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FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISES

CASES, STATUTES, RULINGS

Richard A. Westin
Richard C.E. Beck
Sergio Pareja

Fourth Edition

FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISES

CASES, STATUTES, RULINGS

FOURTH EDITION

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UNITED STATES OF AMERICA

Preface

Albert Einstein once said that "things should be as simple as possible, but no simpler." That wise observation applies to the teaching of federal income taxation, among other things. In recent years, the Internal Revenue Code has become ever more complex, as has the teaching of the taxation of business enterprises. The practical problem is that the law student who plans a career in business law is in an unpleasant predicament. He or she must either avoid federal income tax courses, and bear the guilty knowledge that a large area of relevant law has been overlooked, with significant implications in terms of personal feelings of inadequacy, or face the burden of taking a large dose of notoriously difficult courses in corporate and partnership taxation. This book is designed to alleviate that Hobson's choice. Whether it has succeeded is for the instructor and student to decide.

This book provides teaching materials for a basic income taxation course dealing with the taxation of partnerships, corporations, S corporations, and limited liability companies. In addition, it alludes to a short list of other business enterprises. It can definitely be completed in the usual three hours assigned to such courses, on the assumption that students will spend two hours of preparation for each hour in the classroom.

The book begins with the study of partnerships, moves to C corporations, then to S corporations, then to limited liability companies. In general, we take a cradle-to-grave approach to each subject. Our teaching of the course out of these materials convinces us that the order is realistic and effective.

The cases have been extensively edited, and most footnotes in the original cases have been eliminated (and in one case, split) without any explicit reference to the fact of their elimination, other than the words in this paragraph. Case and statute citations of the court and commentators, as well as footnotes, have been omitted without so specifying; numbered footnotes are from the original materials but do not retain the original numbering, except by accident.

The book is fairly rich with problems that are scattered along the way, rather than at the end of each chapter. They are not especially difficult and are designed to build confidence while at the same time forcing at least some review of the central Code provisions and pertinent regulations. We do not view this as a "problems" book, and we advise students that if they find themselves struggling unduly with a problem, to drop it, but always at least take a crack at the problems, because if they do not, the colloquy in class in which the answer is revealed will pass over their heads.

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Chapter 1

THE TAX CHARACTER OF PARTNERSHIPS

A. INTRODUCTION

1. STATE LAW CHARACTERISTICS

A partnership is a contractually-based relationship among owners of an enterprise organized for a profit. Partnerships fall into the following two broad categories: general partnerships and limited partnerships.

General partnerships can arise orally and may be informal, although most operate under a written partnership agreement, which is to say a foundational contract among its owners. By contrast, limited partnerships are creatures of state law that must satisfy filing requirements, usually with a Secretary of State, in order to come into being, and that must have at least one general partner.

The defining characteristic of a general partnership is that each partner bears unlimited personal liability to third parties for the partnership's obligations. Limited partners, on the other hand, like shareholders in a corporation, are liable to third parties only to the extent of their actual contributions to the limited partnership, plus any promised additional contributions. Again, like shareholders, limited partners as such are generally precluded from managing the partnership. Limited partnership interests, like shares of stock, are fairly easy to market, whereas it is difficult to market general partnership interests.

There is one related concept that merits mentioning at this point – the "joint venture." This is non-tax terminology for a state law partnership that has a limited purpose, such as to build and sell a single apartment project.

2. TAX BACKGROUND

The partnership tax rules appear in §§ 701-777 of the Code, known as Subchapter K. After careful study, Subchapter K was enacted in 1954 in order to straighten out the confusion that had arisen under earlier tax laws. The Senate Finance Committee Report in support of the new framework provided:

> "The existing tax treatment of partners and partnerships is among the most confused in the entire income tax field. The present statutory provisions are wholly inadequate. The published Regulations, rulings, and court decisions are incomplete and frequently contradictory. As a result, partners today cannot form, operate or dissolve a partnership with any assurance as to tax consequences.
>
> This confusion is particularly unfortunate in view of the great number of business enterprises and ventures carried on in partnership form. It should also be noted that the partnership form of organization is much more commonly employed by small businesses and in farming operations than the corporate form.
>
> Because of the vital need for clarification, the House and our committee have undertaken the first comprehensive statutory treatment of partners and partnerships in the history of the income tax laws. In establishing a broad pattern applicable to

partnerships, generally, the principal objectives have been simplicity, flexibility, and equity as between partners."[1]

Whether these goals have actually been achieved seems doubtful, and Subchapter K has a well-deserved reputation for complexity despite the deceptively simple appearance of both the Code sections and the reporting forms.[2]

Some basic principles may be seen in the forms. Begin by looking at the annual partnership return (Form 1065) which appears as an appendix to this book. No tax payment accompanies the Form 1065, which is why it is called an information return. However, each Form 1065 is accompanied by at least two Forms K-1; this is the form on which a report of the individualized results of a partnership's year is made for each particular partner. The partnership's tax return preparer transmits a completed K-1 to each partner at the end of the partnership's taxable year, and it is used by each partner in preparing his own personal return. A Schedule K-1 appears immediately after the Form 1065 as an appendix.

These forms illustrate a basic tension that runs through Subchapter K, namely that a partnership is both an aggregate of individual partners who pay taxes directly on their share of the partnership's profits, but at the same time is also a separate entity for a variety of other purposes, such as filing the tax return, having a distinct taxable year, and adopting an accounting method to compute its profits or losses. The former is referred to as the "aggregate theory"; the latter is known as the "entity theory." The tax law in some instances treats a partnership as if it were an entity and in others as if it were an aggregation of individuals.

B. THE GROWING POPULARITY OF PARTNERSHIPS

The partnership form of doing business (where feasible) is often favored over incorporation. In large measure one can attribute this preference to recent changes in federal tax law which are relatively disadvantageous to corporations. The Internal Revenue Code of 1986 inverted the historic relationship between individual and corporate marginal tax rates in which top individual income tax rates used to exceed top corporate rates. As a result, the corporate form naturally became less desirable than previously. In more recent years, the rate differential between the top personal and corporate federal income rates has all but disappeared. But rates are not the only reason for preferring non-corporate form. Corporations also suffer from the enduring problem of the double tax.

Because corporations are separate legal and taxable entities, doing business in corporate form presents a "double tax" problem, in the sense that the corporation first pays its own tax on its profits, and then when it distributes those same profits as dividends, the shareholders must pay a second tax on those same profits. By contrast, a partnership itself is

---

[1] S. Rep. No. 1622 83d Cong., 2d Sess. 89 (1954).

[2] Little did the 1954 legislators imagine how deep the conflict between simplicity and flexibility could go, and how complicated Subchapter K would turn out to be in practice. The late Professor Boris Bittker seems to have thought the effort was a failure. B. Bittker, Federal Taxation of Income, Estates and Gifts, Vol. 3 at 85.1.2 (1981). Much of the reason for these complications seems to be the exploitation by clever tax advisors of rules designed for simple and straightforward transactions by inappropriately applying them to complicated tax-driven transactional formats for which the rules were not intended. That in turn triggers reactions by Congress and the Internal Revenue Service that are themselves overly complex, if not sometimes paranoid. On a deeper level, however, the underlying problems are probably inherent in the structural ambiguities of Subchapter K itself. In the end, Subchapter K may simply be inappropriate for businesses of any degree of complexity.

not subject to the separate U.S. income tax on corporations; instead, all partnership items of income deduction or credit pass through to the partners, and, when a partnership distributes its profits, there is no second round of taxes. On the other hand, in recent years the corporate double tax has been at least temporarily softened by making most dividends taxable at favorable long-term capital gains rates.

