SUMMER 2015

STUDENT UPDATE MEMORANDUM

FUNDAMENTALS

OF

PARTNERSHIP TAXATION

Ninth Edition

By

STEPHEN SCHWARZ
DANIEL J. LATHROPE

With the Collaboration of

BRANT J. HELLWIG

Copyright © 2015

by

FOUNDATION PRESS

PREFACE

This Summer 2015 Student Update Memorandum brings *Fundamentals of Partnership Taxation* up to date by summarizing major developments since publication of the Ninth Edition in June 2012. The most important federal tax development during the past three years was the enactment of the American Taxpayer Relief Act of 2012, averting a plunge from the fiscal cliff and making the individual income tax rates permanent for the first time in a decade, at least until Congress decides to change them again in the future. Other important partnership tax developments were the issuance of various proposed and final regulations, including sweeping proposals to change the rules on allocation of partnership liabilities and the mechanics of Section 751(b) and new guidance under Section 707(a) on disguised payments for services. This year's Update Memorandum also continues to follow the policy debate about comprehensive tax reform that, predictably, is caught in political gridlock with no clear outcome in sight.

Instructors who have adopted the text may distribute paper or electronic copies of the Update Memorandum to their students.

The Update Memorandum is organized to parallel the text, with cross references to chapter headings and page numbers. It covers developments through July 25, 2015.

STEPHEN SCHWARZ
DANIEL J. LATHROPE
BRANT J. HELLWIG

July 2015

Part One: Introduction

Chapter 1. An Overview of the Taxation of Partnerships and Partners

C. Introduction to Choice of Business Entity

Page 23:

After the second full paragraph, insert:

For the first time in many years, the individual income tax rates are no longer in flux – at least for now. Beginning in 2013, the American Taxpayer Relief Act of 2012 ("ATRA") made permanent what had become known as "the Bush tax cuts" – i.e., lower tax rates on ordinary income and capital gains for most individuals – except, as part of a political compromise, "high income" taxpayers are taxed at a marginal rate of 39.6 percent on income over various thresholds, which are indexed annually and in 2015 are: $464,851 for married filing jointly taxpayers, $413,201 for unmarried filers, $439,001 for heads of household, and $232,426 for married filing separately taxpayers. Congress also finally provided for indexing of the alternative minimum tax, obviating the need for an annual exemption "patch" to prevent more middle class taxpayers from being subject to the AMT.

ATRA made permanent the zero and 15 percent rates for most long-term capital gains and qualified dividends but raised the top rate to 20 percent for high income taxpayers. The 20 percent rate, however, applies only to the extent that these tax-favored items otherwise would fall into the 39.6 percent marginal bracket if they were ordinary income. See generally I.R.C. § 1(h). The 28 and 25 percent rates for collectibles and unrecaptured Section 1250 gain remain unchanged.

Congress also restored the reduction of itemized deductions in Section 68 and the phase-out of personal exemptions in Section 151(d)(3) for high income taxpayers. The effect of both these stealth tax increases is to impose a higher marginal rate on taxpayers whose adjusted gross income exceeds applicable threshold amounts, which in 2015 are: $309,900 for married filing jointly taxpayers, $258,250 for unmarried filers, $284,050 for heads of household, and $154,950 for married filing separately taxpayers. These thresholds, which are different from those used as the starting point for the 39.6 percent marginal bracket, also will be indexed annually for inflation.

The return of a 39.6 percent marginal rate on high income taxpayers coupled with a new 3.8 percent tax on net investment income and retention of a 35 percent top corporate income tax rate has raised anew the question of whether a closely held business should consider operating as a C corporation rather than a pass-through entity. The 4.6 percent rate differential on current operating income usually is not a sufficient advantage when weighed against the tax costs to those businesses that are not easily able to avoid the sting of the double tax. The flexibility of partnerships and LLCs, and the relative simplicity of the S corporation regime and potential employment tax advantages, also may influence the decision.

For now, the conventional wisdom is that in most cases this modest increase in individual rates for high income taxpayers is not enough to tip the scales towards the C corporation for the vast majority of closely held businesses. But a further reduction in statutory corporate tax rates, which both political parties have embraced in principle, could alter the analysis and revive the use of C corporations as an attractive refuge from steeper individual tax rates unless corporate rate reductions are coupled with tax relief for pass-through entities, as some have proposed. As always, the ultimate choice of entity decision turns not just on the relationship between the tax rates but also on the many other variables discussed in the text. For a comprehensive overview of choice of entity considerations under current law, including extensive data on the distribution of business entities by number, size, industry, and net income, see Joint Committee on Taxation, Choice of Business Entity, Present Law and Data Relating to Corporations, Partnerships, and S Corporations (JCX-71-15), April 15, 2015, available at http://www.jct.gov/publications.html?func=startdown&id=4765.

Page 27:

After the first full paragraph, insert:

For 2015, the Social Security tax wage base increased to $118,500 and, with the expiration of the two percent "tax holiday" on the employee's share at the end of 2012, the tax rate for both employers and employees is back to 6.2 percent each. For self employed taxpayers, the Social Security tax portion of self-employment tax is once again 12.4 percent. As previewed in the text (footnotes 25 and 26), in 2013 the Medicare tax rate increased to 3.8 percent for taxpayers with wages or self-employment income above these thresholds (which are not indexed): $250,000 married filing jointly, $200,000 single and head of household, and $125,000 married filing separately.

Page 29:

After the carryover paragraph, insert:

In November 2013, the IRS issued final regulations interpreting the 3.8 percent tax on net investment income that became effective in 2013 along with proposed regulations providing further guidance on specific types of activities. See *infra* p. 36 of this Update Memorandum for an overview of these regulations.

PART TWO: TAXATION OF PARTNERSHIPS AND PARTNERS

CHAPTER 2. FORMATION OF A PARTNERSHIP

A. CONTRIBUTIONS OF PROPERTY

1. GENERAL RULES

Page 32:

Add to the reading assignment for the Code and Regulations:

The reading assignment on this page includes Reg. § 1.453-9(c)(2). Prop. Reg. 1.453B-1(c) would republish the general rule in Reg. § 1.453-9(c)(2) that when the Code provides an exception to the recognition of gain or loss, then gain or loss is not recognized on the disposition of an installment obligation within the exception. See REG-109187-11 (Jan. 12, 2015). The proposed regulation was issued to reflect earlier changes made to Section 453. The rules about dispositions of installment obligations currently in Section 453B were at one time in Section 453.

Page 37:

The proposed regulations discussed in the Note have been finalized. Replace the Note with the following text:

NOTE

A partnership may acquire the capital it uses in its business ventures in a variety of ways. The simplest and most direct way is for the partners to contribute property in exchange for their partnership interests. In more complex transactions, the partnership may issue options that allow the holder to purchase an equity interest in the partnership. Similarly, a partnership may borrow funds in exchange for convertible debt that allows the holder to acquire an equity interest in the partnership through the instrument's conversion feature. How should Section 721 apply in these more complex transactions?

Noncompensatory Options. The Service has issued regulations that govern the tax consequences of "noncompensatory" options to acquire a partnership interest—i.e., an option that is not issued in connection with the performance of services.[1] A noncompensatory option includes a call option or warrant to acquire a partnership interest, the conversion feature in a partnership debt instrument, and the conversion feature in a preferred equity interest in a

[1] Reg. § 1.721-2(f).

partnership.[2] Under the regulations, Section 721 generally does not apply to the transfer of property to a partnership in exchange for a noncompensatory option, but it does apply to the exercise of the option.[3] For example, assume an individual transfers property with a basis of $600 and a fair market value of $1,000 to a partnership in exchange for an option to buy a one-third partnership interest for $5,000 at any time during the next three years. On the transfer for the option, the individual recognizes $400 of gain. If the individual later exercises the option by transferring property with a $3,000 basis and $5,000 fair market value to the partnership for a partnership interest, that transfer is protected by Section 721. The regulations permit the partnership to use open transaction principles on the transfer of property for the option so it does not recognize any option income and it takes a $1,000 basis in the property transferred for the option. Under Section 723 the partnership has a $3,000 basis in the property contributed for the partnership interest.[4]

Debt-for-Equity Exchanges. Section 721 generally applies to a creditor of a partnership who contributes a partnership's recourse or nonrecourse indebtedness to the partnership in exchange for a capital or profits interest in the partnership.[5] For discharge of indebtedness purposes, the debtor partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest.[6] In general, the fair market value of the partnership interest transferred to the creditor is deemed to be the liquidation value of the interest.[7] That is the amount of cash the creditor would receive if immediately after the exchange the partnership sold all of its assets for cash equal to the fair market value of the assets and then liquidated.[8] The "liquidation value" rule is pro-taxpayer because it disregards discounts that might apply to the fair market value of the partnership interest due to lack of marketability for such an interest. However, Section 721 generally does not apply to the creditor in a debt-for-

---

[2]Reg. § 1.721–2(g)(1). For an extensive analysis of the regulations when they were proposed, see Larvick, "Noncompensatory Partnership Options: The Proposed Regulations," 99 Tax Notes 271 (April 14, 2003).

[3]See Reg. § 1.721-2(a) & (b). If the exercise price for the option exceeds the partner's capital account (i.e., excess value is transferred to the partnership), then general tax principles are used to sort out the transaction (e.g., to determine if the excess is paid as compensation, a gift, or some other type of transfer). Reg. § 1.721-2(a)(1). The regulations also address whether or not Section 721 applies in several other specialized situations. See Reg. § 1.721-2(a)(1) & (2), -2(b)(2), -2(c).

[4]This example is Reg. § 1.721-2(h) Example.

[5]Reg. § 1.721-1(d)(1).

[6]Reg. § 1.108-8(a).

[7]Reg. § 1.108-8(b). For the requirements to apply the liquidation-value rule, see Reg. §1.108-8(b)(2)(i).

[8]Reg. § 1.108-8(b)(2)(iii).

equity exchange when the partnership's indebtedness is for unpaid rent, royalties, or interest on indebtedness.[9]

Contribution of Partner's Promissory Note to the Partnership. Suppose a partner does not have sufficient liquidity to make a current cash contribution to the entity, but instead undertakes a contractual obligation, evidenced in the form of a promissory note, to make principal payments to the partnership under the note at a future date. Should the contributing partner be given advance outside basis credit for the contractual obligation, or should the promissory note be treated as a mere placeholder (while held by the partnership at least) so that outside basis credit will be afforded only to the extent the note principal payments are made? In the corporate setting, courts appear content to afford advance basis credit for a contributed note, even if they disagree on the appropriate rationale.[10] In the partnership context, however, the prevailing norm is that a contributed promissory note alone does not supply the contributing partner with outside basis credit.[11] The 2014 case of VisionMonitor Software, LLC v. Commissioner[12] confirms this trend.

In *VisionMonitor*, a limited liability company experienced losses in its early years of existence. One of the LLC's members was willing to invest additional cash if the other partners executed notes in favor of the entity. The partners executed unsecured balloon notes having a seven-year term, and the court noted a variety of defects in their execution. The Tax Court did not view this as a close case. It held that the notes did not give rise to outside basis, citing a string of cases to that effect. The Tax Court distinguished Gefen v. Commissioner,[13] in which a partner received outside basis credit for assuming personal liability for a pro rata share of the partnership's recourse indebtedness to an existing creditor. Note that in the *Gefen* case, the proceeds of the loan had already been received by the partnership.

