Notable Partnership Articles From 2013

By Bradley T. Borden

The partnership tax articles published in student-edited journals in 2013 once again provide broad coverage of important partnership tax matters. They tackle some timely issues and other seemingly timeless ones. For example, one article discusses the cost of guaranteeing partnership liabilities, which involves issues raised in recently proposed regulations. Two articles address the tax treatment of publicly traded partnerships (PTPs) and recommend reform to help reduce some perceived abuses. One of them uses the Blackstone Group LP public offering as a case study. Two other articles examine the anachronistic definition of limited partner in the self-employment setting, discounts for interests in family-controlled tax partnerships, and distributions from tax partnerships.

Allocation of Partnership Liabilities

A few years ago, in Canal Corp. v. Commissioner, the Tax Court disallowed an allocation of a partnership liability to the purported guarantor of the liability. The guarantor voluntarily offered the guarantee as part of a fairly elaborate financing arrangement. The Tax Court’s decision to disregard the allocation of the liability depended in part on the small likelihood that the guarantor would ever be called upon to satisfy it. The holding has drawn criticism by members of the partnership tax bar. Nonetheless, the court’s focus on a partner’s likelihood of satisfying a liability is not without merit. By assuming no more than a remote possibility of having to satisfy the partnership’s liability, the guarantor in Canal Corp. would have been able to avoid the tax consequences of a disguised sale and reap the tax benefits of not reporting gain on it.

In other situations, guaranteeing a partnership liability may ensure that a partner can claim a deduction that would otherwise be disallowed because of insufficient basis in a partnership interest or because an allocation that causes a deficit capital account balance lacks economic effect. A deduction provides a tax benefit by reducing the guarantor’s taxable income. A rational person would most likely be willing to guarantee a partnership’s liability to obtain a tax benefit if the cost of assuming the liability were less than the benefit. Although determining that cost can be difficult, in many situations it appears to be relatively small compared with the benefit of taking a deduction or avoiding gain recognition. An article from 2013 presents a model...
for measuring the cost of assuming a partnership liability and thereby helps explain the significance of guaranteeing that liability.

Bradley T. Borden, Joseph Binder, Ethan Blinder, and Louis Incatasciato, ‘A Model for Measuring the Expected Value of Assuming a Tax-Partnership Liability,’ 7 Brook. J. Corp. Fin. & Com. L. 361 (2013). This article reviews the rules governing the allocation of liabilities and how those allocations can affect the deductibility of allocated losses. It describes how members of tax partnerships can shift the economic risk of loss to allocate or reallocate the partnership liability and the economic benefit that a member of a tax partnership obtains in the form of freed deductions that may result from those shifts. The principal contribution of the article is its examination of the cost that a member of a tax partnership incurs to assume a partnership liability. The article describes how the cost of guaranteeing a partnership liability is a function of the amount of the liability guaranteed, probability of partnership default, and time value of money. The combination of those factors often results in the cost of assuming a partnership liability being very low, almost always lower than the benefit of taking a deduction currently or avoiding gain recognition.

The expected cost of the default is the amount that the guarantor would have to pay multiplied by the probability of making that payment, discounted to the present value. The article discusses problems in determining the probability of default, but it also presents information about default rates for rated debt. Except for the lowest rated debt, default rates generally tend to be low. Consequently, the probability that a partnership will default on a loan is generally low, and the cost of guaranteeing a partnership liability is usually very low. To compare that cost with the current benefit from assuming the tax liability, the cost must be discounted to present value. Except when the probability of default is very high because the debt is junk, the expected cost discounted to the present value will be less than the benefit derived from taking a deduction or avoiding gain recognition.

For example, if assuming a greater share of a partnership liability provides a 35 percent tax savings in the form of a current deduction, the partnership’s probability of defaulting within five years after the assumption would have to exceed 35 percent to make the cost of assuming the larger share of the liability greater than the benefit obtained from the deduction. To put that probability in context, consider that only debt with a Moody’s rating below B had an average default rate greater than 35 percent within five years after issuance from 1983 to 2010. Because any debt with a rating of Baa or below from Moody’s is junk, the cost of guaranteeing a partnership liability generally would be significant only if the liability were junk. In all other situations, members of tax partnerships would obtain a financial benefit by assuming greater partnership liability if doing so would free up current deductions. That benefit increases considerably if the likelihood of partnership default or of making payment on the liability is low.