The choice of entity question has never been easy and has always involved complex trade-offs. Before 1986, for example, when corporate rates were substantially lower than individual rates, it was sometimes desirable to live with the double tax if it could be postponed by making no distributions out of the corporation, because investors would have greater after-tax capital available within their corporate entity than would remain after taxes from comparable profits of a proprietorship or partnership. Now that corporate tax rates are largely the same as individual rates, that is no longer the case. Some other major potential tax costs which may weigh against incorporation and in favor of partnership form include the repeal of the *General Utilities*[3] doctrine in 1986, which now forces corporations to pay federal income taxes on the appreciation in property they distribute. Also, deductible costs, losses, and other tax-reducing items pass through a partnership and take effect, pro rata, in the partners' individual tax returns, where they can be of immediate benefit, something a corporation cannot offer. Finally, the corporation has lost its longtime tax advantage over the partnership in the area of pensions, and both now generally offer the same tax benefits as to retirement plans, although not for certain other less important employee fringe benefits.

Although limited liability would seem to remain a major reason for favoring incorporation over partnership formation, essentially the same limited liability advantages can be gained through a limited partnership. Insulation against personal liability can be especially effective by using a corporation to act as the general partner of a limited partnership. Also, a relatively new form of organization, the "limited liability company," offers limited liability to its owners or members and also is usually subject to the Subchapter K tax regime – no double tax. Limited liability companies will be studied later, in Chapter 26. All you learn here about partnership taxation generally will apply to them.[4]

C. PARTNERSHIP STATUS

The first major inquiry is whether an entity organized as a partnership under local law stands up as such, or whether it has to be reclassified as another form of organization for federal income tax purposes. For federal income tax purposes all business or investment entities that are not sole proprietorships fall into one of the following basic classifications: corporation; trust or estate; or partnership. Reg. §§ 301.7701-2 through 301.7701-4. Thus, for example, even the most obscure or novel foreign entity must be forced into one of these three pigeonholes for U.S. federal income tax purposes if it has to deal with the IRS. (There are some specialized entities, such as farmers' cooperatives that fall into unique categories, but only because Congress carved out special rules for them.)

Conversely, many relationships that appear to involve no entity at all, such as landlord and tenant or debtor and creditor, have the potential for inadvertently producing a partnership for federal income tax purposes.

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[3] *General Utils. & Oper. Co. v. Helvering*, 296 U.S. 200 (1935).

[4] Some closely-held corporations are permitted to make a federal income tax election to be taxed as (Subchapter) S corporations. No separate corporate income tax applies to them, and they are taxed much like, but not the same as, Subchapter K partnerships.

The Supreme Court shaped the process of classifying entities for federal income tax purposes in *Morrissey v. Commissioner*, 296 U.S. 344 (1935). The facts involved a trust that was organized to form and operate a golf course for a profit. The Court evaluated the question in terms of whether the trust more closely resembled a corporation or a traditional trust. Finding a preponderance of corporate characteristics, it declared the entity to be taxable as a corporation.

In later years, physicians took advantage of the tendency of the case law to treat a state law limited partnership as a corporation if it had a "preponderance of corporate characteristics," thereby allowing them to get the benefit of the more generous pension plan arrangements formerly available only to corporations. The Treasury Department counterattacked with the so-called Kintner Regulations, named after the *Kintner* case, which strove to ensure that a limited partnership would be treated as a partnership and not as a corporation. Tax shelter promoters in turn latched onto the generously pro-limited partnership rules and marketed their wares as limited partnership interests, with deductions passing through to the limited partners.

The Regulations required two preliminary factors to exist in order to find either a partnership or a corporation. They required that there be "associates" who joined together in order to conduct a profit-making enterprise, and that they did so with a view to sharing in those profits. There was an acknowledged possible exception for a one-shareholder corporation.

Assuming those two factors existed, then the question became whether the enterprise had three or more of the following characteristics, in which event it was characterized as a corporation for federal income tax purposes:

1. Continuity of life, meaning the entity does not legally dissolve if a member transfers an interest in the entity;

2. Centralization of management, meaning that the power to make managerial decisions is concentrated in less than all the members;

3. Free transferability of interests, meaning the owners can transfer their interests in income and capital of the enterprise; and

4. Limited liability, meaning there is not even one owner who has unlimited liability for the obligations of the enterprise.

Curiously, the government did not amend these Regulations during the tax shelter era. Instead, it took a litigating position that limited partnerships are generally taxable as corporations, as the *Larson* case (next) exemplifies. It was a failure. What follows is a heavily edited version of the Larson decision, which utterly defeated the government. The Kintner Regulations have recently been rewritten, and the four-factor analysis has been obliterated, but the concept of limited liability remains important under the new Regulations with respect to the default rules for foreign entities. Accordingly, the discussion of that concept in *Larson* remains important.

LARSON v. COMMISSIONER
66 T.C. 159 (1976)

[The taxpayers owned limited partnership interests in two real estate syndications (Mai Kai and Soumis) organized under the California Uniform Limited Partnership Act. The general partner in each partnership was a corporation (GHL) that was independent of the limited partners and was organized for the purpose of promoting and managing the syndications. Under California law the partnerships could be dissolved by the bankruptcy of the general partner. The general partner invested no money in the partnerships and held interests that were subordinated to those of the limited partners. The limited partners could vote to remove the general partner. The limited partners could transfer their income rights with the consent of the general partner, which consent could not unreasonably be withheld. A transferee of a limited partner's capital interest, if the transfer was at fair market value, had the right to become a substituted limited partner without the consent of any member. There were clearly "associates" and a "joint profit intent." There was centralized management; interests were found freely transferable on the facts; the entity did legally dissolve if a general partner went bankrupt. The remaining issue was whether the entity had the corporate characteristic of limited liability. The facts as to that point were that the general partner was a corporation with only modest assets and was owned by persons unrelated to the limited partners.]

TANNENWALD, J.

3. Limited Liability

Unless some member is personally liable for debts of, and claims against, an entity . . . the entity possesses the corporate characteristic of limited liability. The regulation provides that "in the case of a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner, except as provided in subparagraph (2) of this paragraph." The first sentence of subparagraph (2) establishes a conjunctive test, under which a general partner is considered not to have personal liability only "when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a 'dummy' acting as the agent of the limited partners." In other words, personal liability exists if the general partner either has substantial assets or is not a dummy for the limited partners . . . . Although the purpose of subparagraph (2) was ostensibly to delineate the conditions under which personal liability of a general partner does not exist, practically all the remaining material in the subparagraph outlines the conditions under which such personal liability does exist. In several examples, personal liability is said to exist, either because the general partner has substantial assets or because he is not a dummy for the limited partners. . . . In no instance is there a suggestion that both conditions established by the first sentence of subparagraph (2) need not be satisfied.

In so concluding, we are mindful that in *Glensder Textile Co.*, supra, the apparent source of the language in the Regulations, the term "dummy" was arguably considered applicable to any general partner without substantial assets risked in the business. The opinion in *Glensder* states:

> "If, for instance, the general partners were not men with substantial assets risked in the business but were mere dummies without real means acting as the agents of the limited partners, whose investments made possible the business, there would be something approaching the corporate form of stockholders and directors. . . ."

Thus, lack of substantial assets seems to be considered the equivalent of being a dummy – an equivalence which respondent apparently sought to avoid by using the word "and" in his existing Regulations.