B. Treatment of Liabilities: The Basics

1. Impact of Liabilities on Partner's Outside Basis

Page 47:

After the second full paragraph, insert:

---

[9]Reg. § 1.721-1(d)(2). However, the debtor partnership does not recognize gain or loss in the exchange. Id.

[10]See Peracchi v. Commissioner, 143 F.3d 487 (9th Cir. 1998), and Lessinger v. Commissioner, 872 F.2d 519 (2d Cir. 1989).

[11]See Gemini Twin Fund II v. Commissioner, 62 T.C.M. 104 (1991); Oden v. Commissioner, 41 T.C.M. 1285 (1981). Note that this trend is consistent with the partnership capital accounting rules. See Reg. § 1.704-1(b)(2)(iv)(2).

[12]108 T.C.M. 256 (2014).

[13]87 T.C. 1471 (1986).

The Service has proposed regulations that, if finalized, would fundamentally alter the allocation of recourse liabilities under Section 752. See *infra* pp. 8-11 of this Update Memorandum for a discussion of the proposed regulations.

2. Contributions of Encumbered Property

Page 51:

After the carryover paragraph, insert:

The Service has proposed regulations that, if finalized, would fundamentally alter the allocation of recourse liabilities under Section 752. See *infra* pp. 8-11 of this Update Memorandum for a discussion of the proposed regulations.

C. Contributions of Services

2. Receipt of a Capital Interest for Services

Page 61:

After the first full paragraph, insert:

NOTE

In Crescent Holdings, LLC v. Commissioner, 141 T.C. 477 (2013), the Tax Court addressed the tax treatment of profits attributable to an unvested capital interest in a partnership held by an individual service provider (Fields). Fields received a two percent capital interest in a partnership in exchange for his agreement to provide services for the benefit of the partnership.[1] The interest would be forfeited if Fields terminated his employment within three years of the partnership being formed, and the interest was not transferrable until the forfeiture restriction lapsed. Fields did not make a Section 83(b) election.

The partnership allocated considerable amounts of income in respect of Fields' two percent interest, but none of those profits were distributed, and it reported those amounts as Fields' distributive share of partnership income under Section 702. Fields contended that he could not be taxed on a share of undistributed income while his interest remained unvested because he was not yet a partner in the entity as a result of the operation of Section 83(a) and the regulations thereunder. The Tax Court agreed. Recognizing that nothing in the statute or the regulations specifically addressed the matter, the court held that the holder of an unvested capital interest in a partnership does not recognize in income the undistributed profit allocations attributable to such interest. The court reasoned that a service provider's interest in the undistributed profits remains subject to the same risk of forfeiture that applies to the underlying

[1] The individual actually was obligated to provide services to a lower-tier partnership in which the issuing partnership held an interest. For purposes of simplicity, however, the summary assumes that the individual agreed to provide services to the issuing partnership.

capital interest. The court noted that these amounts would not escape taxation to the service provider forever, as the undistributed income would be included in the value of the partnership interest to be included in gross income if and when the interest vests.[2] Until that point, however, the undistributed profits are to be taxed to the remaining owners of the entity.

CHAPTER 4. PARTNERSHIP ALLOCATIONS

B. SPECIAL ALLOCATIONS UNDER SECTION 704(B)

2. THE SECTION 704(B) REGULATIONS: BASIC RULES

f. SPECIAL RULES

Page 159:

After the carryover paragraph, insert:

Partners Holding Noncompensatory Options. Generally, an individual holding a noncompensatory option to acquire a partnership interest is not treated as a partner for purposes of allocating partnership income. But if (1) the option provides the holder with rights substantially similar to the rights afforded a partner, and (2) there is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and noncompensatory option holder's aggregate Federal tax liabilities, the option holder is treated as a partner in allocating income.[10.1] Special rules also apply to capital account adjustments and allocations on the exercise of a noncompensatory option.[10.2] These rules are designed to account for any shifts in capital that result from the exercise of noncompensatory options.

C. ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

6. ANTI-ABUSE RULES FOR LOSS PROPERTY

Page 191:

After the first full paragraph, insert:

---

[2] As it turned out, Fields realized the risk of forfeiture with respect to the partnership interest. Fields resigned within the three-year period when the partnership's financial condition deteriorated, and he formally abandoned his partnership interest shortly thereafter.

[10.1] See Reg. § 1.761–3 for all of the details.

[10.2] See Reg. §§ 1.704–1(b)(2)(iv)*(d)(4)*, (*h*)(1) & (2), and (*s*); Reg. § 1.704-1(b)(4)(ix); Reg. 1.704–1(b)(5) Examples 31-35.

Regulations proposed in 2014 address the mechanics of the Section 704(c)(1)(C) limitation by separating the inside basis attributable to such contributed property into two components: (1) an inside basis common to the partnership equal to the fair market value of the property at the time of contribution, and (2) a special inside basis adjustment allocated to the contributing partner equal to the excess of the basis of the contributed property over its fair market value at the time of the contribution (the "section 704(c)(1)(C) basis adjustment").[6] The contributing partner is allocated any depreciation or amortization deductions attributable to the special basis adjustment, and the inside basis adjustment is taken into account in determining the contributing partner's distributive share of gain or loss realized by the partnership on the sale of the property.[7]

The special inside basis adjustment exists for the exclusive benefit of the contributing partner. Accordingly, the basis adjustment does not carry over to a transferee of all or a portion of the contributing partner's equity interest by gift, nor does the basis adjustment transfer to a purchaser of the contributing partner's interest for value. On the other hand, if the contributed built-in loss property is subsequently distributed to a partner other than the contributing partner, the special inside basis adjustment is preserved for the contributing partner through its allocation among the remaining partnership property.

D. ALLOCATION OF PARTNERSHIP LIABILITIES

2. RECOURSE LIABILITIES

Page 199:

After the second full paragraph, insert:

Proposed Regulations on Allocation of Recourse Liabilities. On January 30, 2014, the Service proposed regulations that, if finalized, would fundamentally alter the allocation of recourse liabilities under Section 752.[38] The proposed regulations essentially revisit the baseline assumptions of the doomsday scenario for determining the extent to which partners bear the economic risk of loss for the loan—that is, that all partnership property is worthless,[39] and all partners live up to their contractual commitments regardless of net worth.[40] Recognizing that partnership liabilities often are paid from partnership profits and that, in most cases, the partnership's assets do not become worthless, the Service determined that the payment

---

[6]REG-144468-05 (Jan. 16, 2004), 2014-6 I.R.B. 474, publishing Prop. Reg. § 1.704-3(f).

[7]The special inside basis adjustment created for the benefit of the contributing partner in this setting operates in a manner similar to special basis adjustments in partnership property that may be available to a purchasing partner pursuant to Section 743(b). *See* Chapter 6B supra.

[38]See REG-119305-11 (Jan. 30, 2014), 2014-8 I.R.B. 524.

[39]See Reg. § 1.752-2(b)(1)(ii).

[40]See Reg. § 1.752-2(b)(6).

obligations of partners often are not called upon. A liability allocation regime premised on such payment obligations therefore was viewed as subject to undue manipulation. As explained in the Preamble to the proposed regulations, the Service was "concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner."[41]

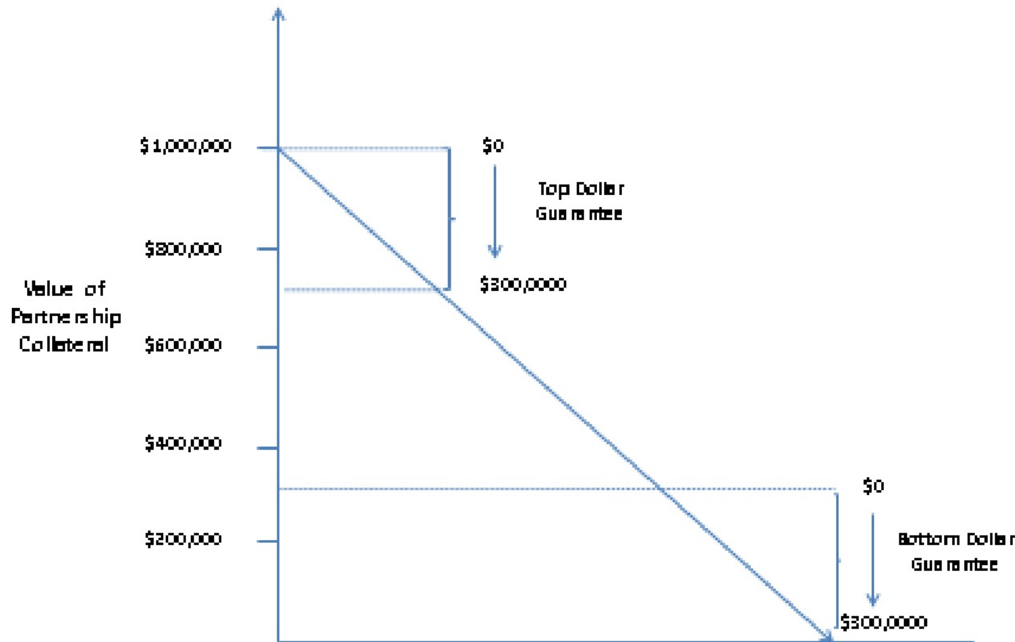
In light of this concern, the proposed regulations eliminate the presumption that partners will be called upon to satisfy their contractual payment obligations. Instead, payment obligations will be respected for Section 752 purposes *only if* the partner satisfies a host of conditions: (1) the partner must maintain a reasonable net worth throughout the term of the payment obligation or is subject to commercially reasonable contractual restrictions on the transfer of assets for inadequate consideration; (2) the partner is required to periodically provide commercially reasonable documentation regarding the partner's financial condition; (3) the term of the payment obligation does not end prior to the term of the partnership liability; (4) the payment obligation does not require that the primary obligor or any other obligor hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor; (5) the partner received reasonable arm's length consideration for assuming the payment obligation; (6) in the case of a guarantee or similar arrangement, the partner is or would be liable for the full amount of the partner's payment obligation if and to the extent any amount of the partnership liability is not otherwise satisfied; and (7) in the case of an indemnity, reimbursement agreement, or similar arrangement, the partner is or would be liable for the full amount of such partner's payment obligation if and to the extent any amount of the indemnitee's or benefitted party's payment obligation is satisfied.[42]

The latter two conditions target the use of so-called "bottom dollar" guarantees to allocate recourse liabilities for outside basis purposes. A bottom dollar guarantee does not obligate the guarantor to satisfy the entire liability; rather, the guarantor is obligated to ensure that the lender receives a determined amount after the lender has exhausted its other remedies (typically foreclosure of the collateral). As a simple example, assume that a partnership borrows $1 million to purchase property, and one of the partners guarantees that the lender will realize at least $300,000 after exercising its other collection remedies. If the lender were to foreclose on the encumbered property and sell it for $200,000, the partner would be required to pay the lender only $100,000 (so that the lender receives $300,000 total). Hence, the bottom-dollar guarantee is not triggered until the value of the collateral falls below the dollar amount of the guarantee. By contrast, a "top-dollar" guarantee of $300,000 from the partner in this context would require the partner to pay the lender the difference between the foreclosure price and the amount of the payment obligation, with such payment not exceeding $300,000. If the lender foreclosed on the partnership property and sold it for $800,000, the partner would be required to pay the lender

[41] Notice of Proposed Rulemaking, REG-119305, 2014-8 I.R.B. 524, 528. One illustration of a transaction that highlights the Service's concern in this regard is the debt-financed distribution transaction at issue in Canal Corp. v. Commissioner, 135 T.C. 199 (2010), included *infra* pp. 18-25 of this Update Memorandum in the context of disguised sales.