The court in Canal Corp. found that the probability that the guarantor would be liable to satisfy the obligation in case of default was extremely remote. The unlikelihood of the guarantor paying when paired with the unlikelihood of the partnership defaulting makes the cost of guaranteeing a partnership liability very low. Taxpayers and their advisers understand that, and they use so-called bottom-dollar guarantees to shift liabilities among members of tax partnerships, realizing that the bottom-dollar guarantor will recognize the tax benefit of the guarantee but in all likelihood will never be called upon to satisfy it. As a consequence, the guarantor gets something (the tax benefits) for almost nothing (the remote possibility of paying the liability). Treasury is, of course, well aware of that fact and has published proposed regulations in an attempt to limit the use of some types of liability allocations. The proposed regulations would recognize a partner’s obligation to make a payment (and the existence of the obligation) only if an arrangement satisfies the following requirements:

1. the partner or a related person is required to maintain a commercially reasonable net worth throughout the term of the payment obligation or is subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration;

2. the partner or a related person is required to periodically provide commercially reasonable documentation regarding its financial condition;

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7A guarantee of an amount of a partnership liability that is a fraction of the value of partnership assets, which obligates the guarantor to pay only if the assets lose almost all their value.

8REG-119305-11.
3. the term of the payment obligation does not end before that of the partnership liability;

4. the payment obligation does not require that the primary obligor or any other obligor of the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds his reasonable needs;

5. the partner or related person received arm’s-length consideration for assuming the payment obligation; and

6. for a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of its payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.9

Those recognition factors appear designed to ensure some likelihood that the guaranteeing partner ultimately will have to pay a partnership liability, if the partnership defaulted. The proposed regulations do not attempt to quantify a minimum likelihood, but because a partner would have to satisfy all the factors listed above, the prospect of being obligated to make a payment is real. The partner’s likelihood of paying a partnership liability is different from the partnership’s likelihood of defaulting on an obligation, the latter of which was the focus of the article. The article and proposed regulations thus suggest that the likelihood that a partner will ultimately be called upon to satisfy a liability is a function of the probability (1) that the partnership will default, and (2) that the guaranteeing members of the tax partnership will have to make a payment. With bottom-dollar guarantees and high-quality debt, the likelihood that a partner would ever be obligated to pay a portion of the liability would be miniscule, so the cost of the guarantee would be very small. A partner would provide that guarantee to obtain a virtually cost-free tax benefit.

The proposed regulations do not, however, explicitly examine the relationship between the cost of guaranteeing a partnership liability and the benefit the guarantee provides. Tax law should not provide a guaranteed tax benefit in the form of freed-up deductible losses if the cost of guaranteeing a liability is almost nonexistent because the probability of having to pay the liability is so small. The proposed regulations take a step toward finding a workable solution for allocating partnership liabilities, but a multifactor approach is not without weaknesses.10 Surely this area of the law is in its infancy, and the proposed regulations are a mere shadow of changes to come.

Publicly Traded Fund Manager Partnerships

The number of PTPs appears to be growing, so it is fitting that they found their way into academic journals this past year. Now that an article has broken the ice in academic journals, perhaps others will follow.

Emily Cauble, ‘Was Blackstone’s Initial Public Offering Too Good to Be True?: A Case Study in Closing Loopholes in the Partnership Tax Allocation Rules,’ 14 Fla. Tax Rev. 153 (2013). The tax treatment of PTPs is an uncommon topic in academic journals. So it was especially nice to see professor Emily Cauble’s article published last year. Despite the growing use of PTPs, Cauble cautions against their expansion. She uses Blackstone as an example of potentially deleterious consequences of extending flow-through taxation to a broader range of publicly traded entities.