While it may be doubtful that GHL could be considered to have had substantial assets during the years in issue, we find it unnecessary to resolve this question since it is clear that GHL was not a dummy for the limited partners of Soumis and Mai-Kai. Respondent contends that GIL fell within the "dummy" concept because it was subject to removal by the limited partners, and thus was subject to their ultimate control. While it is true that a mere "dummy" would be totally under the control of the limited partners, it does not follow that the presence of some control by virtue of the power to remove necessarily makes the general partner a "dummy." It seems clear that the limited partners' rights to remove the general partner were designed to give the limited partners a measure of control over their investment without involving them in the "control of the business"; the rights were not designed to render GHL a mere dummy or to empower the limited partners "to direct the business actively through the general partners." *Glensder Textile Co.*, 46 B.T.A. at 183. Moreover, the record indicates that the limited partners did not use GHL as a screen to conceal their own active involvement in the conduct of the business; far from being a rubber stamp, GHL was the moving force in these enterprises. With a minor exception, the persons controlling GHL were independent of and unrelated to the limited partners.

In view of the foregoing we conclude that personal liability existed with respect to GHL, and the partnerships lack the corporate characteristic of limited liability.

Our task herein is to apply the provisions of respondent's Regulations as we find them and not as we think they might or ought to have been written. . . . On this basis, petitioners must prevail.

NOTES

1. **The IRS's next moves.** In Rev. Rul. 79-106, 1979-1 C.B. 448, the Service accepted the outcome in *Larson* and in effect gave up the fight. Then, almost twenty years later, the IRS promulgated the "check-a-box" regulations (also commonly referred to as "check-the-box" regulations) that let taxpayers elect whether they want to treat unincorporated business entities as partnerships or corporations for federal income tax purposes. Reg. § 301.7701-1 through 3, effective as of the beginning of 1997. (True trusts cannot make the election.) Does this make *Larson* unimportant? Not entirely. Because the concept of "limited liability" in *Larson* is a key issue in determining whether to classify a foreign business entity as a corporation or as a partnership or sole proprietorship. The first appendix at the back of the book contains a flow chart distinguishing among sole proprietorships, partnerships, and corporations and the impact of the check-the-box election. In addition, a copy of Form 8832 (Entity Classification Election) is attached as an appendix at the end of the book. Reg. § 301.7701-2(a) defines "business entity."

2. **But state law changed.** The Revised Uniform Limited Partnership Act (RULPA) is not the same as the UPA contemplated by the *Larson* court. *See* RULPA §§ 402, 801.

It became possible to have the partners agree that the partnership will continue despite the bankruptcy of a general partner by means of selecting a new general partner within a ninety-day window period. This makes partnerships less vulnerable to technical legal dissolutions. You will look at the impact of dissolutions later in the book.

3. **Trusts.** Prior to the check-a-box regulations, if a trust had the power to conduct business, it was treated as a corporation. This was because, in addition to having a business purpose and associates (namely, the beneficiaries, the grantor, or both combined), centralized management, and limited liability, trusts commonly have free transferability and unlimited life; hence, they were generally doomed to corporate status if they had a business purpose. *See* Reg. § 301.7701-4(a). If a trust does not have a power to conduct business, it is simply a trust. Under the check-a-box system, if it does have a power to conduct business (and if it has "associates"), it becomes a "business entity," and it can elect whether to be taxed as a partnership or a corporation. See the Preamble to the Proposed Regulations, issued May 13, 1996. As a result, one can add a business power to a trust document (which would make it a corporation) and then elect to treat it as a partnership.

4. **Associates in a testamentary trust setting.** *Bedell v. Commissioner*, 86 T.C. 1207 (1986), held that a testamentary trust that operated a bedding factory for profit was not to be treated as a corporation, on the theory that there were no "associates." The beneficiaries, who were heirs of the decedent, had no managerial authority and had no hand in forming the trust. The case may offer a blueprint for the wicked who would rather operate under the trust rules than the partnership rules.

5. **Liquidating trusts**. There is another group of trusts that can qualify as trusts despite a business flavor. These consist of liquidating trusts, which are used temporarily to take control of the assets of a corporation that is in the process of being dismantled, and bondholders' protective trusts, which are vehicles by which bondholders take temporary claim to a debtor's assets pursuant to powers granted them by the terms of the debt instrument. As long as their primary purposes are not submerged by the conduct of business, bondholders' trusts and liquidating trusts can retain their income tax status as trusts, despite their possible profitability. Reg. § 301.7701-4(d). Likewise, investment trusts sold to the public and holding portfolios of income-producing assets can retain their status as long as their reinvestment powers are highly circumscribed. Reg. § 301.7701-4(c). These are commonly referred to as "unit investment trusts" and are frequently advertised in business sections of newspapers.

6. ***Per se* corporations**. Regulations identify the following eight specific business organizations that each will be deemed a "*per se* corporation" for federal tax purposes: all statutory corporations; joint-stock companies; associations; insurance companies subject to Subchapter L; state-chartered banks that have deposits insured by the Federal Deposit Insurance Act; state-owned entities; non-§ 7701(a)(3) entities (*e.g.*, publicly traded partnerships subject to § 7704); and specified foreign business entities (*i.e.*, eighty different foreign entities designated by name). Reg. § 301.7701-2(b).

7. **Grandfather rules**. The check-a-box regulations generally apply only to entities formed on or after January 1, 1997. The regulations promise to respect the partnership classification of any domestic eligible entity that was in existence before 1997 if three conditions are met: (i) the entity had a reasonable basis for partnership classification; (ii) the entity and all owners of the entity recognized the federal tax consequences of any change in the entity's classification after 1991; and (iii) neither the entity nor any member was notified by the IRS in writing on or before May 8, 1996, that the entity's classification was under audit. Reg. § 301.7701-3(0(2). There was also limited grandfathering for foreign entities.

8. **Election and Default rules**. If the entity is a business entity (and not a trust), then it may be a per se corporation. If it is not, then it falls into the residual group of business entities, which is the topic of the rest of this paragraph. (If the business enterprise existed before 1997, it is likely to be grandfathered.) Assuming it is not grandfathered, then the owners are free to make the check-a-box election. Let's assume they do not elect. What then? If it is a U.S. business entity, then the "default" outcome is that it is a sole proprietorship if there is only one owner and a partnership if there are several owners. Reg. § 301.7701-3(b)(1). If it is foreign business entity and no one has personal liability, then the default result is that it is a corporation for federal income tax purposes; if at least one person has personal liability, then the enterprise is a sole proprietorship if there is only one owner and a partnership if there are several owners. Reg. § 301.7701-2(b). An election must be made by all the owners, and may not be changed again for five years.

9. **State law and entity classification**. Just because an entity achieves a particular status for federal income tax purposes does not mean that the same status will apply for state tax law purposes. For example, at least at one point the California Franchise Tax Board stated that it would not follow the check-a-box classification structure and would continue to rely on the *Kintner* four-factor test to determine whether an entity is a partnership for California state tax purposes. BNA Daily Tax Report, at G-8 (Feb. 3, 1997); 18 Cal. Code Reg. § 23038. Likewise, Texas taxes limited liability companies under its franchise tax, regardless of whether they elect to be taxed as partnerships, and recently imposing the franchise tax on state law limited partnerships. Texas Tax Code Chapter 171.

10. **Partner?** Even if an entity is a partnership, that does not determine whether everyone who is engaged in it is a partner. *See, e.g.,* Rev. Rul. 77-332, 1977-2 C.B. 484 (even though such arrangements are illegal under state law, a non-accountant may be treated as a member of an accounting partnership for federal income tax purposes).