[42] Prop. Reg. § 1.752-2(b)(3)(ii). The latter two requirements do not apply to the right of proportionate contribution running between partners who are co-obligors with respect to the payment obligation and who share joint and several liability for the entire obligation. Prop. Reg. § 1.752-2(b)(3)(ii)(F), (G).

$200,000 under the top-dollar guarantee. As illustrated in the graphic below, the two types of guarantees represent significantly different degrees of economic risk:



The proposed regulations provide the following example relating to top dollar and bottom dollar guarantees:[43]

> A, B, and C are equal members of limited liability company, ABC, that is treated as a partnership for federal tax purposes. ABC borrows $1,000 from Bank. A guarantees payment of up to $300 of the ABC liability if any amount of the full $1,000 liability is not recovered by Bank. B guarantees payment of up to $200, but only if the Bank otherwise recovers less than $200. Both A and B waive their rights of contribution against each other. . . .
>
> Because A is obligated to pay up to $300 if, and to the extent that, any amount of the $1,000 partnership liability is not recovered by Bank, A's guarantee satisfies [requirement (6) of the proposed regulations.] Therefore, A's payment obligation is recognized [for purposes of Section 752.] However, because B is

[43]Prop. Reg. § 1.752-2(f) Example 10.

> obligated to pay up to $200 only if and to the extent that the Bank otherwise recovers less than $200 of the $1,000 partnership liability, B's guarantee does not satisfy [requirement (6) of the proposed regulations] and B's payment obligation is not recognized. Therefore, B bears no economic risk of loss . . . for ABC's liability. As a result, $300 of the liability is allocated to A . . . and the remaining $700 liability is allocated to A, B, and C under [the provisions governing allocation of nonrecourse liabilities] under § 1.752-3.

Regulations proposed in late 2013 address the manner in which a partnership recourse liability should be allocated among the partners for purposes of Section 752 if the sum of the amounts of economic risk of loss borne by the partners exceeds the amount of the obligation.[44] By way of illustration, assume that Partners *A* and *B* each provide a guarantee for full payment of a $1,000 loan to the entity. *A* and *B* should not each receive outside basis credit of $1,000 with respect to the loan ($2,000 total), as the total inside basis attributable to the loan is $1,000. The proposed regulations allocate the partnership liability among the partners based on the ratio that each partner's economic risk of loss bears to the collective risk of loss borne by the partners.[45] Thus, under the example above, *A* and *B* each would be allocated $500 of the $1,000 partnership liability for purposes of Section 752.

3. NONRECOURSE LIABILITIES

Page 210:

After the second full paragraph, insert:

NOTE

Proposed regulations issued at the beginning of 2014,[1] if finalized, would significantly alter the allocation of nonrecourse liabilities among the partners for purposes of Section 752. Recall that the default category of "excess nonrecourse liabilities" is allocated among the partners in accordance with the partners' share of partnership profits, taking into account all facts and circumstances relating to the economic arrangement among the partners. Under the existing regulations, the partners may specify their interests in partnership profits for this purpose so long as those interests are "reasonably consistent" with allocations of some other significant item of partnership income or gain that have substantial economic effect.[2] The proposed regulations would overhaul this effective safe harbor by permitting the partners to specify their interests in partnership profits for this purpose only if those interests are based on the partners' "liquidation

---

[44] REG-136984-12 (Dec. 16, 2013), 2014-2 I.R.B. 378.

[45] Prop. Reg. § 1.752-2(a)(2).

[1] REG-119305-11 (Jan. 30, 2014), 2014-8 I.R.B. 524.

[2] Reg. § 1.752-3(a)(3).

value percentages."[3] A partner's liquidation value percentage is determined under a "liquidation value test," which looks to the amount a partner would be entitled to receive if all of the partnership property were sold for fair market value and each partner received his or her proportionate share of the proceeds.[4] Once that amount is determined for each partner, the figure is converted to a percentage by dividing the liquidation value to be received by each partner by the combined liquidation value to be received by all partners. The proposed shift represents a nod in favor of so-called "target allocations" of items of partnership income and loss among the partners, under which such allocations are driven by the change in the amounts to be received by the partners upon liquidation.[5] Given the extent of the departure from the status quo, it is by no means certain that the approach embodied in the proposed regulations will survive in final form.

4. TIERED PARTNERSHIPS

Page 210:

After first paragraph, insert:

The current regulatory regime presents the prospect of overlap between the regular recourse liability allocation rules and the tiered partnership rules. For instance, suppose that a partner who owns an interest in both the lower-tier partnership and the upper-tier partnership guarantees a liability of the lower-tier partnership. The liability could be allocated entirely to the partner under the standard rules for allocating recourse liabilities given that the partner bears the economic risk of loss through the guarantee, or the tiered partnership provisions could apply to allocate the liability based on the partner's exposure for the obligations of the upper-tier partnership. Regulations proposed in 2013 provide that the liability is or will be allocated in this setting directly to the partner under the standard regime for allocating recourse liabilities.[2] Hence, the partner would be allocated the entire liability for Section 752 purposes in this scenario.

---

[3] Prop. Reg. § 1.752-3(a)(3).

[4] The proposed regulations do not require the partnership property to be valued for this purpose annually. Rather, the approach depends on the fair market value of the partnership property as determined upon the partnership formation and, subsequently, upon the occurrence of any event that would permit the partnership to restate the book value of the partners' capital accounts to fair market value pursuant to Reg. § 1.704-1(b)(2)(iv)(*f*)(5).

[5] For a discussion of target allocations, see Chapter 4B4, supra.

[2] REG-136984-12 (Dec. 16, 2013), 2014-2 I.R.B. 378, publishing Prop. Reg. § 1.752-2(i)(2).

CHAPTER 5. TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

A. PAYMENTS FOR SERVICES AND THE USE OF PROPERTY

3. DISGUISED PAYMENTS

Page 234:

At the bottom of the page, insert:

On July 22, 2015, the IRS issued (REG-115452-14) proposed regulations under Section 707 to provide guidance on when certain partnership arrangements should be treated as disguised payments for services rather than distributive shares of partnership income. Section 707(a)(1) grants the Service broad authority to identify and recast arrangements that purport to be special allocations of partnership income and treat them as direct payments for services. The legislative history (see pp. 230-234 of the casebook) elaborates on the Congressional intent and sets forth a non-exclusive list of factors to be taken into account in enforcing Section 707(a)(2)(A).

The proposed regulations apply a "facts and circumstances" test to ferret out disguised payments by providing a list of factors, many of which are lifted from the legislative history, and applying them to contemporary fact patterns. By far the most important factor is whether the arrangement lacks significant entrepreneurial risk to the service provider relative to the overall entrepreneurial risk of the partnership at the time the parties enter into or modify the arrangement.[8] To assist in the inquiry, the proposed regulations list certain additional factors creating a presumption that an arrangement lacks significant entrepreneurial risk unless that presumption can be rebutted by clear and convincing evidence. For example, if the facts and circumstances demonstrate that there is a high likelihood that the service provider will receive an allocation of income regardless of the overall success of the partnership's business, the arrangement will be presumed to lack significant entrepreneurial risk. Other examples include a capped allocation of partnership income if the cap is reasonably expected to be met in most years; an allocation for a specific number of years and the service providers's share of income during that period is reasonably certain; an allocation of gross rather than net income; and an allocation predominantly fixed in amount that is reasonably determinable or is designed to assure that sufficient net profits are highly likely to be available.[9] The proposed regulations elaborate on these and other factors, digging deep into what the IRS has discovered about current deal structures, and they include six examples.

While potentially broad in scope, the proposed regulations are aimed at arrangements where managers of private equity partnerships (e.g., venture capital and buyout funds) seek to convert ordinary fee income into more lightly taxed long-term capital gain by waiving all or part of their management fees in exchange for an additional interest in the future profits of the

---

[8] Prop. Reg. § 1.707-2(b)(2), (c).

[9] Prop. Reg. § 1.707-2(c)(1).

partnership. Private equity funds typically are managed by a limited liability company affiliated with the general partner. The management company is entitled to receive a fee equal to a specific percentage (the industry norm is one to two percent) of capital committed by the limited partner investors, and the partnership agreement allocates 20 percent of future profits of the firm to the general partner (this profit share is what is known as a "carried interest"). Because management fees are taxable as ordinary income and any future profits (including dividends) are taxable as long-term capital gains, the tax savings from a fee waiver can be considerable over the life of a fund. But the economics only make sense if the waiver arrangement is structured to eliminate or at least minimize any economic risk to the manager with respect to the management fee. Fee waivers first received public attention during the 2012 presidential campaign when it was reported that Bain Capital, the private equity firm founded by Mitt Romney, used the strategy to save approximately $200 million in taxes over 10 years. This revelation and the negative response by the media and some commentators increased pressure on the IRS to study the issue and curtail the most abusive arrangements through administrative guidance.

Four of the six examples in the proposed regulations address management fee waiver scenarios.[10] The goal in each fact pattern is to illustrate when an allocation of future profits is reasonably determinable, causing the arrangement to lack significant entrepreneurial risk. Example 3 involves a partnership formed to acquire a portfolio of assets that are not readily tradable – i.e., a typical private equity fund. The investment manager ("M") contributes cash in exchange for a one percent capital and profits interest in the partnership and, in addition, is entitled to receive a priority allocation and distribution of net gain from the sale of any one or more assets during any 12-month accounting period in which the partnership has overall net gain. The amount of the priority allocation is intended to approximate the fee M normally would charge for its services. The general partner ("A"), an affiliate of M, has legal control over when partnership assets are bought and sold and it determines the timing of distributions arising from M's priority allocation. Example 3 conveniently assumes that the amount of partnership net income allocable to M is "highly likely" to be available and reasonably determinable based on all the facts and circumstances at the time the partnership is formed. Having nicely orchestrated the facts, the regulations conclude that the allocation presumptively lacks significant entrepreneurial risk and the arrangement is thus a disguised payment for services rendered by M. In this example, the ability of the general partner to control the timing of gains and losses was a significant factor leading to the conclusion of a lack of significant entrepreneurial risk.