Blackstone owns interests in several subsidiary partnerships and corporations. Those subsidiary entities own interests in other partnerships, which are various private equity, real estate, and hedge funds. The subsidiary entities receive both carried interest and management fees from the funds. Amounts allocated to the subsidiary partnerships retain their character and flow through in that character to the Blackstone public investors. Amounts allocated to the subsidiary tax corporations are subject to tax at the corporate level, and Blackstone reports those allocations as gross income only if the subsidiary corporations make dividend payments to it. The funds allocate the income to the subsidiary entities in a way that maximizes the benefits of the PTP rules.

Partnerships whose interests are traded on established securities markets or readily tradable on a secondary market are generally taxed as corporations.11 That general rule does not apply, however, if at least 90 percent of a partnership’s income is qualifying income — income from dividends, interest, real property rentals and sales, oil and gas operations, and the sale of capital assets (that is, passive income).12 Management fees allocated to Blackstone’s subsidiary entities are not qualifying income because they represent compensation for

9Prop. reg. section 1.752-2(b)(3)(ii).


11See section 7704(a).

12See section 7704(c).

13See section 7704(d).
services, not passive income. Income from the carried interest may consist of one or both of qualifying and nonqualifying income. To ensure that Blackstone avoids the general tax corporation classification under the PTP rules, the funds allocate the qualifying income portion of the carried interests to the subsidiary partnerships. That income flows through to Blackstone as qualifying income that does not disrupt its flow-through status. The funds allocate the remaining portion of the carried interests and the management fees to the corporate subsidiaries, which must report and pay tax on those allocated amounts.

Any dividends distributed by the corporate subsidiaries to Blackstone would come within the definition of qualifying income, so Blackstone would meet the 90 percent test and retain flow-through status.

Cauble is critical of the tax treatment given to Blackstone. She recognizes that without the subsidiary partnerships and corporations, Blackstone’s qualifying income would be significantly less than 90 percent of its total income, and it would therefore not qualify for flow-through taxation. She confirms, however, that the nonqualifying income allocated to the subsidiary corporations is subject to corporate taxation, and dividends paid by those entities are subject to a second level of tax. Consequently, the Blackstone structure allows qualifying income to flow through to its members tax free but subjects nonqualifying income to an entity-level tax. Cauble’s concern is that “if Blackstone Group LP earned directly the income to which it is entitled, less than 90 percent of Blackstone Group LP’s income would consist of qualifying income, and, as a consequence, Blackstone Group LP would be treated as a corporation for tax purposes.” Thus, the structure allows Blackstone to receive income from the funds and retain flow-through status, which would be unavailable to it without the structure. That result troubles Cauble.

Others might be troubled by the structure because tax law appears to require a partnership to create a complicated ownership structure and jump through several unnecessary and inefficient hoops to obtain tax treatment that the law seems to condone. Tax law appears to allow the flow-through of passive income and require the double taxation of all other income of publicly traded entities. The Blackstone structure achieves that result. Congress had clear concerns about granting flow-through tax treatment to all PTPs, so it provided generally that they should be subject to corporate tax. Nonetheless, it carved out an exception for partnerships that derive almost all of their income from passive sources.

Cauble uses a fairly technical analysis of the law to illustrate that the partnership tax allocation rules are likely insufficient to require a reallocation of the fund income to overcome the result of the Blackstone structure. That is unsurprising because the test for substantial economic effect (substantiality in particular) is almost impossible to apply, and determining whether allocations are in accordance with partners’ interests in a partnership is probably impossible in most situations. Consequently, Cauble recommends that the IRS challenge the structure using section 482. Her technical argument for using section 482 appears to be sound, but it does not answer why disallowing this structure is a better idea than sanctioning it or providing for the economic equivalent explicitly through a law that allows the separate treatment of income. A look at the legislative history of the PTP rules illustrates the law’s purpose.

