerships of investors.[8] And the great growth of trade in the Netherlands during the sixteenth century can be directly traced to partnerships in which investors held shares and entrusted their capital to the hands of active partners.[9]

The use of partnerships is also inextricably linked to the founding of this country. Although the original Virginia Company that founded the Jamestown settlement was a corporation chartered by the Crown, the Pilgrims who landed at Plymouth Rock conducted their enterprise as a partnership. There were "Adventurers," who provided the capital and supplies needed for the settlement. The settlers themselves were often described as "partners in land" who would be entitled to a sharing of the proceeds with the Adventurers.[10]

Partnerships were so common that they could be found in everyday conversation and in famous literature. For example, in *A Christmas Carol*, when Ebenezer Scrooge and Jacob Marley left to form their own business, they formed a partnership, Scrooge and Marley. Shakespeare referred to partners in business enterprises in several of his plays.[11]

The story goes on and on. People joining together to collectively promote their interests — to form partnerships — are a fundamental part of the history of man. Partnerships are simply a part of fundamental human relationships — people enter into partnerships in order to conduct commercial enterprise, with the hope that this will improve their lives.

**Why Are There Separate Tax Rules for Partnerships?** If partnerships are such a fundamental building block for human relations, why is it necessary to have separate tax rules for partnerships? This seemingly simple question can be answered with an equally simple statement — our tax system focuses on income, and income eventually goes to the people who receive it. The income tax originally applied only to individuals, and the taxation of partnerships was always focused on the taxation of the people who formed those partnerships.

There is, needless to say, a long history of partnership taxation that pre-dates the current income tax. However, for much of antiquity, there was no income tax (as we currently understand such taxes), although partnerships would have been subject to wealth, property, and similar taxes. However, as far back as 519 B.C., King Darius of Persia established a tax system that was based on the anticipated yield of land. Although this was not a true "income" tax, the tax was imposed upon the source of production of income. Even earlier, in ancient Sumer and Babylon, professional

7. *Columbus' Campaign for Funding*, Wikipedia.org.

8. *The Beginning of the End: The Drake-Norris Expedition, 1589*, www.loc.gov/rr/rarebook/catalog/drake.

9. Jan de Vries, *The Dutch Atlantic Economies*, *in* Coclanis Books, at 10 (2005).

10. *The Present [1624] Estate of New Plymouth*, from the Mayflower Web Pages, Mayflo1620.

11. *See*, *e.g.*, The Winter's Tale act 4, sc. 2; Coriolanus act 5, sc. 6.

workers had to pay "taxes" to royal collectors in order to remain employed. Thus, both individuals and partnerships have long had tax burdens, although much of this taxation was not directly related to income.[12]

Of course, it also is possible to tax business entities, as the tax treatment of corporations shows. Arguments have been made that all business entities — corporations, partnerships, limited liability companies, business trusts — should be directly subject to taxation. The difficulty with this argument is that there is little difference between a sole proprietorship, which is difficult to tax as a separate business entity, and a two-person general partnership. The distinction becomes even harder to discern when families are involved. For example, if a woman sets up a business in her home and it is not taxable, but then brings her daughter into the business to help her and gives her daughter an ownership interest in the business, would the former not be a business entity subject to taxation but the latter would? Unless every business entity of any size, and without regard to the number of owners, is subject to entity-level taxation, there will always be some business entities that are effectively taxed to their owners directly and not to the entity itself.

Moreover, some state and local governments (and some foreign countries) currently tax partnerships as business entities, so it is clear that there is no fundamental cosmic reason why a partnership could not be subject to taxation. But in the United States, as a general rule, a partnership has been viewed not as a separate taxable entity but, instead, as a "pass-through" entity in which its owners (and not the partnership itself) are subject to taxation. This axiom — that income tax is paid by the partners of a partnership, and not the partnership itself — underlies many of the issues that will be discussed herein.

**Aggregate versus Entity Treatment.** The assumption that a partnership will be treated as a pass-through entity that is not directly subject to income taxation does not answer the question whether the calculation of income will be conducted at the partner or partnership level. In other words, even if the partners in the partnership (and not the partnership itself) are directly subject to taxation on income, the computation of income can be made either at the entity level (by treating the partnership as a separate entity for purposes of computing the income that is taxable to its owners) or at the partner level (by disregarding the partnership and treating it as an aggregation of its owners, each of whom determines his own income separately).