Several other examples appear at first glance to be more taxpayer-friendly but their fact patterns may not be typical of fee waiver deal structures that would be acceptable to most fund managers. In Example 5, the manager ("M") is entitled to receive a management fee equal to one percent of committed capital but managers of comparable funds earn a two percent fee. The general partner ("A"), which controls M, is entitled to the usual 20 percent profits interest and an additional interest in future net profits (not gross income) with an estimated present value of one percent of committed capital, determined annually. The example assumes, without explanation, that the amount of profits allocable to this additional interest is neither likely to be available nor reasonably determinable based on all the facts and circumstances known to the parties when the partnership was formed. Finally, A has what is known as a "clawback" obligation under which it

[10]Prop. Reg. § 1.707-2(d) Examples 3-6.

must repay any amounts periodically distributed during the term of the partnership to the extent they exceed what A should have received based on the overall profits earned over the life of the fund. Taken together, the regulations conclude that the arrangement with respect to A creates significant entrepreneurial risk and thus is not a disguised payment for services.

In Example 6, the fund manager was found to be subject to significant entrepreneurial risk when it could elect to waive its fees in exchange for an additional profits interest by giving written notice to the limited partners 60 days before the beginning of a partnership tax year. Presumably, the manager only would make the election when it was confident that the partnership would have sufficient future net income to compensate for the foregone fee revenue. The regulations nonetheless upheld the allocation because: (1) it was based on net profits rather than gross income; (2) it was subject to a clawback obligation over the life of the fund; and (3) there were no countervailing factors to suggest that the arrangement should be characterized as a payment for services.

The Preamble to the proposed regulations also fires a warning shot by stating that the IRS intends to make changes to Rev. Proc. 93-27, 1993-2 C.B. 343 (see casebook, p. 71), which contains a safe harbor providing, with limited exceptions, that the receipt by a partner of a profits interest for services will not be a taxable event. The IRS announced that it will add a new exception for profits interests issued in connection with a partner forgoing payment of a substantially fixed amount for the performance of services, or when one party (e.g., a manager of an investment fund) provides services and another party (e.g., the affiliated general partner) receives an allocation and distribution of partnership income or gain. The scope of this proposed exception remains to be seen, but the IRS appears to be saying that the issuance of a profits interests in a fee waiver arrangement could be taxable upon receipt (or at least not within the safe harbor) even if, as in the examples discussed above, the interest is subject to significant entrepreneurial risk and thus is not a disguised payment for services under Section 707(a). The IRS is likely to receive negative comments on this proposal, which introduces the type of uncertainty (e.g., valuation of future profits interests) that Revenue Procedure 93-27 was intended to settle.

The proposed regulations will not go into effect until they are issued in final form, but the Preamble states that the IRS views them as generally reflecting Congressional intent as to the types of arrangements appropriately treated as disguised payments for services. This puts taxpayers and their advisors on notice that the regulations may be applied immediately in partnership audits.

For press coverage immediately following issuance of the fee waiver regulations, see Gretchen Morgenstern, I.R.S. Targets Tax Dodge by Private Equity Firms, N.Y. Times, July 22, 2015, at B5. For academic commentary that influenced the IRS to issue this guidance, see, e.g., Gregg D. Polsky, Private Equity Management Fee Conversions, 122 Tax Notes 743 (2009), also available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1342030##.

4. GUARANTEED PAYMENTS

Page 242:

After the table at the end of Rev. Rul. 69-180, insert:

NOTE

Proposed regulations issued by the IRS in July 2015 (discussed *supra* pp. 13-15 of this Update Memorandum) would change the analysis in Revenue Ruling 69-180 and revise Reg. § 1.707-1(c) Example 2. The ruling and the example use a similar approach to characterizing arrangements where a partner is entitled to the greater of an allocation of a specified percentage of partnership income or a minimum guaranteed amount. They provide that if the income allocation exceeds the guaranteed minimum, the entire income allocation to the service provider is treated as a distributive share. If the income allocation is less than the guaranteed amount, the the partner is treated as receiving a distributive share to the extent of the income allocation and a guaranteed payment to the extent that the minimum amount exceeds the income allocation.

The Preamble to the proposed regulations notes that Reg. § 1.707-1(c) Example 2 is inconsistent with Congress's emphasis on significant entrepreneurial risk and its intention that an allocation must be subject to such risk to be treated as part of a service partner's distributive share. The proposed regulations would modify Example 2 to provide that the entire minimum amount is treated as a guaranteed payment under Section 707(c) regardless of the amount of the income allocation. As proposed, Example 2 would be amended as follows:

> **Example 2**. Partner C in the CD partnership is to receive 30 percent of partnership income, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000). Of this amount, $10,000 is a guaranteed payment to C. The $10,000 guaranteed payment reduces the partnership's net income to $50,000 of which C receives $8,000 as C's distributive share.

The IRS also announced that it intends to revise Revenue Ruling 69-180 when the Section 707 regulations are issued in final form. In the ruling, the partnership's net income before any guaranteed payment was $200x, and thus F's income allocation of $60x was less than the guaranteed minimum of $100x. Under the new approach, the entire $100x minimum amount would be a guaranteed payment taxable as ordinary income, reducing the partnership's net income to $100x, consisting of $20x of ordinary income and $80x of capital gain, all of which would be allocated to G.

5. POLICY ISSUES: TAXATION OF "CARRIED INTERESTS"

Page 246:

At the end of the paragraph after the indented text, insert:

The carried interest debate continues. For many years, President Obama's budget proposals have included a proposal to tax carried interests as ordinary income and as income subject to self-employment tax. For the most recent version, see Department of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals 163 (February 2015), available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

Page 247:

At the end of the Problem 1, insert:

(e) How would the results in (c) and (d), above, change under Prop. Reg. § 1.707-1(c) Example 2?

B. SALES AND EXCHANGES OF PROPERTY BETWEEN PARTNERS AND PARTNERSHIPS

2. DISGUISED SALES

Page 252:

After the first full paragraph, insert:

In recent years, the "debt-financed distribution" transaction has emerged as a technique for deferring gain on the effective sale of property. The technique is premised upon the regulations under Section 707(a)(2)(B), which generally provide that if a partner transfers property to a partnership and the partnership incurs a liability the proceeds of which are allocable to a distribution to the partner within 90 days of the liability being incurred, the transfer of money to the contributing partner is taken into account for purposes of Section 707(a)(2)(B) *only to the extent* the amount of money exceeds the contributing partner's allocable share of the liability.[25] The idea behind this regulatory exemption is fairly straightforward: because the proceeds of a loan incurred by the partnership may be distributed to the partners on a tax-free basis provided each partner receives his or her allocable share of the liability under Section 752, the same transaction should not be treated differently merely because a partner has recently contributed appreciated property to the partnership.

The debt-financed distribution, in broad terms, proceeds as follows. The "seller," looking to transfer an asset to "buyer," first forms a partnership with the buyer and contributes the asset to the partnership. The partnership then incurs a loan roughly equivalent to the "purchase" price. The loan is structured with the goal of allocating the liability to the "seller" for purposes of Section 752. The partnership then distributes the loan proceeds to the "seller" in a tax-free manner under Section 731(a)(1) (due to the basis increase under Section 752(a)), and the disguised sale rules do not disrupt this tax treatment due to the regulatory exemption. In this manner, the "seller" receives cash but will not recognize gain until the deemed cash distribution

[25] Reg. § 1.707-5(b)(1).

occurs under Section 752(b) upon the satisfaction of the liability (by the "buyer"), which typically is scheduled to occur years in the future.

The disguised sale transaction gained considerable attention when it was used in conjunction with the 2009 sale of the Chicago Cubs baseball franchise by its parent corporation, the Tribune Company.[26] As reflected in the decision below, this transaction has been heavily scrutinized by the Service.

Canal Corp. v. Commissioner

United States Tax Court, 2010.
135 T.C. 199.

KROUPA, JUDGE:

[Chesapeake Corporation (which would later become Canal Corporation) owned a subsidiary, Wisconsin Tissue Mills, Inc. (WISCO) which manufactured commercial tissue paper products. Chesapeake considered selling its stock in WISCO to Georgia Pacific (GP), but decided against it due to Chesapeake's low basis in the WISCO stock. Instead, Chesapeake caused WISCO to contribute most of its assets into a leveraged partnership formed with GP. The partnership incurred a loan of approximately $750 million, the proceeds of which were distributed to WISCO. The loan was guaranteed by GP, and WISCO in turn agreed to indemnify GP in the event GP was called to pay under the guarantee. The proceeds of the loan in turn were distributed to WISCO. The exact terms of the transaction, central to the case, are detailed in the decision.]

* * *

Indemnity Agreement

GP agreed to guarantee the joint venture's debt and did not require Chesapeake to execute an indemnity. [The tax advisor] advised Chesapeake, however, that an indemnity was required to defer tax on the transaction. Chesapeake's executives wanted to make the indemnity an obligation of WISCO rather than Chesapeake to limit the economic risk to WISCO's assets, not the assets of Chesapeake. The parties to the transaction agreed that GP would guarantee the joint venture's debt and that WISCO would serve as the indemnitor of GP's guaranty.

WISCO attempted to limit the circumstances in which it would be called upon to pay the indemnity. First, the indemnity obligation covered only the principal of the joint venture's debt, due in 30 years, not interest. Next, Chesapeake and GP agreed that GP had to first proceed against the joint venture's assets before demanding indemnification from WISCO. The agreement also provided that WISCO would receive a proportionately increased interest in the joint venture if WISCO had to make a payment under the indemnity obligation.

---

[26] *See* Robert Willens, Tribune's Divestiture of the Cubs Reprises "Levpar" Structure, 125 Tax Notes 585 (Nov. 2, 2009).

No provision of the indemnity obligation mandated that WISCO maintain a certain net worth. [The tax advisor] determined that WISCO had to maintain a net worth of $151 million to avoid taxation on the transaction. GP was aware that WISCO's assets other than its interest in the joint venture were limited. GP nonetheless accepted the deal and never invoked the indemnity obligation.

Joint Venture Agreement

Chesapeake, WISCO, and GP executed the joint venture agreement. The two members (partners) of the joint venture were WISCO and GP. The agreement provided that GP would reimburse WISCO for any tax cost WISCO might incur if GP were to buy out WISCO's interest in the joint venture.

* * *

The Transaction

GP and WISCO formed Georgia-Pacific Tissue LLC (LLC) as the vehicle for the joint venture. GP and WISCO treated the LLC as a partnership for tax purposes. Both partners contributed the assets of their respective tissue businesses to the LLC. GP transferred to the LLC its tissue business assets with an agreed value of $376.4 million in exchange for a 95-percent interest in the LLC. WISCO contributed to the LLC all of the assets of its tissue business with an agreed value of $775 million in exchange for a 5-percent interest in the LLC. The LLC borrowed $755.2 million from Bank of America (BOA) on the same day it received the contributions from GP and WISCO. The LLC immediately transferred the loan proceeds to Chesapeake's bank account as a special cash distribution.[1] GP guaranteed payment of the BOA loan, and WISCO agreed to indemnify GP for any principal payments GP might have to make under its guaranty.

The LLC had approximately $400 million in net worth based on the parties' combined initial contribution of assets ($1.151 billion) less the BOA loan ($755.2 million), and it had a debt to equity ratio of around 2 to 1. The LLC assumed most of WISCO's liabilities but did not assume WISCO's [legacy environmental] liability. Chesapeake and WISCO both indemnified GP and held it harmless for any costs and claims that it might incur with respect to any retained liabilities of WISCO, including the [environmental] liability.