Congress identified four reasons for generally treating PTPs as corporations: (1) the proliferation of PTPs has generated concern about the long-term erosion of the corporate tax base; (2) PTPs resemble publicly traded corporations in their business functions and in the way their interests are marketed; (3) limited partners resemble corporate shareholders as a practical matter; and (4) the availability of PTPs as an alternative to corporations creates an unintended unfair competitive advantage for some types of businesses. Regarding the fourth reason, Congress was concerned that “mature businesses with a steady cash flow, [which] can be marketed effectively as publicly traded partnerships because of the tax-advantaged yield, are unfairly favored over start-up companies or those with high capital expenditures, which cannot take advantage of the publicly traded partnership structure.”

The analysis of the Blackstone structure should consider the concerns Congress had when it enacted the PTP rules. If the structure is consistent with the purposes for granting flow-through treatment to some PTPs, it should qualify for that treatment.

Congress’s third reason reflects the entity classification rules that were in effect in 1987 but no longer exist. At that time, the Kintner regulations governed entity classification and applied a version of the corporate resemblance test that considered

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If a fund has income from non-U.S. sources, it will generally allocate that income to a foreign corporate subsidiary, which does not pay U.S. income tax on the income.
factors such as continuity of life, centralized management, limited liability for members, and free transferability of interests.\textsuperscript{18} Congress cited those factors in the legislative history accompanying the PTP rules.\textsuperscript{19} The corporate resemblance and multifactor tests were abandoned in 1997 with the promulgation of the check-the-box regulations.\textsuperscript{20} That makes Congress’s third reason irrelevant today. Because tax law no longer uses entity attributes to classify entities generally, arguably, those attributes should not factor into the distinction between PTPs taxed as corporations and those that qualify for flow-through taxation. Consequently, any current rationale for the distinction must lie in the first, second, or fourth reason.

The first reason focuses on erosion of the tax base. Granting flow-through taxation to Blackstone would not appear to necessarily lead to erosion of the corporate tax base. If Blackstone did not qualify for flow-through taxation, the publicly traded structure, with its entity-level tax, might not appeal to investors, so it would exist only in a private format. Because this is not the type of business that is commonly publicly traded, the threat of other publicly traded companies (other than private equity funds) changing their entity structure is small. Consequently, the first concern does not support an entity-level tax on Blackstone.

The second reason focuses on the business functions of PTPs and the manner in which those interests are marketed. The interests of all PTPs are marketed similarly, so that concern should be irrelevant in distinguishing between PTPs that are subject to corporate tax and those that are not. Business functions, however, appear relevant to the distinction. Congress retained flow-through treatment for PTPs that have income from passive sources because there is less reason to treat them as corporations, either because investors could earn that income directly or because the income is already subject to corporate-level tax. Thus, if a partnership’s business functions had produced mainly passive income, Congress would have been unconcerned about it being subject to corporate tax. Congress recognized that interest income derives from the type of investment that an individual could own and earn from directly, so it did not see fit to subject that income to entity-level taxation. Because dividends are subject to double tax, Congress was unconcerned about imposing another layer of tax on PTPs that held corporate stock. The analysis of the Blackstone structure and its tax treatment should examine whether Blackstone’s business functions are similar to those of publicly traded corporations subject to an entity-level tax or more like those of partnerships that qualify for flow-through taxation.

That analysis is complicated, however, by uncertainty about the nature of the business functions of a private equity fund. For example, the First Circuit’s recent holding that a private equity fund carried on a trade or business suggests that much of the fund’s income may not be the passive type that Congress looks for in granting an exception to the corporate tax treatment of PTPs.\textsuperscript{21} Although the court did not address the nature of the private equity fund for federal income tax purposes, it relied on the federal income tax definition of trade or business, and the decision raises the question whether private equity funds engage in active trades or businesses.\textsuperscript{22} If Blackstone and other private equity funds in fact carry on the trade or business of managing acquired companies, Blackstone would appear to have the type of business function that Congress intended to be subject to corporate tax.

Another question is whether the carried interests are simply disguised management fees that should be taxed at ordinary rates.\textsuperscript{23} If that question were answered unfavorably to Blackstone and other private equity funds, they would have almost no qualifying income and would not qualify for the flow-through exception to the PTP rules. Those are questions that the PTP rules don’t answer, and, until they are addressed, the assumption appears to be that private equity funds do not engage in a trade or business and that the nature of carried interest income is determined at the partnership level of the partnership that generates the income. Until the law answers those questions differently, private equity funds like Blackstone do not appear to have the business functions of most publicly traded corporations.