REV. RUL. 75-374
1975-2 C.B. 261

Advice has been requested whether, under the circumstance described below, the co-owners of an apartment project would be treated as a partnership for Federal income tax purposes.

X, a life insurance company, and Y, a real estate investment trust, each own an undivided one-half interest in an apartment project. X and Y entered into a management

agreement with Z, an unrelated corporation, and retained it to manage, operate, maintain, and service the project.

Generally, under the management agreement Z negotiates and executes leases for apartment units in the project; collects rents and other payments from tenants; pays taxes, assessments, and insurance premiums payable with respect to the project; performs all other services customarily performed in connection with the maintenance and repair of an apartment project; and performs certain additional services for the tenants beyond those customarily associated with maintenance and repair. Z is responsible for determining the time and manner of performing its obligations under the agreement and for the supervision of all persons performing services in connection with the carrying out of such obligations.

Customary tenant services, such as heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas are furnished at no additional charge above the basic rental payments. All costs incurred by Z in rendering these customary services are paid for by X and Y. As compensation for the customary services rendered by Z under the agreement, X and Y each pay Z a percentage of one-half of the gross rental receipts derived from the operation of the project.

Additional services, such as attendant parking, cabanas, and gas, electricity, and other utilities are provided by Z to tenants for a separate charge. Z pays the costs incurred in providing the additional services, and retains the charges paid by tenants for its own use. These charges provide Z with adequate compensation for the rendition of these additional services.

Section 761(a) of the Internal Revenue Code of 1954 provides that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership. Tenants in common may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.

The furnishing of customary services in connection with the maintenance and repair of the apartment project will not render a co-ownership a partnership. However, the furnishing of additional services will render a co-ownership a partnership if the additional services are furnished directly by the co-owners or through their agent. In the instant case by reason of the contractual arrangement with Z, X and Y are not furnishing the additional services either directly or through an agent. Z is solely responsible for determining the time and manner of furnishing the services, bears all the expenses of providing these services, and retains for its own use all the income from these services. None of the profits arising from the rendition of these additional services are divided between X and Y.

Accordingly, X and Y will be treated as co-owners and not as partners for purposes of section 761 of the Code.

1. PARTNER IN A PARTNERSHIP OR A LENDER?

It is sometimes difficult to distinguish common commercial relationships from partnerships for federal income tax purposes. The following early case deals with the knotty question of sorting a lending arrangement from a partnership.

DORZBACK v. COLLISON

195 F.2d 69 (3d Cir. 1952), *aff'g* 93 F. Supp. 935 (D. Del. 1950)

MARIS, CIRCUIT JUDGE

This is an appeal from a judgment for the plaintiff taxpayer in an action brought in the United States District Court for the District of Delaware for the recovery of income taxes and interest paid to the defendant Collector pursuant to deficiency assessments made by the Commissioner of Internal Revenue for the years 1943, 1944 and 1945.

The facts are these. On May 14, 1941 the taxpayer's wife loaned to the taxpayer from her own funds the sum of $8,500 to pay off an existing indebtedness of his in that amount and to evidence his resulting indebtedness to her the taxpayer gave her his bond in that amount bearing interest at 5% per annum. On January 4, 1943 the taxpayer and his wife entered into a written agreement in which they agreed that in lieu of the interest she had been receiving on this indebtedness she should share in the net profits derived from the taxpayer's retail business by receiving 25% of the net profits after the payment of an annual salary of $4,000 to the taxpayer. It was further agreed that the wife should continue to be a creditor and not a partner of the taxpayer but that her standing as a creditor should be subordinated to the rights of all general business creditors of the taxpayer.

Under this agreement the taxpayer's wife received $6,892.33 for 1943, $7,681.63 for 1944 and $10,346.32 for 1945. In computing their taxable net incomes for these years these amounts were reported as income by the wife and deducted by the taxpayer as interest paid. The Commissioner of Internal Revenue disallowed taxpayer's interest deductions of 25% of net profits, allowing deductions only in the amount of 5% of the principal sum of $8,500. The present action was instituted to recover the deficiencies assessed and paid by reason of the disallowance of these deductions.

At the trial, the district judge directed the jury to bring in a verdict for the taxpayer on the ground that there was no evidence of lack of a bona fide debtor creditor relationship between the taxpayer and his wife as a result of the agreement of January 4, 1943. The question whether or not the 25% share of net profits could legally be construed as a payment of interest was reserved and decided, as a matter of law, in favor of the taxpayer by the district judge. Alternatively, the district judge concluded that the taxpayer and his wife were joint adventurers and accordingly taxable on their respective shares in the profits of the business for the years involved. The defendant's motions for judgment n. o. v. and for a new trial were accordingly denied. D.C., 93 F. Supp. 935. This appeal followed.

The defendant contends that the district judge erred in not submitting to the jury the question whether a debtor-creditor relationship existed between the taxpayer and his wife and in concluding that the payments made by the taxpayer to his wife in 1943, 1944 and 1945 were deductible interest payments.

Section 23(b) of the Internal Revenue Code provides that in computing net income there shall be allowed as a deduction "All interest paid or accrued within the taxable year on indebtedness." The taxpayer contends that under the express terms of this section he is entitled to the whole of the deductions which he claimed. For, he says, he was indebted to his wife and the amounts he paid her were interest on that indebtedness. The defendant contends, on the other hand, that there was evidence from which the jury might have found that the 1943 agreement did not create a debtor-creditor relationship but was merely a scheme to reallocate family income and that therefore the taxpayer was not entitled to deduct as interest the amounts paid his wife during 1943, 1944 and 1945.

The defendant points to the following facts to which the taxpayer testified: The year 1942 had been fairly profitable for the taxpayer; the arrangement agreed upon would be advantageous to him in reporting his income; his wife desired a larger return on her money than 5%; he felt grateful to her because of the fact that in 1932, when his bank was pressing him for payment of his debt in the amount of $25,000, she had endorsed his note to provide additional security. The defendant urges that these circumstances surrounding the 1943 agreement show the arrangement to be a device to reallocate income among the family group and therefore raised an issue as to the bona fides of the agreement and whether a bona fide debtor-creditor relationship resulted from it. The defendant, however, does not deny that prior to January 4, 1943 the taxpayer was unconditionally indebted to his wife in the amount of $8,500. Nor does he contend that the controlling state law does not recognize inter-spouse indebtedness. The agreement of January 4, 1943 expressly provided that the wife should continue to be a creditor of the taxpayer. We think that the evidence would support no other finding than that the indebtedness which resulted from the wife's loaning of her own money to her husband in 1941 continued after the agreement of 1943.

We have not overlooked the principle that transactions between husband and wife calculated to reallocate family income or reduce family taxes are subject to careful scrutiny. But here, as we have pointed out, the wife had a personal stake of her own, the $8,500 of her own money which she had loaned the taxpayer, upon which she was entitled to a return. Indeed the defendant concedes this since the Commissioner allowed the deduction of interest at 5% for the years in question, a position clearly inconsistent with the denial of any debtor-creditor relationship.

We think that the district judge rightly held that the agreement of 1943 did not change that relationship. For that agreement concerned only the return which the wife was to receive on her loan. It did not change her status as a creditor. Nor did it affect her relationship as a creditor when she agreed to subordinate her claim to the claims of the general business creditors. *Commissioner of Internal Revenue v. O.P.P. Holding Corp.*, 2 Cir., 1935, 76 F.2d 11, 12. And even if the 1943 agreement had operated to change the wife's status from creditor to partner or joint adventurer the result, taxwise, would have been the same, as the district judge concluded. For in that situation the wife would still have been taxable on her 25% share of the profits of the business. We accordingly conclude that the district judge rightly held that the evidence established the existence of a bona fide debtor-creditor relationship between the taxpayer and his wife during the years in question.