There is no clearly "correct" way to determine how a partnership should be treated, *i.e.*, both entity and aggregate treatments are appropriate at different times. Many of the chapters that follow will illustrate the tension between aggregate and entity treatment of partnerships in calculating the income that is taxable to the partners in a partnership. This is particularly evident in the various anti-abuse rules that have been adopted by Congress or promulgated by the IRS. Most of the anti-abuse

12. Michael Hudson, *Mesopotamia and Classical Antiquity — Taxation History*, Am. J. Econ. & Soc. (Dec. 2000).

rules address situations in which treating a partnership as a separate taxable entity results in more favorable tax consequences than would occur if the partnership were treated as an aggregation of its owners — the anti-abuse rules frequently treat the partnership as an aggregate in order to "correctly" determine the taxable income of its partners.

**Where Do Substance and Form Fit In?** If simplicity is ever to be achieved in the area of partnership taxation, then "substance" and "form" will remain significant determinants of the tax consequences of partnership transactions. It can be argued that much of the complexity in the more recent legislation and Regulations concerning partnership taxation are the result of Congress and the IRS not trusting that the courts will look at the substance (rather than the form) of partnership transactions. Many of the more recent rules appear to be designed to address situations in which the form of the transaction differed from its substance. It is possible that some of this complexity could be eliminated if Congress and the IRS would simply allow the courts to do their job in weighing the bona fides of partnership transactions.

For example, consider the decision in *ASA Investerings Partnership v. Commissioner*.[13] The case involved the application of the installment sale rules under I.R.C. § 453 in the context of a partnership with foreign and domestic partners. The partnership was formed so as to cause an allocation of income (resulting from the installment sale) to the foreign partner. To address this transaction, the court could not rely upon the technical words in the Code, because these rules supported the taxpayer's position. Instead, the court had to look at the substance of the transaction (rather than its form) to find that the foreign party was not a "partner" to whom income could be allocated.

**What About Anti-Abuse Rules?** Recent years have seen significant legislative and regulatory developments in the partnership area. Many of the newest rules can only be described as "anti-abuse" provisions which are intended to address one particular transaction or another that was considered to be abusive. The result is that the laws concerning partnership taxation have metamorphosed from the broad, general principles that were established in the 1950s into particularized rules that attempt to address every potential abuse. Of course, it is impossible to cover every conceivable situation, so Congress and the IRS have crafted numerous rules that unfortunately can be aptly described as "heads I win, tails you lose."

Several examples illustrate the approach taken by Congress in these new rules. For example, I.R.C. §§ 737, 721(b), and 731(c) all provide for the potential recognition of gain, but not loss, in certain situations. If the transaction is an appropriate event to trigger the recognition of gain, why is it not also an appropriate event for the recognition of loss?

13. 76 T.C.M. (CCH) 325 (1998), *aff'd*, 201 F.3d 505 (D.C. Cir. 2000), *cert. denied*, 531 U.S. 871 (2000).

Likewise, the basis rules in I.R.C. §§ 734 and 743 were amended in 2004 to address situations in which partners could benefit from not making an election under I.R.C. § 754 to adjust the basis of partnership assets. Basically, the amendment functions so that: (1) if there would be a basis increase that would potentially benefit partners, an election must be filed, and if no election is timely filed, the partners could face double recognition of gain, but (2) if there is a loss that would result in a significant basis reduction (which benefits the IRS), an election will be deemed to have been filed except in some very limited circumstances. This provision is a classic "heads I win, tails you lose" situation[14] and is representative of the approach taken in recent legislation and Regulations.

**How Do the Tax Rules Affect Partnerships?** Any practitioner who has worked with partnerships is well aware that the tax laws affect every single transaction. It would be naïve to assume that a partnership would be formed, enter into transactions, distribute its profits, bring in new partners and redeem old ones, incur liabilities, and (eventually) dissolve without looking at the applicable tax rules each and every step of the way. In fact, because partnerships receive more favorable tax treatment than corporations (one level of taxation instead of two), it is possible that even more attention is paid to the tax consequences of partnership transactions than to corporate ones.

The impact of the tax rules can be seen in everyday transactions. For example, assume that Jack wants to contribute property to a partnership, and Jill wants to contribute money. The contributing partners will need to consider numerous tax issues in forming their partnership, including the impact of any built-in gain or loss with respect to the contributed property, the manner in which basis will be allocated and depreciation calculated, the potential application of the disguised sale rules as distributions are made to Jack, the allocation of liabilities that encumber the property, and on and on. Even the simplest transaction can result in significant confusion.

If the goal of partnerships is to allow people or corporations to pool their efforts for the common good, then partnership tax rules should be judged by whether they make it easier or more difficult to attain this goal. Many of the more complex rules in the Code will certainly fail to meet this goal. Indeed, the most significant issue in partnership taxation is the complexity, much of which arises from more recent rules and Regulations.