\textsuperscript{18}See reg. section 301.7701-2 and -3; and T.D. 6503. See also Steven A. Dean, “Attractive Complexity: Tax Deregulation, the Check-the-Box Election, and the Future of Tax Simplification,” 34 Hofstra L. Rev. 405 (2005) (recounting the history of the entity classification rules).


\textsuperscript{20}See reg. section 301.7701-2 and -3; and T.D. 8697.
likely have to raise the tax on flow-through income. Congress’s second reason doesn’t appear to justify an entity-level tax today.

Congress’s fourth concern could be viewed either as a reason to subject Blackstone to entity-level tax or as support for not imposing it. Blackstone is an established firm and can use its size to tap into public funds. Other private equity firms do not have that luxury, so Blackstone has an advantage over them. It would argue, however, that the structure provides the opportunity for a broader cross section of society to invest in private equity. Thus, that factor appears to be a tossup at best.

Because the purpose of the PTP rules seems to favor flow-through tax treatment of Blackstone, the structure does not appear abusive. Blackstone has found a way to split income in such a way that the passive income flows through to the members tax free, as allowed under the PTP rules, and the non-passive income is subject to double taxation as required by the PTP rules. The private ordering of that tax treatment does not appear abusive based on the history of the PTP rules. Still, the application of the partnership tax rules to PTPs can be difficult and may warrant different treatment.

The potential for frequent transfers of partnership interests generally complicates the application of partnership tax to PTPs. Partnerships must track built-in and reverse built-in gain and loss and allocate them to the appropriate partners. If partnership interests change hands frequently, as they could with PTPs, partnerships will have great difficulty applying those rules accurately, and gain and loss could be allocated in a manner inconsistent with partnership flow-through taxation. The rules are especially difficult to apply if a partnership holds depreciable property. Unsurprisingly, therefore, the application of flow-through rules to large partnerships is susceptible to criticism. Those concerns might form a better basis for arguing against granting flow-through treatment to PTPs.

Karen C. Burke, ‘Passthrough Entities: The Missing Element in Business Tax Reform,’ 40 Pepp. L. Rev. 1329 (2013). Professor Karen C. Burke also takes note of the Blackstone structure and considers whether public trading of an entity should be the demarcation line between entity taxation and flow-through taxation. She considers those matters in the context of the current corporate tax reform proposals, which generally seek to lower the corporate tax rate and broaden the corporate tax base. To fund a lower corporate tax rate, Congress would most likely have to raise the tax on flow-through income or subject more of it to the corporate tax, Burke observes. Owners of flow-through entities and the partnership tax bar would undoubtedly oppose any law that subjected flow-through income to higher taxes.

A lower corporate tax rate and integration of corporate and individual rates would help eliminate the double tax imposed on corporations. Burke recognizes, however, that if the corporate tax rate becomes lower than the individual tax rate, individuals could use corporations to shelter income. They would prefer to have corporations earn and retain income at the lower corporate rates instead of having it flow through to the members subject to the higher individual rates. The lower corporate rates would also encourage shareholder-owners to disguise compensation as dividends, requiring a more rigorous look at the rules governing the classification of compensation for employment tax purposes.

A lower corporate rate without some changes to flow-through taxation makes other reform alternatives seem more attractive, so Burke considers the possibility of subjecting large flow-through entities to corporate taxation. She acknowledges that size alone does not distinguish publicly traded entities from private entities because some private entities are much larger than some publicly traded entities, in which case the larger private entity would have access to flow-through taxation. Nonetheless, the larger size of some entities, with the possibility of frequent transfers of interests, complicates the application of the rules.