The other question to be determined is whether the taxpayer was entitled to deduct the payments made under the 1943 agreement "in lieu of interest" as interest payments under Section 23(b). The defendant contends that the payments of 25% of net profits, which amounted almost to the amount of the principal in 1943 and 1944 and in 1945 were greater than the actual indebtedness, could not be considered to be interest under that section. He claims that it was error for the district judge to determine as a matter of law that payments of a share in the net profits of the business made in lieu of interest were deductible as interest payments.

Interest on indebtedness has been defined to mean "compensation for the use or forbearance of money." *Deputy v. Du Pont*, 308 U.S. 488, 498 (1940). The word must be given the "usual, ordinary and everyday meaning of the term." *Old Colony R. Co. v. Commissioner,* 1932(a), 284 U.S. 552, (a). In the Old Colony case the Supreme Court said [284 U.S. at page 560]: "And as respects `interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money. He who pays and he who receives payment of the stipulated amount conceives that the whole is interest."

The defendant contends that although Section 23(b) provides that "All interest paid" shall be deductible, yet when payments are made in lieu of interest at such high rates as are present in this case they are so unreasonable that they must be held not to be allowable interest deductions but rather a subterfuge to reallocate business profits. We are not, however, persuaded that a payment made "in lieu of interest" is not the equivalent of "interest." The phrase "in lieu of" means "instead of." Webster's New International Dictionary, 2d Ed., p. 1427. In *Kena, Inc., v. Commissioner*, 1941, 44 B.T.A. 217, 219-220, 221, the Board of Tax Appeals said:

> It is axiomatic that the language used to describe a thing does not determine its character. The contract of December 13, 1932, denominated the amount to be paid to the petitioner as "an additional sum in lieu of interest." The word "lieu" means "place or stead." It does not imply that the character of the payment was different from interest but indicates that the method of computation was not in accord with the usual method of computing interest, the percentage of profit being employed as a substitute. The contract itself must be examined to determine whether the sum so designated was actual interest or was something else. . . .

It is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of the lender and borrower.

Generally speaking, payments made for the use of money "in lieu of interest" are deductible as interest under Section 23(b).

Throughout the ages lenders have exacted all they could from borrowers for the use of money. How much has been exacted has depended upon the desperation of the borrower and the exigency of the moment. There is no requirement in Section 23(b) that deductible interest be ordinary and necessary or even that it be reasonable. Hence the phrase "All interest paid" contained in that section must be taken in its plain and literal meaning to include whatever sums the taxpayer has actually had to pay for the use of money which he has borrowed. *Arthur R. Jones Syndicate v. Commissioner of Internal Revenue*, 7 Cir., 1927, 23 F. 2d 833. We conclude that the district judge did not err in holding that the payments made by the taxpayer to his wife in 1943, 1944 and 1945 were interest paid on indebtedness and deductible under Section 23(b) of the Internal Revenue Code.

The judgment of the district court will be affirmed.

NOTES

1. **Bifurcation of debt and equity**. In *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960), the court held that what the taxpayer claimed was "contingent interest," payable out of the appreciation in value of a building the taxpayer financed, was not interest at all, but instead reflected an equity (ownership) interest in the building. The court stopped short of declaring the arrangement a partnership, but it did deny interest expense deductions with respect to the equity component. The case is commonly seen as the first major pruning back of *Dorzback v. Collison.*

2. **The IRS's position on shared appreciation mortgages**. *Farley Realty* is an early example of an effort to create a shared appreciation mortgage (SAM). Such mortgages became popular in the 1970s when interest rates and inflation were especially high and

lenders sought to share in the increases in property values caused by high rates of inflation that made lending money a more difficult business than in more stable times. In Rev. Rul. 83-51, 1983-1 C.B. 48, the IRS stated that a borrower's obligation to pay the lender a portion of the increase in value of the taxpayer's principal residence constituted deductible interest under § 163. The ruling is limited to the underlying situation, namely a fixed date for payment of both the contingent interest and the principal amount, a method for calculating the interest specified in the mortgage contract, an intent to create a debtor-creditor relationship, and payment that is made in cash or with funds borrowed from a different lender. The ruling is limited to residential loans, leaving commercial lenders in the dark as to the IRS's position on this important matter.

3. **Other relationships**. There are numerous other arrangements that may produce a partnership for federal income tax purposes. For some nondefinitive definitions, *see* I.R.C. §§ 761(a), 6231. 6031(a), 7701(a)(2). It is difficult to generalize about the factors that will cause a court to characterize the arrangement one way or another, but one important factor to keep in mind is that there need not be a sharing of losses in order to classify a person as a member of a partnership. *See McDougal v. Commissioner,* 62 T.C. 720 (1974). One noteworthy case has suggested that even an attorney and his client can form a partnership for tax purposes. *See Allum v. C.I.R.*, 90 T.C.M. (CCH) 74 (T.C. 2005), *aff'd*, 231 F.Appx. 550 (9th Cir. 2007).

2. PUBLICLY TRADED PARTNERSHIPS

In the late 1980s a number of major partnerships began trading on national stock exchanges. This novel trend was motivated by two events. One was the declining attractiveness of operating in the corporate form; the other was a trend in favor of combining tax shelter partnerships into larger enterprises. Congress became mildly alarmed at the potential revenue loss, and responded by including in the Revenue Act of 1987 a new § 7704, which treats certain publicly traded partnerships as corporations. As the name implies, a publicly traded partnership is any partnership whose interests are traded on an established securities market or readily tradable on a secondary market (or its equivalent). § 7704(b). There is a major exception for partnerships at least 90% of whose income is from passive investment sources or from certain natural resource related activities, or from both combined. § 7704(c). The exceptions are best explained as lobbying triumphs.

The 1997 Act softened the rules for pre-existing publicly traded partnerships by enacting one of the few income taxes on gross income. Specifically, a publicly traded partnership in existence in 1997 could elect to be subject to a tax on gross income from the active conduct of a trade or business. If it elects, then the rule of present law treating a publicly traded partnership as a traditional corporation does not apply. The tax is 3.5% of the partnership's gross income from the active conduct of a trade or business. This could be a bargain for older publicly traded partnerships with high profit margins. § 7704(g).

PROBLEM 1-1

Which of the following arrangements constitute a partnership for federal income tax purposes?

1) Harry and Igor jointly own a warehouse, which they lease to the Acme Brick Company. They provide no services aside from paying the taxes and maintaining the warehouse. They share the revenues and expenses. *See* Reg. § 301.7701-1(a)(2).

2) Would the result differ if Harry and Igor drafted a contract to reflect this arrangement and declared in that document that it was a partnership agreement?

3) They also jointly own the H&I Hotel and share the profits and losses 50:50. The hotel has the usual guest services.

4) Same as 3) immediately above, but Igor shares in profits, but not in losses.

5) Allie recently lent the H&I hotel business $100,000 dollars for five years. Her return is based on 5% per year plus 10% of the hotel's net profits. Is Allie a partner?

6) Allie and her friend from architecture school days, Sally, occupy office space that they rent. Each has her own clients and each bills separately, but they share the cost of a secretary, furniture, equipment, supplies and mailing (which are all their costs). Are they partners in a business partnership?