WISCO used a portion of the funds from the special distribution to repay an intercompany loan to Cary Street, Chesapeake's finance subsidiary. WISCO also used portions of the funds to pay a dividend to Chesapeake, repay amounts owed to Chesapeake and lend $151.05 million to Chesapeake in exchange for a note (intercompany note).

WISCO's assets following the transaction included the intercompany note with a face value of $151 million and a corporate jet worth approximately $6 million. WISCO had a net worth,

[1]The value of WISCO's assets contributed ($775 million) less the distribution ($755.2 million) equals the initial value of WISCO's 5-percent LLC interest ($19.8 million).

excluding its LLC interest, of approximately $157 million. This represented 21 percent of its maximum exposure on the indemnity. WISCO remained subject to the [environmental] liability.

Characterization of the Transaction for Tax and Non-Tax Purposes

Chesapeake timely filed a consolidated Federal tax return for 1999. Chesapeake disclosed the transaction on Schedule M of the return and reported $377,092,299 book gain but no corresponding tax gain. Chesapeake treated the special distribution as non-taxable on the theory that it was a debt-financed transfer of consideration, not the proceeds of a sale.

Unlike its treatment for tax purposes, Chesapeake treated the transaction as a sale for financial accounting purposes. Chesapeake did not treat the indemnity obligation as a liability for accounting purposes because Chesapeake determined that there was no more than a remote chance the indemnity would be triggered. Despite Chesapeake's characterization for tax purposes, [the transaction advisors] each referred to the transaction as a sale.

Standard & Poor's, Moody's and stock analysts also treated the transaction as a sale. Chesapeake executives represented to Standard & Poor's and Moody's that the only risk associated with the transaction came not from WISCO's agreement to indemnify GP but from the tax risk.

Respondent issued Chesapeake the deficiency notice for 1999. In the deficiency notice, respondent determined the joint venture transaction to be a disguised sale that produced $524 million of capital gain includable in Chesapeake's consolidated income for 1999. Chesapeake timely filed a petition. Respondent asserted in an amended answer a $36,691,796 accuracy-related penalty under section 6662 for substantial understatement of income tax.

* * *

OPINION

We are asked to decide whether the joint venture transaction constituted a taxable sale. Respondent argues that Chesapeake structured the transaction to defer $524 million of capital gain for a period of 30 years or more. Specifically, respondent contends that WISCO did not bear any economic risk of loss when it entered the joint venture agreement because the anti-abuse rule disregards WISCO's obligation to indemnify GP. See sec. 1.752-2(j), Income Tax Regs. Respondent concludes that the transaction should be treated as a taxable disguised sale.

Chesapeake asserts that the transaction should not be recast as a sale. Instead, Chesapeake argues that the anti-abuse rule does not disregard WISCO's indemnity and that the LLC's distribution of cash to WISCO comes within the exception for debt-financed transfers. We disagree and begin with the general rules on disguised sales.

I. ***Disguised Sale Transactions***

The Code provides generally that partners may contribute capital to a partnership tax free and may receive a tax free return of previously taxed profits through distributions. See secs. 721, 731.

These nonrecognition rules do not apply, however, where the transaction is found to be a disguised sale of property. See sec. 707(a)(2)(B).

A disguised sale may occur when a partner contributes property to a partnership and soon thereafter receives a distribution of money or other consideration from the partnership. *Id.* A transaction may be deemed a sale if, based on all the facts and circumstances, the partnership's distribution of money or other consideration to the partner would not have been made *but for* the partner's transfer of the property. Sec. 1.707-3(b)(1), Income Tax Regs. (emphasis added). Such contribution and distribution transactions that occur within two years of one another are presumed to effect a sale unless the facts and circumstances clearly establish otherwise (the 2-year presumption). Sec. 1.707-3(c)(1), Income Tax Regs.

Here, WISCO transferred its assets with an agreed value of $775 million to the LLC and simultaneously received a cash distribution of $755.2 million. After the transfer and distribution, WISCO had a 5-percent interest in the LLC. Its assets included only its interest in the LLC, the intercompany note and the jet. We therefore view the transactions together and presume a sale under the disguised sale rules unless the facts and circumstances dictate otherwise.

Chesapeake contends that the special distribution was not part of a disguised sale. Instead, it was a debt-financed transfer of consideration, an exception to the disguised sale rules. See sec. 1.707-5(b), Income Tax Regs. Chesapeake argues that the debt-financed transfer of consideration exception to the disguised sale rules limits the applicability of the disguised sale rules and the 2–year presumption in this case.

A. *Debt-Financed Transfer of Consideration*

We now turn to the debt-financed transfer of consideration exception to the disguised sale rules. The regulations except certain debt-financed distributions in determining whether a partner received "money or other consideration" for disguised sale purposes. See *id.* A distribution financed from the proceeds of a partnership liability may be taken into account for disguised sale purposes to the extent the distribution exceeds the distributee partner's allocable share of the partnership liability. See sec. 1.707-5(b)(1), Income Tax Regs. Respondent argues that the entire distribution from the LLC to WISCO should be taken into account for purposes of determining a disguised sale because WISCO did not bear any of the allocable share of the LLC's liability to finance the distribution. We turn now to whether WISCO had any allocable share of the LLC's liability to determine whether the transaction fits within the exception.

B. *Partner's Allocable Share of Liability*

In general a partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner bears the economic risk of loss. See sec. 1.752-1(a)(1), Income Tax Regs. A partner bears the economic risk of loss to the extent that the partner would be obligated to make an unreimbursable payment to any person (or contribute to the partnership) if the partnership were constructively liquidated and the liability became due and payable. Sec. 1.752-2(b)(1), Income Tax Regs.; see *IPO II v. Commissioner,* 122 T.C. 295, 300–301 (2004). Chesapeake contends that WISCO's indemnity of GP's guaranty imposes on WISCO the economic risk of loss for the LLC debt. Respondent concedes that an indemnity agreement generally is recognized as an obligation

under the regulations. Respondent asserts, however, that WISCO's agreement should be disregarded under the anti-abuse rule for allocation of partnership debt.

C. *Anti-Abuse Rule*

Chesapeake counters that WISCO was legally obligated to indemnify GP under the indemnity agreement and therefore WISCO should be allocated the entire economic risk of loss of the LLC's liability. We assume that all partners having an obligation to make payments on a recourse debt actually perform those obligations, irrespective of net worth, to ascertain the economic risk of loss unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. Sec. 1.752-2(b)(6), Income Tax Regs. The anti-abuse rule provides that a partner's obligation to make a payment may be disregarded if (1) the facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's risk of loss or to create a facade of the partner's bearing the economic risk of loss with respect to the obligation, or (2) the facts and circumstances of the transaction evidence a plan to circumvent or avoid the obligation. See sec. 1.752-2(j)(1), (3), Income Tax Regs. Given these two tests, we must review the facts and circumstances to determine whether WISCO's indemnity agreement may be disregarded as a guise to cloak WISCO with an obligation for which it bore no actual economic risk of loss. See *IPO II v. Commissioner, supra* at 300–301.

1. *Purpose of the Indemnity Agreement*

We first consider the indemnity agreement. The parties agreed that WISCO would indemnify GP in the event GP made payment on its guaranty of the LLC's $755.2 million debt. GP did not require the indemnity, and no provision of the indemnity mandated that WISCO maintain a certain net worth. WISCO was chosen as the indemnitor, rather than Chesapeake, after [the accounting firm] advised Chesapeake's executives that WISCO's indemnity would not only allow Chesapeake to defer tax on the transaction, but would also cause the economic risk of loss to be borne only by WISCO's assets, not Chesapeake's. Moreover, the contractual provisions reduced the likelihood of GP invoking the indemnity against WISCO. The indemnity covered only the loan's principal, not interest. In addition, GP would first have to proceed against the LLC's assets before demanding indemnification from WISCO. In the unlikely event WISCO had to pay on the indemnity, WISCO would receive an increased interest in the LLC proportionate to any payment made under the indemnity. We find compelling that a Chesapeake executive represented to Moody's and Standard & Poor's that the only risk associated with the transaction was the tax risk. We are left with no other conclusion than that Chesapeake crafted the indemnity agreement to limit any potential liability to WISCO's assets.

2. *WISCO's Assets and Liabilities*

We now focus on whether WISCO had sufficient assets to cover the indemnity regardless of how remote the possibility it would have to pay. Chesapeake maintains that WISCO had sufficient assets to cover the indemnity agreement. WISCO contributed almost all of its assets to the LLC and received a special distribution and a 5-percent interest in the LLC. Moreover, Chesapeake contends that WISCO did not need to have a net worth covering the full amount of its obligations with respect to the LLC's debt. See sec. 1.752-2(b)(6), Income Tax Regs. WISCO's assets after the transfer to the LLC included the $151.05 million intercompany note and the $6 million jet. WISCO had a net

worth, excluding its LLC interest, of approximately $157 million or 21 percent of the maximum exposure on the indemnity. The value of WISCO's LLC interest would have been zero if the indemnity were exercised because the agreement required GP to proceed and exhaust its remedies against the LLC's assets before seeking indemnification from WISCO.

We may agree with Chesapeake that no Code or regulation provision requires WISCO to have assets covering the full indemnity amount. We note, however, that a partner's obligation may be disregarded if undertaken in an arrangement to create the appearance of the partner's bearing the economic risk of loss when the substance of the arrangement is in fact otherwise. See sec. 1.752-2(j)(1), Income Tax Regs. WISCO's principal asset after the transfer was the intercompany note. The indemnity agreement did not require WISCO to retain this note or any other asset. Further, Chesapeake and its management had full and absolute control of WISCO. Nothing restricted Chesapeake from canceling the note at its discretion at any time to reduce the asset level of WISCO to zero. In fact WISCO's board, which included many Chesapeake executives, did cancel the note and issued an intercompany dividend to Chesapeake in 2001. We find WISCO's intercompany note served to create merely the appearance, rather than the reality, of economic risk for a portion of the LLC debt.

In addition, WISCO remained subject to the [environmental] liability, and WISCO and other Chesapeake subsidiaries guaranteed a $450 million credit line obtained by Chesapeake in 2000. This guaranty and the [environmental] liability further reduced WISCO's net worth. GP neither asked for nor received any assurances that WISCO would not further encumber its assets. We find that WISCO's agreement to indemnify GP's guaranty lacked economic substance and afforded no real protection to GP.

3. ***Anti-Abuse Rule Illustration***

Chesapeake seeks to distinguish the transaction in this case from the transaction illustrated in the anti-abuse rule. See sec. 1.752-2(j)(4), Income Tax Regs. (illustrating when payment obligations may be disregarded). The illustration considers a consolidated group of corporations that use a thinly capitalized subsidiary as a partner in a general partnership with a recourse debt payment guaranteed by the other partner. The circumstances are deemed indicative of a plan enabling the corporate group to enjoy the losses generated by the partnership's property while avoiding the subsidiary's obligation to restore any deficit in its capital account. Chesapeake argues WISCO was not a newly-created entity, as was the subsidiary in the illustration, but had been in business before the transaction. We find WISCO's preexistence insufficient to distinguish this transaction from the illustration.