Burke says that the continued expansion of PTPs and the growth of private equity signal a need to rethink the public trading line that separates entities subject from those not subject to corporate taxation. Her concerns mirror those raised by professor Andrea Monroe in her work25 — namely, proponents of flow-through taxation tend to overlook the abusive use of it to create shelters and drain revenue from corporate and individual tax bases. Reform of flow-through taxation often results in greater complexity, with little evidence that the changes deter tax-motivated planning. Burke therefore suggests an entity-level tax to enhance efficiency and improve compliance (by requiring tax collection from fewer entities instead of from all the individual members of those entities).

Large partnerships have difficulty complying with all the technical rules of flow-through taxation, and Burke is concerned that some types of tax

24See section 704(c).

partnerships operate under special rules outside subchapter K. She finds unconvincing the argument that managers of widely held partnerships are unfamiliar with their members’ individual profiles, so they cannot structure affairs to benefit any particular member. She is therefore critical of the aggregation method used by securities partnerships to allocate built-in gain and loss. She is also critical of those entities’ use of so-called stuffing allocations. Consequently, Burke suggests that tax law consider imposing an entity-level tax on some securities partnerships as well as PTPs.

That broader reform may be the most appropriate way to address the many issues that flow-through taxation raises, but U.S. tax advisers would most likely find ways to exploit the new regime to reduce taxes. Then again, there is much less abuse of flow-through tax rules in jurisdictions such as Canada that have integrated corporate and individual taxes, so perhaps corporate tax reform could help reduce flow-through tax abuse.

Definition of Limited Partner

The student-edited articles from a couple of years ago included professor Kristin Balding Gutting’s call for a statutory reform of the section 469(h)(2) per se limited partner rule. Treasury has since proposed regulations that would address the issues raised in Gutting’s article and would define a limited partnership interest based on managerial rights. Even though tax law refers to limited partners in many provisions, most of them predate the state law changes in the last few decades that give more managerial authority to members of tax partnerships who have limited liability. Congress needs to consider further changing tax law to better reflect the current state of affairs in state law. Two recent articles make recommendations along those lines regarding the limited partner rule in the self-employment tax.

David W. Mayo and Rebecca C. Freeland, ‘Delimiting Limited Partners: Self-Employment Tax of Limited Partners,’ 66 Tax Law. 391 (2013); and Laura E. Erdman, Note, ‘Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base,’ 70 Wash. & Lee L. Rev. 2389 (2013). These two articles have much in common. They both do a wonderful job of recounting the history of section 1402(a)(13), which provides that allocations to limited partners generally are not included in the computation of the limited partners’ self-employment tax base. They also recount the development of state law, which has resulted in the proliferation of limited liability companies and limited liability partnerships, and the changes in many state laws to allow limited partners to participate in partnership management without jeopardizing their limited liability shield.

In light of those changes, the IRS in 1997 attempted a regulatory amendment to the section 1402(a)(13) definition of limited partner to extend it to members of other entities, but Congress intervened. The articles provide excellent reviews of the IRS’s attempt to promulgate those regulations and the congressional response, which appears to leave the law unchanged. In the self-employment tax’s current state, however, its application is inconsistent and inequitable. The definition of limited partner in section 1402(a)(13) and other provisions is also anachronistic. Consequently, the definition is in need of repair, and both articles suggest a similar fix.

Part of the impetus for each article also appears to be the Tax Court’s decision in Renkmeyer v. Commissioner. In that case, three lawyers were the partners of an LLP law firm, and almost all of the firm’s revenue was from the partners’ legal services. The law partners also formed an S corporation (which was wholly owned by the lawyers’ employee stock ownership plan) to be a partner, but the court disregarded the firm’s allocation of income to the S corporation. One question presented by the case was whether the allocations of partnership income to the law partners should be included in their self-employment tax base. The court found that the members of an LLP not only have limited liability, but also provide management services. The court also recognized that to become an LLP, a general partnership typically files a statement of qualification with the secretary of state.

The Tax Court said that Congress intended for the section 1402(a)(13) definition of limited partner to extend only to partners who do not actively participate in the partnership’s business operations. When it enacted the provision, Congress was concerned that some public employees would invest in limited partnerships to receive income credits toward Social Security coverage. Lawmakers intended section 1402(a)(13) to prevent that use. They wanted to ensure that people with labor income qualified for the benefits and that limited partners did not perform services for limited partnerships. Based on that history of the provision, the Tax Court


27 See REG-108369-10; and prop. reg. section 1.469-5(e)(3)(i).

Morse reports that the tax losses resulting from the loss of flow-through taxation for losses typically recognized by those businesses following start-up. Morse focuses on why start-ups forgo both benefits, but this review focuses on her discussion of lost flow-through benefits.