Take, for example, the potential application of the disguised sale rules to the partnership formed by Jack and Jill. Even a simple transaction, in which one partner contributes property and the other contributes cash, will need to be carefully reviewed to make sure that the transaction is not treated as a disguised sale. Moreover, all distributions by the partnership to Jack and Jill will need to be carefully

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14. This provision was enacted to address a transaction, undertaken by Enron Corporation prior to its demise, in which a failure to make an I.R.C. § 754 election resulted in basis duplication.

monitored for at least seven years to make certain that Jack is not treated as having engaged in a "mixing bowl" transaction. Thus, the simple contribution of property to a partnership can result in years of diligence. This complexity is one of the banes of the partnership tax rules at the present time.

**The Spirit of Partnership Taxation.** If there is an underlying "spirit" to partnerships, it is people getting together to conduct business in a manner which provides mutual benefits. This is how partnerships have always been used, and this is why partnerships have generally been treated as non-taxable entities, because it is the partners (and not the partnership as an entity) that should be subject to income taxation.

The tax rules for partnerships should be approached with the intention of furthering this goal by allowing persons to enter into mutually beneficial economic arrangements, the tax consequences of which can be simply (and definitively) determined. Moreover, the tax results should be self-evident to both the partners in the transaction and their tax advisors. The spirit which underlies partnership taxation should be the same as the spirit underlying partnerships — partnerships should be taxed in a manner which reflects the underlying business arrangements of the partners. If partnerships are a "basic" form of human economic organization, the tax rules for partnerships should also be built on the "basics" that tax consequences should be related to the underlying economic relationships of the partners.

The remainder of this book will be filled with discussion of the actual rules for partnership taxation. You will encounter complex rules, with exceptions, exceptions to the exceptions, and "heads I win, tails you lose" anti-abuse rules. We will leave it to you to determine whether each of these rules — particularly the more recent statutory and regulatory limitations on partnerships and their transactions — are consistent with or contrary to the underlying spirit of partnerships and their transactions.

The foregoing said, it is purely wishful thinking to believe that the partnership tax rules can return to the days of yore, in which there were a few simple rules and general principles guiding partnership taxation. Complexity is here to stay, and the ongoing trend is to make the rules more complex rather than simpler. Moreover, as tax practitioners find ways to take advantage of the rules, it can be anticipated that Congress and the IRS will continue to attempt to make the rules for partnership taxation more one-sided than ever.

**How Practitioners Can Further the Spirit of Partnerships and Partnership Taxation.** The following chapters will illustrate many of the aspects of partnership taxation. You will learn about the definition of a partnership, the tax consequences of forming a partnership, the effect of contributions to the partnership and distributions by the partnership, the determination of basis, the tax treatment of partnership liabilities, the calculation and allocation of partnership income, the disposition of partnership interests and the tax treatment of retiring partners, the tax treatment of transactions between a partnership and its partners, partnership mergers and divisions, and the myriad anti-abuse rules that are now part of the partnership tax universe. Each of these areas has its own rules, some of which are instinctual, some of which are artificial, and many of which are subject to complex rules and Regulations.

As a tax practitioner in the partnership area, you will need to be fully conversant with the rules that are discussed herein. But you also need to have a fundamental understanding of the "spirit" which underlies these rules, which is that a partnership provides a means for different persons to jointly conduct economic arrangements. The tax consequences of the partnership should be linked inextricably to the underlying economic arrangement, and although the rules are complex, they are generally intended to reach that result. Indeed, it is most likely that an anti-abuse rule will apply any time that the partnership tax rules lead to a result which is non-economic or does not appear to be consistent with the underlying economic arrangement of the partners. And in those situations which happen to lie outside of one of the anti-abuse rules, it is still possible that a court would attempt to recharacterize the transaction — whether under substance over form principles or simply on the basis of "economic reality" — so as to cause the tax consequences of the transaction to comport with the economic arrangement of the partners.

When you are advising partnerships, therefore, you should always be mindful of the underlying economic arrangement. The partnership agreement, and all of the other documents evidencing the partnership and the arrangements of the partners, should be drafted so as to clearly embody and further the partners' intent. Indeed, it often is best to state clearly in the agreement both the intended economic effect and intended tax consequences of the partnership transaction. If it cannot be stated clearly and succinctly, or if the partners are not willing to allow their intent to see the light of day, then the practitioner should be concerned about the substance of the transaction and the resulting tax consequences. However, if the partners' economic arrangement is clear and the intended tax consequences flow inevitably from the partners' economic arrangement, then it is likely that both will be respected. The practitioner's goal should be to create partnership arrangements and transactions where, notwithstanding the complexity of the Code, the Regulations, the rulings, and the case law, there is little doubt as to what the tax consequences will be.