A thinly capitalized subsidiary with no business operations and no real assets cannot be used to shield a parent corporation with significant assets from being taxed on a deemed sale. Chesapeake intentionally used WISCO, rather than itself, to limit its exposure under the indemnity agreement. It further limited its exposure only to the assets of WISCO. We refuse to interpret the illustration to provide additional protection. Moreover, this appears to be a concerted plan to drain WISCO of assets and leave WISCO incapable, as a practical matter, of covering more than a small fraction of its obligation to indemnify GP. We find this analogous to the illustration because in both cases the true economic burden of the partnership debt is borne by the other partner as guarantor. Accordingly,

we do not find that the anti-abuse rule illustration extricates Chesapeake, but rather it demonstrates what Chesapeake strove to accomplish.

4. *Rev. Proc. 89-12 Does Not Apply to Anti–Abuse Rule*

Chesapeake also argues that it would be found to bear the economic risk of loss if the Court would apply a 10-percent net worth requirement. In so arguing, Chesapeake relies on Rev. Proc. 89-12, 1989-1 C.B. 798, which stated that a limited partnership would be deemed to lack limited liability for advance ruling purposes if a corporate general partner of the partnership had a net worth equaling 10 percent or more of the total contributions to the partnership. We decline Chesapeake's invitation to extend the 10-percent net worth test. Requirements for advance ruling purposes have no bearing on whether a partner will be treated as bearing the economic risk of loss for a partnership's liability. There are no mechanical tests. The anti-abuse rule mandates that we consider the facts and circumstances. We decline to establish a bright-line percentage test to determine whether WISCO bore the economic risk of loss with respect to the LLC's liability.

5. *Speculative Fraudulent Conveyance Claims*

Chesapeake argues alternatively that WISCO bore the economic risk of loss because GP had a right to make fraudulent conveyance claims against Chesapeake and Chesapeake's financial subsidiary Cary Street. Chesapeake contends that such potential claims exposed WISCO to a risk of loss in excess of WISCO's net worth. This argument is flawed on many points. First, a fraudulent conveyance is simply a cause of action, not an obligation. The Court may consider obligations only in allocating recourse liabilities of a partnership. See sec. 1.752-2(b)(3), Income Tax Regs. Next, Chesapeake's fraudulent conveyance argument connotes that Chesapeake engaged in a plan to circumvent or avoid the obligation. This argument completely undercuts and overrides Chesapeake's attempt to create an obligation on behalf of Chesapeake and Cary Street. Finally, we would render the anti-abuse rule meaningless by creating an automatic exception for speculative fraudulent conveyance claims. Accordingly, we reject this argument.

We have carefully considered the facts and circumstances and find that the indemnity agreement should be disregarded because it created no more than a remote possibility that WISCO would actually be liable for payment. Chesapeake used the indemnity to create the appearance that WISCO bore the economic risk of loss for the LLC debt when in substance the risk was borne by GP. We find that WISCO had no economic risk of loss and should not be allocated any part of the debt incurred by the LLC.

Consequently, the distribution of cash to WISCO does not fit within the debt-financed transfer exception to the disguised sale rules. Instead, we find Chesapeake has failed to rebut the 2-year presumption. The facts and circumstances evince a disguised sale. Accordingly, we conclude that WISCO sold its business assets to GP in 1999, the year it contributed the assets to the LLC, not the year it liquidated its LLC interest.

* * *

NOTE

The *Canal Corp.* case sent shockwaves through the partnership tax bar, mainly because the Tax Court proceeded to uphold the Service's imposition of an accuracy related penalty under Section 6662(a) even though the taxpayer had received an opinion from a national accounting firm that the transaction "should" qualify for deferral under the debt-financed distribution exception to Section 707(a)(2)(B). The value of the income tax deferral at issue in the *Canal Corp.* transaction was considerable. Chesapeake required GP to indemnify it for any loss of tax deferral should the transaction be unwound earlier than anticipated. When it became necessary for GP to purchase WISCO's interest in the LLC just two years after the transaction, GP paid Chesapeake $196 million to compensate for the loss of tax deferral.

At one point in the opinion, the Tax Court observes that "GP did not have any interest in Chesapeake receiving a tax deferral." Is that true? Hint: Immediately after that sentence, the court remarks that "GP recognized, however, that it was a necessary part of bridging the purchase price gap." What does that say about the nature of tax benefits bestowed upon a party to a negotiated transaction?

The debt-financed distribution transaction depends on the partnership liability being allocated to the "selling" partner for purposes of Section 752(a). As the proceeds of the liability often represent the selling price in substance, the liability generally represents the obligation of the "purchasing" partner. Indemnity or reimbursement agreements therefore are used to allocate the ultimate risk of loss for the liability to the "selling partner." Under the proposed regulations governing the allocation of recourse liabilities for purposes of Section 752 issued in 2014,[1] these payment obligations often will not be respected for Section 752 purposes. If finalized, these regulations will go a long way in combating use of the leveraged partnership transaction as a means of deferring gain on the effective sale of property.

CHAPTER 6. SALES AND EXCHANGES OF PARTNERSHIP INTERESTS

A. CONSEQUENCES TO THE SELLING PARTNER

3. COLLATERAL ISSUES

b. INSTALLMENT SALES OF PARTNERSHIP INTERESTS

After the second full paragraph, insert:

Page 278:

In Mingo v. Commissioner, 105 T.C.M. 1857 (2013), the taxpayer sold an interest in a partnership for an $832,090 convertible promissory note. At the time of the sale in 2002, the selling partner's share of partnership unrealized receivables was $126,240. For five years, the partner did not report any income other than interest paid on the note. In 2007, the taxpayer

---

[1]See Chapter 4D2 and *infra* pp. 8-11 of this Update Memorandum.

converted the note into IBM stock worth $1,213,259 and reported that amount as long-term capital gain. The Tax Court held that because the unrealized receivables could not have been sold directly in a Section 453 installment sale, the $126,240 of gain attributable to the unrealized receivables should been reported in 2002. Because the use of the installment method was a change of accounting method, the Court sustained the IRS's determination that the taxpayer had $126,240 of additional ordinary income in 2003. The taxpayer was also allowed a $126,240 basis increase in the note for purposes of determining the gain on the 2007 conversion.

B. Consequences to the Buying Partner

Page 281:

At the end of the first full paragraph, insert:

Proposed regulations issued in 2014 provide that, if a partnership has a substantial built-in loss immediately after the transfer of a partnership interest, the partnership is treated as having a Section 754 election in effect for the taxable year in which the transfer occurs, but only with respect to that transfer.[8.1]

After the second full paragraph, insert:

Tiered Partnerships. In 2014, the Service issued proposed regulations addressing the application of Section 743(b) adjustments in the context of tiered partnerships.[11.1] Generally speaking, in the event of a transfer of an interest in an upper-tier partnership that holds an interest in a lower-tier partnership that has a substantial built-in loss with respect to the transfer, (1) the lower-tier partnership will be treated as if it had a Section 754 election in effect for the taxable year of the transfer, and (2) an interest in the lower-tier partnership (equal to the percentage interest owned by the upper-tier partnership attributable to the interest being transferred) will be deemed to have been transferred by sale or exchange. These presumptions will cause the lower-tier partnership to adjust the basis of its properties.

Chapter 7. Operating Distributions

E. Distributions Which Alter the Partners' Interests in Ordinary Income Property

Page 322:

Delete the last sentence of the first full paragraph and Notice 2006-14, and insert:

[8.1] See REG-144468-05 (Jan. 16, 2014), 2014-6 I.R.B. 474, publishing Prop. Reg. § 1.743-1(k)(1)(iii).

[11.1] See REG-144468-05 (Jan. 16, 2014), 2014-6 I.R.B. 474, publishing Prop. Reg. § 1.743-1(*l*).

After signaling its intention to fix the glaring deficiencies in the Section 751(b) regulatory regime in 2006, the Service and the Treasury issued proposed regulations under Section 751(b) in 2014 that fundamentally alter the determination of when Section 751(b) is implicated.[37] Additionally, if Section 751(b) applies, the proposed regulations provide flexibility to the parties in determining the tax consequences that flow from the mandatory ordinary income recognition to one or more of the partners. As these proposed regulations are likely to be finalized in substantially similar form, the contours of the new regulatory regime under Section 751(b) are described below.

Is Section 751(b) Implicated? The most significant change introduced through the proposed regulations under Section 751(b) is the test for determining if the subsection is implicated. The existing regulatory regime utilizes gross values in determining whether a partner's interest in Section 751(b) property has been altered through a distribution. As explained in the casebook, the gross fair market value of partnership property is a crude measure for analyzing the change in each partners' share of ordinary income lurking in partnership property. The proposed regulations under Section 751(b) therefore jettison the existing approach, opting instead for a comparison of each partner's share of unrealized income or loss in Section 751(b) property before and after the distribution at issue.

Similar to the hypothetical sale approach employed in the Section 751(a) regulations for determining when the proceeds of a sale of a partnership interest are attributable to the sale of ordinary income property, the proposed regulations under Section 751(b) employ a hypothetical sale approach to determine if a distribution alters the partners' interests in Section 751(b) property. In so doing, they apply the rules of Section 704(c) to any contributed property held by the partnership. A partner's pre-distribution interest in Section 751(b) property is determined by calculating the amount of ordinary income or loss that would be allocated to the partner if the partnership sold all of its assets for cash equal to the fair market value of the property, taking into account any remedial allocations of Section 704(c) gain and special basis adjustments under Section 743. This amount represents the partner's pre-distribution "net section 751 unrealized gain or loss."[38] A partner's post-distribution "net section 751 unrealized gain or loss" is determined in the same manner, albeit with one addition—the post-distribution figure includes any ordinary income that would be realized by the distribute partner upon the hypothetical sale of the distributed property by such partner.[39]

Because the hypothetical sale approach applies Section 704(c) principles and relies on each partner's share of unrealized gain or loss in Section 751(b) property, the partnership must accurately record and reflect those shares if it owns Section 751(b) property after the distribution. In determining these gains or losses, the proposed regulations require partnerships that properly maintain capital accounts in accordance with the Section 704(b) regulations to revalue their assets and capital accounts immediately prior to the distribution and reflect the manner in which

[37] REG-151416-06 (Nov. 3, 2014).

[38] Prop. Reg. § 1.751-1(b)(2)(ii).

[39] Prop. Reg. § 1.751-1(b)(2)(iii).

the unrealized gains or losses would be allocated among the partners.[40] Allocations of gain or loss under this approach are sometimes called "reverse" Section 704(c) allocations because they apply to all property, including assets that were not contributed to the partnership and thus technically not subject to Section 704(c). Alternatively, a partnership that does not maintain capital accounts in accordance with the Section 704(b) regulations must compute its partners' shares of partnership gain or loss immediately before the distribution as if the partnership assets were sold for cash in a fully taxable transaction and by taking those computed shares of gain or loss into account under the principles of Section 704(c), making subsequent adjustments for cost recovery and other events that affect the basis of the property.[41] Regardless of the computation method employed, the goal of the proposed regulations is to ensure that the unrealized gain or loss in Section 751(b) property ultimately will be allocated to the appropriate partner.[42]

The Section 751(b) Amount. If the net Section 751 unrealized gain or loss for a partner before the distribution differs from that following the distribution, the difference gives rise to a "section 751(b) amount." Most commonly, a partner's Section 751(b) unrealized gain decreases as a result of the distribution.[43] The existence of a Section 751(b) amount for a partner triggers the application of Section 751(b) in general, and the partner must recognize ordinary income equal to the Section 751(b) amount.