7) Allie left architecture and became a sharecropper, using the owner's land to plant wheat and paying for the right to plant on the land with 10% harvests. Is this sharecropping arrangement a partnership for federal income tax purposes?

8) Allie could not stand sharecropping anymore. She left and became an associate at the Very Big Architecture Firm, which is a partnership for federal income tax purposes. It pays her a good salary plus a "bonus" equal to 10% of her billings every year. Is Allie a partner of Very Big Architecture Firm for federal income tax purposes?

9) Which of the following entities is a sole proprietorship, partnership, or corporation for federal income tax purposes?

    a) A "Berhad", organized in Malaysia. *See* Reg. § 301.7701-2(b)(8).

    b) Bob, a U.S. citizen residing in Tulsa, signs an Oklahoma limited partnership agreement with the Berhad, known as Bob-Berhad Partners, Ltd. The partnership agreement is properly filed pursuant to Oklahoma law. Bob is the limited partner, and the Berhad is the general partner.

        i) The partners elect to treat the entity as a corporation, filing a Form 8832 on time. *See* Reg. § 301.7701-3(a).

        ii) The partners make no election. *See* Reg. § 301.7701-3(b).

iii) Instead, the Berhad and Bob contribute the same assets to a Delaware corporation. Can the corporation be electively rendered a partnership for federal income tax purposes? *See* Reg. § 301.7701-2(b).

c) Bob contributes his partnership interest in Bob-Berhad Partners, Ltd. to an irrevocable trust (not a grantor trust under §§ 671-679) formed pursuant to California law.

i) The trust will hold the limited partnership interest and will distribute the earnings of the limited partnership to Bob. *See* Reg. § 301.7701-2(a).

ii) Same as "(i)", but the trust is empowered to and does conduct business. *See Id.* and Reg. § 301.7701-4.

iii) Same as "(ii)," but the trust elects to be taxed as a corporation. *See* Reg. § 301.7701-3(b).

iv) Same as "(i)", but the trust is revocable at will.

d) For many years Bob has run a cigar store as a sole proprietor. On the advice of his lawyer, he contributes the assets of the store to a limited liability company ("LLC"), which assures him he has no personal liability beyond what he contributes to the LLC. Can the LLC elect to be treated as:

i) A corporation? *See* Reg. §§ 301.7701-1(a)(4) and 301.7701-2(a).

ii) A partnership? *See* Reg. § 301.7701-2(a).

iii) Sole proprietorship? *Id.*

iv) Assume that Bob transfers the assets to a Ruritanian LLC (a foreign limited liability company), which assures him limited liability. He makes no tax elections of any sort. *See* Reg. § 301.7701-3(b). He is the sole owner of the LLC.

v) Same as iv). Can the Ruritanain LLC elect to be taxed as a partnership or sole proprietorship? *See* Reg. § 301.7701-3(a).

e) Bob has capitalized brilliantly on the cigar craze and has recently admitted thousands of customers as partners. The partnership trades on the New York Stock Exchange. Is it a partnership or something else? How is it taxed? *See* § 7704 and Reg. § 301.7701-2(b)(7).

3. ELECTION AGAINST PARTNERSHIP STATUS

Read § 761(a) and Reg. § 1.761-2(a)-(b).

Section 761(a) and the Regulations thereunder allow a partnership that is teetering on the brink of being a mere collection of individuals to elect out of Subchapter K, hence eliminating partnership status for purposes of that part of the Code. The statute identifies three situations in which this can be done: (1) where the entity operates solely as an investment vehicle, (2) where it operates solely for the joint extraction or joint use of property, or (3) where securities dealers join forces to engage in a particular underwriting transaction.

The first and third cases are easy to understand. The second case is designed to assist passive co-owners of oil, gas or mineral properties who depend on an active operating company for their revenues. This avoids the need to file partnership tax returns and permits the co-owners to make specialized individual elections. For example, electing out of partnership status may allow a partner to make an otherwise impermissible like-kind exchange of partnership interests. The congressional quid pro quo is that in all cases it must be possible to calculate each member's individual tax liability without the need to compute "partnership taxable income." Conversely, it is possible for an enterprise that is a partnership for tax purposes to be a co-ownership arrangement for state law purposes. Such entities are known as "tax partnerships," as the next case illustrates.

MADISON GAS & ELECTRIC CO. v. COMMISSIONER

72 T.C. 521 (1979), *aff'd* 633 F.2d 512 (7th Cir. 1980)

SCOTT, JUDGE

[The taxpayer is a regulated public utility that entered into a cooperative effort to build a nuclear power plant and to share the plant's output among its three principals. There was no agreement to share profits, only to take a share of the electric output.]

The second issue in this case involves deductions claimed by petitioner as ordinary and necessary business expenses under section 162(a) for certain training costs and other expenses paid in connection with its interest in Plant 2, the nuclear power plant.

Petitioner takes the position that the amounts paid in connection with its interest in the nuclear power plant for which it claims a deduction meet all the requirements of section 162(a) for deductible ordinary and necessary business expenses and are not capital expenditures within the meaning of section 263. Petitioner argues that these expenses were incurred in carrying on its trade or business and were not "start-up costs of a new business." Petitioner's primary position is that its agreement of joint ownership of its nuclear plant with WPS and WPL does not create a partnership and that even if it does the expenses which it paid are ordinary and necessary business expenses of the partnership.

Respondent takes the position that although the expenses which petitioner seeks to deduct would be ordinary and necessary expenses in its production of electricity if the construction of the nuclear plant were solely for use in its own business, these expenses are not deductible since they were incurred as pre-operating expenses of a partnership formed through petitioner's agreement with WPS and WPL. . . .

Thus, the determination of whether expenses are related to an existing trade or 'business of the taxpayer is essential. Although the taxpayer may actively be engaged in a trade or business, the start-up costs or pre-operating expenses of another activity, not a part of such trade or business are not deductible under section 162(a) as they are not incurred in the carrying on of a trade or business.

It initially appears that all additional expenses involved in the present case were expended in the conduct of Petitioner's existing trade or business, the production of electricity. Although the means of production in the case of the nuclear facility may be radically different from conventional methods, the end product, electricity, is the same.

However, closer analysis reveals that all additional expenses claimed are in fact incurred in the initial activity of the partnership formed through Petitioner's agreement with WPS and WPL.

Respondent argues that the fact that the partners have elected under section 761(a) of the Code and section 1.761-1(a) (2), Income Tax Regs., for the partnership to be excluded from the application of Subchapter K of the Code is an admission that petitioner's arrangement with WPS and WPL is a partnership. Respondent argues that irrespective of this election the agreement and relationship between petitioner, WPS and WPL creates a partnership within the meaning of section 7701(a)(2). Respondent contends that the expenses which petitioner claims to be deductible are start-up costs which must be capitalized and not [current] expenses, relying primarily on *Richmond Television Corp. v. United States*, *supra.*

The question on which the parties initially join issue is whether the arrangement between petitioner, WPS and WPL creates a partnership as defined in section 7701. While we agree with petitioner that the fact that the partners elected under section 761(a) not to be subject to the provisions of Subchapter K is not an admission that the arrangement is a partnership, the definition of partnership contained in sections 761(a) and 770l (a) (2) are the same.5 It is therefore necessary for us to decide whether the arrangement between petitioner, WPS and WPL is a partnership as defined by section 7701(a)(2).

While petitioner denies that filing an election out under section 761(a) is an admission that a partnership exists for tax purposes, it does not contend that because of this election under section 761(a) no partnership exists for the purposes of determining what constitutes deductible expenses under section 162.