Path dependency appears to be the predominant reason start-ups continue to incorporate in Delaware despite the loss of significant tax benefits they could obtain by using a tax partnership. For example, venture capitalists insist that start-ups incorporate in Delaware, so entrepreneurs incorporate there to qualify for venture capital funds. Morse reports that part of that path dependency derives from the attorneys who serve as gatekeepers for start-ups. Because attorneys form Delaware corporations regularly, they are familiar with Delaware law and have the documents for creating them. The frequent use of Delaware corporations and familiarity with Delaware law drive down the cost of forming those entities to $2,000 to $3,000 per start-up. Attorneys estimate that the cost to form an LLC, on the other hand, could be as much as $10,000. Because start-ups often lack significant resources, forming an LLC at the higher cost can be cost prohibitive. Business owners and investors also heed the advice of their attorneys, who generally recommend that start-ups form as Delaware corporations. Finally, even though corporations have tax costs, investors understand and know about those costs and appear willing to accept them. The primary reason start-ups incorporate in Delaware therefore appears to be purely one of path dependency, with attorneys, as gatekeepers, recommending Delaware corporations and reinforcing that dependency.

Morse appears to be spot on with her analysis and reporting, but the practices and decision-making in this area are somewhat surprising. Business and property owners all across the country use LLCs regularly, including those who are just starting a business. Many of them would lack the resources to pay $10,000 to form an LLC. Nonetheless, attorneys who represent small businesses have developed templates that they use to form LLCs for their clients at less than $10,000. Because they can develop those systems, attorneys who represent start-ups should be able to quickly reduce the cost of LLC formation if clients decide to use LLCs instead of corporations.

The absence of significant analysis of noncorporate entities may also be partly to blame for attorneys’ hesitancy to recommend them to clients. Morse points out that attorneys and investors understand the concept of corporate stock and can grasp the distinction between common and preferred stock. If commentators, including academics, began to devote more time to LLCs, it might become easier to understand the capital structure of LLCs.
those entities, and the language and structure of LLCs might become as common as that of corporations. Arguably, the efficient markets cannot be denied forever. LLCs will eventually overtake Delaware corporations as the entity of choice if the lost tax benefits truly are in the billions of dollars.

Distributions and Dispositions of Interests

“Complex” is a common descriptor of partnership taxation. The articles that address distributions from tax partnerships illustrate and analyze that complexity.

Daniel L. Simmons, ‘The Tax Consequences of Partnership Break-Ups: A Primer on Partnership Sales and Liquidations,’ 66 Tax L. 653 (2013). In this article, professor Daniel Simmons provides a comprehensive description of the tax treatment of distributions from tax partnerships and transfers of tax-partnership interests. It is a must-have desk reference for anyone practicing partnership taxation. Its 79 pages affirm the complex nature of the law governing distributions and dispositions. Simmons clearly explains the tax treatment of disposi-
tions of tax-partnership interests, liquidations, and nonliquidating distributions. The article includes in-depth coverage of the section 754 election and basis adjustments under sections 734 and 743. It also covers the effect of section 751 on the character of gain recognized by a selling partner and on the potential gain recognition of a distributee. The sheer length of the article is a testament to the complexity of this area of the law. On cue, Monroe (even though her article appeared before the publication of this one) writes critically of the complex nature of the distribution and disposition rules.