Examples. Assume the ABC partnership has three equal partners. A contributed cash of $60,000, B contributed inventory having a basis of $45,000 and a value of $60,000, and C contributed a capital asset having a basis of $30,000 and a value of $60,000. Upon formation, the ABC partnership had the following balance sheet:

Assets			***Partner's Capital***		
	A.B.	**Book Value**		**A.B.**	**Book Value**
Cash	$60,000	$60,000	A	$60,000	$60,000
Inventory	45,000	60,000	B	45,000	60,000
Capital Asset	30,000	60,000	C	30,000	60,000
	$135,000	$180,000		$135,000	$180,000

[40]Prop. Reg. § 1.751-1(b)(2)(iv). Under the current Section 704 regulations. revaluations generally are optional (see Chapter 4B2b, at p. 138 of the casebook), but they would be mandatory under the proposed regulations if a partnership makes a distribution to a partner in consideration for an interest in a partnership that owns Section 751 property immediately after the distribution. See also Prop. Reg. § 1.704-1(b)(2)(iv)(*f*).

[41]Prop. Reg. § 1.751-1(b)(2)(iv).

[42]The Section 704(c) regulations provide partners with choices and elections regarding application of that section to contributed property. Thus, Section 704(c) principles might be employed or manipulated by partners in some instances to avoid the application of Section 751(b). The proposed regulations guard against this possibility with a highly technical anti-abuse rule. See Prop. Reg. § 1.751-1(b)(4)(i).

[43]See Prop. Reg. § 1.751-1(b)(2)(i)(A). However, a Section 751(b) amount for a partner also can arise if the partner's net unrealized Section 751(b) increases as a result of the distribution, or some combination of the two. Prop. Reg. § 1.751-1(b)(2)(i)(B), (C).

Now assume the partnership distributes $30,000 of cash to C several years after the partnership formation with no change in the value of the partnership assets. The distribution leaves C with a 1/5 interest in partnership capital and profits. Under the existing Section 751(b) regulations, C's interest in the Section 751(b) property would have decreased from $20,000 (1/3 of the $60,000 fair market value of the inventory) before the distribution to $12,000 (1/5 of the $60,000 fair market value) after the distribution. This reduction in turn triggers Section 751(b), requiring a hypothetical distribution of inventory with a fair market value of $8,000 and a $6,000 adjusted basis to C followed by a sale of the inventory by C back to the partnership. C therefore would recognize $2,000 of ordinary income on the distribution – a nonsensical result. Because there existed no post-contribution appreciation in the inventory, C did not have any ordinary income exposure when the distribution occurred. Hence, there was no ordinary income for C to possibly shift to A or B through the distribution.

In contrast, the proposed regulations under Section 751(b) achieve the proper result under these circumstances. Prior to the distribution, C would not have recognized any ordinary income from the partnership's sale of all the partnership property for fair market value. Rather, all of the ordinary income lurking in the inventory would have been allocated to B under Section 704(c). As the "net section 751 unrealized gain or loss" for each partner remains the same before and after the distribution ($0 for A; $15,000 for B; and $0 for C), there exists no "section 751(b) amount" for any partner. Hence, Section 751(b) is not implicated under these facts. The regular distribution rules apply, and C would receive the $30,000 distribution tax-free under Section 731(a)(1) because C has sufficient basis in the partnership interest.

For purpose of this next example, assume that the inventory has appreciated in value to $90,000 when the ABC partnership makes the $30,000 cash distribution to C. Because the partnership owns Section 751(b) property after the distribution, assume it restates the book value of its assets and capital accounts to fair market value. Accordingly, immediately prior to the distribution, the balance sheet for the ABC partnership appears as follows:

Assets			***Partner's Capital***		
	A.B.	**Book Value /FMV**		**A.B.**	**Book Value /FMV**
Cash	$60,000	$60,000	A	$60,000	$70,000
Inventory	45,000	90,000	B	45,000	70,000
Capital Asset	30,000	60,000	C	30,000	70,000
	$135,000	$210,000		$135,000	$210,000

Before the distribution, C has a net Section 751 unrealized gain of $10,000 through the lurking allocation of reverse Section 704(c) gain (1/3 of the $30,000 of post-contribution appreciation). After the distribution, C's net Section 751 unrealized gain remains $10,000. C's share of the reverse Section 704(c) gain does not change even if his overall interest in the partnership is reduced from 1/3 to 1/6 by the distribution. Because there is no change in C's net section 751 unrealized gain or loss, the distribution does not trigger application of the statute.

So what type of distribution would trigger the application of Section 751(b) under the proposed regulations? Staying with the same modified facts, assume first that the ABC partnership sold one-half of the capital asset for $30,000, with the resulting $15,000 of capital gain being allocated to C under Section 704(c). Then, when the inventory had appreciated in

value to $90,000, the partnership redeems C's interest in the partnership through a $70,000 cash distribution.

Immediately prior to the distribution, the balance sheet of the ABC partnership appears as follows:

Assets			***Partner's Capital***		
	A.B.	**Book Value /FMV**		**A.B.**	**Book Value /FMV**
Cash	$90,000	$90,000	A	$60,000	$70,000
Inventory	45,000	90,000	B	45,000	70,000
Capital Asset	15,000	30,000	C	45,000	70,000
	$150,000	$210,000		$150,000	$210,000

Immediately prior to the distribution, C has a net Section 751(b) gain of $10,000, just as in the example above. Yet, because the distribution terminates C's interest in the partnership (thereby eliminating C's share of reverse Section 704(c) gain), C's net Section 751 unrealized gain is reduced to zero. C therefore has a Section 751(b) amount of $10,000, which in turn means he must recognize $10,000 of ordinary income under Section 751(b).

Collateral Tax Consequences. The proposed regulations under Section 751(b) offer a measure of flexibility to the partnership in determining the tax consequences resulting from the application of the statute. Recall that, under the current Section 751(b) regulations, a change in a partner's interest in Section 751(b) property requires a hypothetical distribution of property to the partner followed by a sale back to the partnership. As illustrated in the prior discussion of Section 751(b) in this chapter, the hypothetical sale or exchange can accelerate the recognition of capital gain for partners whose overall interests in Section 751(b) property have not changed.

That hypothetical sale approach remains available under the proposed Section 751(b) regulations, but it is not required. Rather, the proposed Section 751(b) regulations merely state that the partnership must "choose a reasonable approach that is consistent with the purpose of section 751(b)."[44] Yet once an approach is selected, the partnership must continue to apply that approach in all circumstances implicating Section 751(b), and the partnership cannot circumvent this requirement by triggering a termination of the entity under Section 708(b)(1)(B).[45]

One reasonable approach endorsed by the proposed regulations is a "deemed gain" approach. Under this option, a partner who has recognized ordinary income under Section 751(b) increases his or her basis by such amount, and he partnership increases its inside basis in the partnership property that implicated the Section 751(b) inclusion to the same extent. These adjustments would take place immediately before analyzing the distribution under generally applicable tax principles.[46]

---

[44]Prop. Reg. § 1.751-1(b)(3)(i).

[45]Id.

[46]See Prop. Reg. § 1.751-1(g), Ex. 3(v).

Looking back at the example above in which C's interest in the partnership was redeemed for $70,000, recall that the distribution gave rise to a Section 751(b) amount for C of $10,000. C therefore would recognize $10,000 of ordinary income under Section 751(b). As a result of this inclusion, C would increase the outside basis of the partnership interest by $10,000 to $55,000, and the ABC partnership would increase the inside basis of the inventory by $10,000. Immediately before the distribution, the balance sheet of the ABC partnership would appear as follows:

Assets			***Partner's Capital***		
	A.B.	**Book Value /FMV**		**A.B.**	**Book Value /FMV**
Cash	$90,000	$90,000	A	$60,000	$70,000
Inventory	55,000	90,000	B	45,000	70,000
Capital Asset	15,000	30,000	C	55,000	70,000
	$160,000	$210,000		$160,000	$210,000

The liquidating distribution of $70,000 to C therefore would be analyzed under the general provisions of Subchapter K. C would recognize $15,000 of gain under Section 731(a)(1), and the gain would be characterized as long-term capital gain under Section 741. If the ABC partnership had a Section 754 election in place, it would be able to increase the inside basis in the Capital Asset by $15,000 under Section 734(b)(1)(A) and Section 755. In that event, the ending balance sheet for the ABC partnership would appear as follows:

Assets			***Partner's Capital***		
	A.B.	**Book Value /FMV**		**A.B.**	**Book Value /FMV**
Cash	$20,000	$20,000	A	$60,000	$70,000
Inventory	55,000	90,000	B	45,000	70,000
Capital Asset	30,000	30,000			
	$105,000	$140,000		$105,000	$140,000

Capital Gain Recognition. While the proposed regulations under Section 751(b) appear to simplify application of the statute in the majority of cases, the regime creates its own complications resulting from basis adjustments to partnership property. For instance, if a distribution would trigger a basis reduction under Section 734(b) that would reduce other partners' shares of net unrealized section 751 gain or loss, the regulations require the distributee partner to recognize capital gain to avoid that result.[47] If a distribution would cause a reduction in the basis of distributed Section 751(b) property under Section 732(a)(2) or (b), the proposed regulations allow the distributee partner to elect to recognize capital gain to avoid this result.[48] These instances reach beyond the scope of the fundamentals addressed in this text.

Effective Date and Enforcement. The proposed regulations under Section 751(b) would apply to distributions made in any taxable period ending on or after the date on which the final regulations are published. However, a partnership and its partners may rely on the hypothetical

---

[47]See Prop. Reg. § 1.751-1(b)(3)(A).

[48]See Prop. Reg. § 1.751-1(b)(3)(B).

sale approach provided in Prop. Reg. § 1.751-1(b)(2) for determining a partner's interest in Section 751(b) property (that is, the fundamental structural change introduced by the proposed regulations) on or after November 3, 2014, provided the partnership and its partners abide by the correlative provisions of the proposed regulations.[49]

In order to aid the Service in the enforcement of the statute, the proposed regulations call for the partnership to submit a statement with its tax return for each Section 751(b) distribution made during the year that identifies the date of the distribution and identifies the reasonable approach adopted by the partnership for determining the tax consequences of the distribution.[50] This reporting obligation certainly will make it more difficult to dismiss Section 751(b) as something so complex as to be ignored.