The clear import of petitioner's brief is that if we conclude that its arrangement with WPS and WLP is a partnership as defined in section 7701, then the deductibility of the expenses here involved is dependent upon whether those expenses are deductible by the partnership. Respondent makes no argument with respect to the election-out of the partnership under section 761(a) but merely cites his Rev. Rul. 65-118, 1965-1 C.B. 30. Respondent does not cite or discuss *Bryant v. Commissioner*, 46 T.C. 848 (1966), aff'd. 399 F.2d 800 (5th Cir. 1968), although in that case we in effect approved Rev. Rul. 65-118, supra, specifically pointing to the definition of partnership in section 7701(a)(2) "when used in this title" and the fact that section 48(c)(2)(D) (involved in the *Bryant* case and the revenue ruling) contained a specific provision with respect to limitations in the case of a partnership. We have found no case dealing with an election-out under section 761(a) when the controlling statute outside of Subchapter K makes no reference to partnerships. In texts on partnerships we have found

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[5] Respondent in Rev. Rul 68-344, 1968-1 C.B. 569, concludes that a venture formed by four electrical power companies substantially similar to the arrangement here of petitioner, WPS and WPL is properly classified as a partnership for federal tax purposes. The ruling then proceeds to discuss the provision of section 761(a) and concludes that the members of the venture may elect under section 761(a) to have the venture excluded from the application of Subchapter K. The parties stipulated in this case that it was the intention of the co-tenants – petitioner, WPS and WPL – that they created only a co-tenancy and not a partnership and that they be taxed as co-tenants and not partners. This stipulation is followed by the stipulated statement: To that end WPS filed a federal partnership return, Form 1065, and an election out of the provision of Subchapter K of the [Code].

statements which indicate that an election-out in such a situation is not controlled by the *Bryant* decision and other indications in the same text that it is. . . .

Since petitioner here makes no contention that an election-out under section 761(a) causes the unincorporated group not to be a partnership except for purposes of those statutes which contain a specific reference to "partnerships," we have not considered and do not here decide such a possible issue even though a question in this respect is raised by writers of texts on partnerships and a number of law review articles dealing with partnership problems.

It is petitioner's position that a profit motive of the partnership as an entity is a requirement of partnership status and that such a motive is lacking from the arrangement present in this case. Petitioner argues that only a co-ownership and expense-sharing arrangement was created from its agreement with WPS and WPL.

Petitioner notes that section 1.761-1(a), Income Tax Regs., and section 301.7701-3(a), Proced. & Admin. Regs., provide that "a joint undertaking merely to share expense is not a partnership" and that mere co-ownership of property is not a partnership. Petitioner also points out that these regulations provide that "Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof." Petitioner relies, in support of its position of the necessity of a profit motive by the entity for partnership status, on *Cooperative Power Plant v. Commissioner*, 41 B. T. A. 1143 (1940), and *Co-operative Insurance v. Commissioner*, 41 B. T. A. 1151 (1940), in which arrangements somewhat similar to those in the instant case were held not to be associations taxable as corporations because gain was not an objective of the arrangement. In our view, these cases have no bearing on whether the arrangement here involved created a partnership under the definition of section 7701(a)(2).

In addition, petitioner cites Wisconsin State law to support his view that the arrangement in this case is not a partnership. It is clear, however, that state law is in no way controlling on the question of whether an unincorporated activity is a partnership for Federal tax purposes. *Luna v. Commissioner*, 42 T.C. 1067, 1077 (1964).

Petitioner argues that respondent's Rev. Rul. 68-344, 1968-1 C.B. 569, is erroneous in concluding that an arrangement similar to the one here is a partnership. The essence of petitioner's argument is that the construction and operation of the nuclear power plant in this case is equivalent to a joint undertaking to share expenses such as that described in the regulations and therefore does not constitute a partnership. Section 1.761-1(a) and section 301.7701-3(a), Income Tax Regs., declare that "if two or more persons jointly construct a ditch merely to drain surface water from their properties, they, are not partners." In our view, petitioner's arrangement with WPS and WPL is in no way comparable to the joint construction of a drainage ditch.

Prior to 1954, the following definition of a partnership for Federal tax purposes was found in section 3797(a)(2), I.R.C. 1939:

(2) Partnership and Partner. The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. . . .[6]

As petitioner points out, it has long been recognized that mere co-ownership of property will not create a partnership. *Estate of Appleby v. Commissioner*, 41 B.T.A. 18 (1940). In that case co-owners of inherited property, at the suggestion of automotive dealers, erected a garage on the property and rented the space to defray the expenses of owning the inherited property, primarily real estate taxes. We held that the erection and renting of the garage was not a group, joint venture or other organization within the partnership definition of the 1939 Code. Whether co-ownership of property gives rise to a partnership for Federal tax purposes is determined by "the degree of business activities of the co-owners or their agents. . . ." *See Hahn v. Commissioner*, 22 T.C. 212 (1954), which held the requisite activities not to be present. The regulations set forth this test in slightly different words and it is the wording of the regulations as interpreted by petitioner, which it would have us follow in equating the construction of a drainage ditch with the construction and operation of a nuclear power plant. Section 1.761-1(a), Income Tax Regs., and section 301.7701-3(a), Proced. & Admin. Regs., as noted above, declare that "Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof." Petitioner, relying on this regulation, contends that a partnership must have a profit motive for the partnership entity and that, because petitioner received the electricity from the nuclear power plant in kind, such a profit motive did not exist in its arrangement with WPL and WPS. We do not agree.

First, the statute does not require a profit motive; rather it merely requires "an unincorporated organization, through or by means of which any business, financial operation, or venture is carried on . . . " The business activity or profit motive test is important in distinguishing partnerships from the mere co-ownership of property. However, this test is not the only test for what constitutes a partnership for Federal tax purposes. Second, the test of business activity or profit motive for purposes of finding a Federal tax partnership is clearly met in the situation at hand where a group of business organizations decide to band together to produce with economies of scale a common product to be distributed to the members of the venture in kind. In *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565, 571 (1953), we found without any extended discussion that an organization formed to extract oil under an operating agreement which called for distribution of the oil in kind was a partnership for Federal tax purposes. The agreement in the *Bentex* case was analogous to the agreement in the instant case. That an agreement such as the one here under consideration creates a partnership is implicit in the holdings in *Cooperative Power Plant, supra, and Cooperative Insurance, supra* . . . Joint construction of a drainage ditch simply does not require the business activity or

[6] The definition was first placed in the Code by sec. 1111(a)(3) of the Revenue Act of 1932. The purpose of this provision was to broaden the Federal partnership definitions to include therein a number of arrangements that under state law were not partnerships, such as joint ventures. *See* S. Rep. No. 665, 72nd Cong., 1st Sess. (1932), 1939-1 (Part 2) C.B. 496, 538. In the 1954 Code, this definition of partnership was unchanged and is contained in the following two sections: section 761(a) and section 7701(a)(2).

contain the profit motive found in the joint extraction of oil or the joint production of electricity by a nuclear power plant.

Following the *Cooperative* cases and the *Bentex* case, Congress reenacted the definition of partnership in the 1954 Code. In addition to carrying the definition forward in section 7701(a)(2) without change, Congress also placed the definition within Subchapter K, section 761(a), with the added caveat allowing certain organizations to elect to be excluded from the application of Subchapter K. Section 761 (a) reads as follows:

(a) Partnership. For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this Subchapter, if it is availed

(1) for investment purposes only and not for the active conduct of a business, or

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

If distribution in kind of jointly produced property was enough to avoid partnership status, we do not see how such distribution could be used as a test for allowing an election to be excluded from the partnership provisions of Subchapter K. Although there is no discussion of the reason for the "election-out" provision of section 761(a) in the legislative history of the section, it has been generally considered that this provision was enacted as Congressional approval of the *Bentex* case coupled with a recognition of the hardships caused by that decision.[7]

In sum, we hold that petitioner's arrangement with WPS and WPL was an unincorporated organization carrying on a business, financial operation or venture. To the extent a profit motive may be required for an unincorporated organization to be a partnership for Federal tax purposes, we hold that it is present in this case with the in kind distribution of electricity produced by the nuclear power plant.

NOTES

1. **IRS position**. The IRS continues to believe that joint production for separate sale is the same as "joint profit." *See* Flower & Holbrook, *Partners and Co-owners: The Use of Undivided Interests in Equipment Leasing,* 41 Tax Law. 733 (1988). Naturally, this conclusion has no bearing on whether there is a partnership for state law purposes.

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[7] Thus, Congress afforded such organizations an election to be excluded from the provisions of Subchapter K. Petitioner makes some interesting arguments as to the policy reasons for not penalizing it because economies of scale have forced it to combine forces with other utilities to enjoy the advantages of nuclear power. These arguments, however, are misplaced with respect to the question of the definition of a partnership. Instead, they should have been addressed with respect to the effect of the sec. 761(a) election to be excluded from the application of Subchapter K. . . .

2. **The "tax partnership."** Note that the product of the *Madison Gas* case is a so-called tax partnership, an entity that is a co-ownership at state law, but a partnership for federal income tax purposes. These are common in the oil patch, where they are used in connection with joint oil and gas operating agreements. The advantages are: no need to negotiate a partnership agreement; a simple (often one page) agreement as to allocations; ability of each owner to encumber his or her own interest (as opposed to the difficult process of encumbering a partnership interest); and no participant with unlimited liability. If the partnership in *Madison Gas* had managed to elect out of Subchapter K, it would then have been a co-ownership for federal income tax purposes as well.

3. **Expense sharing.** What if the taxpayer's deal with the other two utilities had merely involved sharing expenses for maintaining a common facility? Clearly, there would be no partnership because there would be no sharing of revenues in cash or in kind. Reg. § 301.7701-3(a). What if they shared revenues from a commonly-owned rental property? Now it is getting more difficult. However, the same regulation tells us that there is still no partnership, but that if the co-owners provide significant services to the tenants in connection with renting the property, there is a partnership. *Id.*

4. **Failure to file by small partnerships**. Small partnerships often fail to file their federal income tax forms. Section 6698 of the Code imposes a $50 per partner penalty on failure to file a partnership return, but contains a built-in loophole in that it excuses the penalty if there is reasonable cause for nonfiling, and Rev. Proc. 84-35, 1984-1 C.B. 509 presumes the existence of reasonable cause if the miscreant is a domestic partnership with not over ten partners, all of whom are U.S. individuals (or their estates) who have adequately reported their shares of the partnership's profits or losses, and each partner reported a simple pro-rata share of each item of partnership income, deduction, and so forth. That probably wipes thousands of simple partnership returns off the tax rolls.

5. **Lack of coordination with Subchapter K.** The entity-aggregate distinction can be a serious problem when partnership tax issues overlap with non-partnership tax law questions. The explanation is fairly simple. Congress does not always consider the impact on the partnership rules when a new tax provision is added or an old one is tampered with. Indeed, it may take years for the lack of coordination between the partnership tax law and some other part of the tax law to show up. In general, it is usually best to apply the aggregate approach to partnerships outside of Subchapter K unless there are strong policy reasons not to do so.

6. **The lack of coordination between Subchapter K and the rest of the Code is chronic.** To take just a few simple examples, under § 453A there is an interest charge when a non-dealer sells property on the installment obligation for a price exceeding $150,000 if the seller also has total installment obligations outstanding at year end in excess of $5 million. § 453A(b)(1)-(2). The IRS asserts that the $5 million threshold is applied at the partner level. Notice 88-81, 1988-2 C.B. 397. By contrast under § 179(d)(8), annual expensing of $250,000 (for 2008) under § 179 is explicitly limited at both the partner and partnership levels. (Here, the IRS does not have to assert; it *knows.)* Thus, if a ten-person equal partnership had $40,000 of § 179 expenses, the partners would each report only $4,000.

4. RETROACTIVE AMENDMENTS OF PARTNERSHIP AGREEMENT

The partnership agreement generally controls the tax incidents associated with being a partner, but what if the agreement is amended? Can the amendment have retroactive force? Perhaps surprisingly, § 761(c) declares that the controlling agreement can be amended as late as the prescribed filing date for the entity's federal tax return (March 15 for a calendar year partnership), as long as the amendment is valid under local law. This means that the partners can wait up to the filing date to modify the agreement and, subject to some limits to be discussed later in this book, have the modifications stick for the year reported on the tax return. Reg. § 1.761-1(c). However, extensions of time granted to extend the filing date cannot extend the mandatory cut-off date for amending the partnership agreement.

D. IRS AUDITS

Prior to the enactment of §§ 6221-6232 in 1982, partnerships posed serious examination and collection problems for the IRS because the Service had to investigate and dispose of the liabilities of the partners one-by-one. Nowadays, they are disposed of as a group, except for partnerships with ten or fewer partners.

There are three key features to the new system. The first is that each partnership that is subject to "unified audit proceedings" must have a so-called "tax matters partner." That is the general partner identified in the partnership agreement, or if no partner is designated, then the partner with the largest profits interest. § 6231(a)(7). The tax matters partner faces off against the IRS in the audit process. The second key feature is the opportunity for minority partners who collectively have at least 5% of the profits to gang up and form their own group, which becomes a separate force in dealing with the audit. § 6223(b). The third factor is that each partner is obligated to report items that appear on the partnership return consistently on their personal returns, or else notify the IRS of the inconsistency. § 6222. The details are ornate. This is only a thumbnail sketch.

IRS audit adjustments flow through to each partner, because the partnership is just a reporting entity and does not incur federal income tax liabilities.

PROBLEM 1-2

Travis H. Harbaugh and his family own a productive oil and gas property operated by an unrelated oil company. The family elects out of partnership status under § 761(a) and Reg. § 1.761-2(b). The family members own the property as tenants-in-common, and they are legally free to dispose of their individual interests. Absent the election out, the Harbaugh family's arrangement is a partnership for federal income tax purposes. Travis is the 60% partner/owner, and each of his other family members has 10% of the oil-producing property.

a) Can each owner use his or her own tax year (*i.e.*, a calendar year) to report the profits or losses from the property regardless of the tax year used by the partnership (*i.e.*, suppose that the partnership uses a fiscal year)? *See* § 706(b)(1)(A).

b) Prior to the election out, does the Harbaugh family's arrangement constitute a "tax partnership"?

c) Can Travis engage in a tax-free exchange of his interest in the real estate under § 1031?

d) In Rev. Rul. 58-465, 1958-2 C.B. 376, the IRS ruled that an election out could not affect the limitation found in § 704(d). Is the ruling still viable?

e) Assume there is no election out and that in year 2 the family decides it wants to alter the partnership agreement. Assuming the partnership uses a calendar year tax year, must the amendment be made by March 15, the usual latest filing date for filing its partnership return, or can it be amended after that? *See* Reg. § 1.761-2(b).

f) Assuming there is no "election out" and there is no provision for a specific tax matters partner, is Travis the tax matters partner by default?