CHAPTER 8. LIQUIDATING DISTRIBUTIONS AND TERMINATIONS

B. LIQUIDATION OF A PARTNER'S INTEREST

1. SECTION 736(b) PAYMENTS

Page 332:

After the sentence in the first full paragraph ending with footnote 23, insert:

Proposed regulations issued in 2014 provide that, if a liquidating distribution results in a substantial basis reduction, the partnership is treated as having an election under Section 754 in effect for the year in which the distribution occurs, but only with respect to the distribution to which the substantial basis reduction relates.[23.1]

After the first full paragraph, insert:

Tiered Partnerships. In 2014, the Service issued proposed regulations addressing the application of Section 734(b) adjustments in the context of tiered partnerships. Generally speaking, if there is a substantial basis reduction with respect to a distribution by an upper-tier partnership that holds an interest in a lower-tier partnership, (1) the lower-tier partnership will be treated as if it had a Section 754 election in effect for the taxable year in which the distribution occurs, and (2) the lower-tier partnership must make adjustments (equal in amount to the adjustment made by the upper-tier partnership to the basis of its interest in the lower-tier partnership) to the upper-tier partnership's share of the lower-tier partnership's assets.[24.1]

---

[49]See Prop. Reg. § 1.751-1(f).

[50]See Prop. Reg. § 1.751-1(b)(6)(i).

[23.1]See REG-144468-05 (Jan. 16, 2014), 2014-6 I.R.B. 474, publishing Prop. Reg. § 1.734-1(a)(2).

[24.1]See REG-144468-05 (Jan. 16, 2014), 2014-6 I.R.B. 474, publishing Prop. Reg. § 1.734-1(f)(1).

D. LIQUIDATION OF A PARTNERSHIP

2. PARTNERSHIP TERMINATIONS FORCED BY STATUTE

Page 383:

At the end of the carryover paragraph, insert:

A technical termination under Section 708(b) cannot be used to accelerate the amortization of start-up and organization expenditures under Section 709. Rather, pursuant to Reg. § 1.708-1(b)(6)(i), finalized through T.D. 9681 (Aug. 11, 2014), any remaining expenses of the new partnership will continue to be amortized under the 15-year schedule in effect for the terminated partnership.

Part Three: Taxation of S Corporations

Chapter 11. S Corporations and Their Shareholders

C. Election, Revocation and Termination

Page 423:

At the end of footnote 3, insert:

See also Rev. Proc. 2013-30, 2013-36 I.R.B. 173, which consolidates and modifies previous guidance and provides simplified methods for taxpayers to request relief for late S corporation elections.

D. Treatment of the Shareholders

2. Loss Limitations

a. IN GENERAL

Page 437:

At the end of the Note, insert:

In T.D. 9682 (Aug. 11, 2014), the IRS issued final and temporary regulations relating to basis of indebtedness of S corporations to their shareholders. They provide that shareholders receive basis in such indebtedness if it is "bona fide" indebtedness of the S corporation to the shareholder. Whether the indebtedness is bona fide is determined under general tax principles and depends on all facts and circumstances. Reg. § 1.1366-2(a)(2)(i). The regulations make it clear that the all facts and circumstances rule applies regardless of how the indebtedness arises. The examples in the regulations include a loan directly from a shareholder to an S corporation; a back-to-back loan arrangement where one S corporation makes a loan to a shareholder and the shareholder then loans money to a different S corporation; and a loan restructuring where an individual who is the sole shareholder of two S corporations receives the loan of one corporation to the other in a distribution. See Reg. § 1.1366-2(a)(2)(iii) Examples 1-3. A special rule applies for shareholder guarantees of S corporation indebtedness. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to the loan. But when a shareholder makes a payment on a bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, the shareholder then may increase the basis of indebtedness to the extent of the payment. Reg. § 1.1366-2(a)(2)(ii).

F. Taxation of the S Corporation

Page 446:

At the end of footnote 4, insert:

For tax years beginning in 2009 or 2010, the recognition period in Section 1374(d)(7) was reduced from ten to seven years and then further reduced to five years for 2011. The American Taxpayer Relief Act of 2012 extended the shorter five-year recognition period for two more years, through the end of 2013. In late 2014, it was extended again for another year, but for tax years beginning in 2015 the recognition period is back to 10 years. As this Update Memorandum was being completed, legislation to reduce the recognition period yet again, either temporarily or permanently, was pending in both the House and Senate. See Staff of the Joint Committee on Taxation, Description of the Chairman's Mark of a Bill to Extend Certain Expired Tax Provisions (JCX-101-15), July 17, 2015, available at http://www.jct.gov/publications.html?func=startdown&id=4800.

H. Compensation Issues

Page 458:

At the end of footnote 1, insert:

In 2015, the employer and employee's Social Security (FICA) tax rate are 6.2 percent each, with the expiration at the end of 2012 of the two percent "tax holiday" on the employee's share. The wage base for 2015 is $118,500. For most taxpayers, the Medicare tax rate remains 1.45 percent on both employer and employee (and 2.9 percent for self-employed taxpayers), with no cap on the amount subject to tax. Beginning in 2013, an additional 0.9 percent Medicare tax on combined wages and self-employment income in excess of $250,000 for married filing jointly taxpayers ($200,000 for single taxpayers and $125,000 for married filing separately) became effective. I.R.C. § 3101(b)(2). As a result, the Medicare tax rate for these "high-income" taxpayers with earned income has increased from 2.9 to 3.8 percent for amounts over the thresholds. Also beginning in 2013, a 3.8 percent tax is imposed on the lesser of a taxpayer's "net investment income" or adjusted gross income (with some modifications) in excess of $250,000 for joint filers, $200,000 for single taxpayers and heads of household, and $125,000 for married filing separately. I.R.C. § 1411.

Although the net investment income tax mirrors the Medicare tax imposed on "high income" taxpayers, the proceeds of the net investment income tax are not dedicated to the Medicare Trust Fund but instead are paid to the General Fund of the Treasury.

Page 462:

After the carryover paragraph, insert:

Net Investment Income Regulations. In late 2013, the Service issued final regulations interpreting the 3.8 percent tax on net investment income in meticulous detail.[11.1] The regulations include the general operating rules applicable to Section 1411; specific provisions for individuals, estates, and trusts; an intricate technical definition of net investment income; and lots of highly specialized rules. The regulations confirm that net investment income items and properly allocable deductions of partnerships, LLCs and S corporations are determined at the entity level and pass through to their partners, members and shareholders. At the same time, the Service issued new proposed regulations to provide further clarification on specific types of activities, including the disposition of partnership interests and S corporation stock, and the treatment of guaranteed payments for capital and Section 736 payments.[11.2]

The regulations are must reading for tax advisors to clients with investment income, but for now we are declaring them beyond the scope of sensible "fundamentals" coverage in a law school partnership tax class.

I. TAX POLICY ISSUES: SUBCHAPTER K VS. SUBCHAPTER S

Page 465:

After the second full paragraph, insert:

NOTE: BUSINESS ENTITY TAX REFORM UPDATE

A muted conversation about comprehensive tax reform took place during the 2012 Presidential campaign, with both candidates supporting corporate income tax rate reductions but neither offering much specificity on what "loopholes and subsidies" to eliminate. Since then, a meandering discussion comes and goes in Congress and elsewhere, as both the House Ways and Means and Senate Finance Committees deliberate about the issues and options. The taxation of business entities is a major topic in the debate.

In March 2013, House Ways and Means Committee chair Dave Camp (R-Mich.), who has since retired from Congress, released a provocative discussion draft of small business tax reform proposals. Two major options were floated. The first would essentially retain the structure of the present system, leaving Subchapter C intact but make several significant changes to the taxation of partnerships, LLCs and S corporations. The more radical second option would eliminate Subchapters K and S and replace them with a single unified pass-through regime that

---

[11.1] T.D. 9644, 2013-51 I.R.B. 676.

[11.2] REG-130843-13 (Jan. 30, 2014), 2014-8 I.R.B. 524. See Prop. Reg. § 1.1411-4(g) (guaranteed payments and § 736 payments); 1.1411-7 (sales of partnership interests and S corporation stock).

supposedly would simplify tax compliance for many small businesses but also would limit flexibility for partnerships and limited liability companies.

In June 2013, the Senate Finance Committee staff issued a bipartisan option paper on taxation of business income and entities. Three goals for tax reform were articulated: simplification, neutrality (reducing differences in tax burdens across different types of entities, income and owners), and reduction or elimination in the different tax treatment of debt and equity. The paper summarizes without commentary a non-exhaustive list of competing reform proposals advanced by a variety of legislators, academics and think tanks over the past 30 or so years. It is more a "laundry list" than a specific agenda for reform. See Types of Income and Business Entities, Senate Finance Committee Reform Options for Discussion (June 6, 2013), available at http://www.finance.senate.gov/issue/?id=0fb586fb-ba29-46ea-a194-df488e41b1bd.

In early 2014, then House Ways and Means Committee chair Camp released draft legislation with the stated goals of strengthening the economy and making the tax code simpler, fairer and flatter. The extensive business tax reforms in Chairman Camp's bill included repeal of numerous business-related exclusions, deductions and credits; repeal of the alternative minimum tax; reduction of corporate tax rates; and a long list of micro and macro changes to the tax treatment of pass-through entities. See Joint Committee on Taxation, Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III–Business Tax Reform (JCX-14-14) Feb. 26, 2014, available at https://www.jct.gov/publications.html?func=startdown&id=4556.

In 2015, the Senate Finance Committee, under new leadership, formed various tax reform working groups, one of which focused on business tax issues. A comprehensive Business Income Tax Bipartisan Working Group Report was issued in July 2015 and is available at http://www.finance.senate.gov/newsroom/chairman/release/?id=e9eefc66-7e11-4276-939f-3eca6fd6d959. The report does not suggest any specific business tax reform plan but attempts to explore certain "threshold issues" and describe "principles, considerations and options," as well as the trade-offs inherent in any serious tax reform effort. It contains the usual list of weaknesses in the current tax system, such as: promotion of inefficiency by incentivizing businesses to make decisions (e.g., choice of form) based on tax rather than business considerations; a statutory corporate income tax rate that is higher than most other developed countries, placing the United States at a competitive disadvantage in the global economy; and fostering of uncertainty through the use of temporary provisions that frequently expire and are reenacted late in the year when there is little or no time to benefit from them.

The Working Group agreed on several familiar principles to drive business tax reform: (1) lowering tax rates to encourage economic growth and job creation and to create an internationally competitive tax code; (2) addressing structural biases (e.g., debt financing over equity); (3) promoting innovation (e.g., through a permanent research and development tax credit and source neutral incentives for energy production; and (4) simplifying the system.

The Working Group's report does not break much new ground, but it does a good job outlining the challenges and trade-offs in any serious business tax reform discussion. For example, there is bipartisan support for lowering statutory corporate tax rates but sharply differing views on how or whether to pay for the rate reduction by broadening the tax base, such

as by scaling back accelerated depreciation and other corporate tax expenditures. Another challenge (some would say obstacle) is a concern that pass-through entities, which now represent more than 90 percent of all American businesses, would be treated inequitably if corporate rates were reduced because most of their income would be taxed at higher marginal individual rates. Owners of pass-through entities also might bear an increased effective tax rate if the tax base is broadened.

Despite all this hard work, prospects for serious reform are slim to none in the current political environment. The talk will continue through the next election cycle, with competing narratives, and the future direction and shape of tax reform will be influenced by the outcome of the 2016 Presidential election and the balance of power in the next Congress.