Andrea Monroe, ‘Taxing Reality: Rethinking Partnership Distributions,’ 47 Loy. L.A. L. Rev. ___ (Winter 2013) (forthcoming). Monroe writes critically of the complex nature of the partnership distribution and disposition rules. She recognizes that tax law has multiple sets of rules governing distributions. Among them are the general rule that allows for tax-free distributions; the anti-mixing-bowl rules, which impose tax on some distributions; and the section 751 rules, which impose tax on distributions that involve specific types of property that generate ordinary income. Monroe demonstrates how those multiple sets of rules create complexity and provide an opportunity for well-advised tax partnerships to use the rules to reduce tax liability. She thus argues that the rules are inequitable because they provide a tax benefit to some tax partnerships but not others, and they reduce the tax liability of wealthy taxpayers. That inequity makes the rules problematic.

Monroe contends that the complexity of the rules derives from their general nonrecognition orientation. Nonrecognition of distributions gives partner-
ships the opportunity to structure transactions that are not subject to taxation, even though they are economically equivalent to taxable transactions. Congress recognized that potential and enacted several rules to help curb the use of the distribution rules for that purpose. Monroe claims that the law could be much simpler if it generally required gain recognition on distributions. Applying an aggregate theory of partnership taxation, she argues that a distribution from a partnership to a partner is an exchange of property and should therefore generally be a taxable event.

Monroe’s recommendation could simplify partnership taxation, but potentially at a cost. For instance, the article suggests that the purpose for allowing nonrecognition is to give partners flexibility in ordering their affairs. Taxing distributions could have a chilling effect on economic activity because some partnerships that would otherwise dissolve might remain intact. Business and property owners may decide not to form partnerships because dissolution could be taxable. Even though corporate tax is imposed on distributions, that fact may not justify a tax on distributions from partnerships. A recommendation to abandon the existing law would be better supported with a more thorough analysis of the theory of taxing distributions.

Moreover, Monroe’s discussion focuses on section 751 and mentions the other distribution rules in very general terms. Although the various rules deal generally with distributions, they address a diverse set of transactions. A one-size-fits-all rule may not accommodate all the issues that arise in distributions from partnerships. Further analysis of each rule and how recognition would affect it would be helpful.

Finally, the deemed exchange mechanism that Monroe describes would affect tax partnerships as well as the distributees. Her analysis did not address the tax treatment of the distributing tax partnership. Thus, the reader is left to wonder whether the tax partnership, which also does a deemed exchange under her proposal, would recognize gain or loss on the distribution. The proposed rules would have to consider how to allocate those gains and losses.

Taxing partnership distributions generally could deter some parties from forming partnerships and dissuade partners from dissolving. Those effects may prevent resources from being put to their highest and best use. For example, two parties may wish to join resources in a partnership to see how the combination will perform. If they can do so tax free and later separate tax free if the combination is unsuccessful, they may decide to test the partnership. If they face the possibility of paying tax on a breakup, they may decide that the potential tax cost

June 30, 2014 1521
makes the experiment untenable. Similarly, assume that after conducting a business together for some time, two partners decide it’s time to part ways. One of the partners would like to try something different, and the other partner would like to join with someone else who is interested in carrying on the business. If the partners cannot separate tax free, they may decide to stay together. The partner who wishes to leave may, however, be less motivated in the continuing partnership and may cause it to perform below its optimum level. Meanwhile, the person who wants to join is unable to bring new talents to the endeavor. Consequently, the tax-induced decision to not break up creates inefficiency. Any decision to invert the partnership tax distribution rules must consider those and other types of factors that a rule change would affect.

Other Topics

The remaining topics from the 2013 partnership tax articles cover the valuation of interests in family limited partnerships and charitable contributions by partnerships.

John F. Coverdale, ‘Of Red Bags and Family Limited Partnerships: Reforming the Estate and Gift Tax Valuation Rules to Achieve Horizontal Equity,’ 51 U. Louisville L. Rev. 239 (2013). Professor John F. Coverdale writes to express frustration with minority and marketability discounts that apply to transfers of interests in FLPs and family-controlled LLCs (collectively FLPs). In his view, the difference between equal amounts of assets held directly and in an FLP is tantamount to the difference between equal amounts of gold held in bags of different colors. The FLP structure has as much economic significance to Coverdale as the color of the bag has to the value of gold, so tax law should not provide a discount to FLP interests.

Because he perceives no economic significance in the FLP, Coverdale argues that the discounts granted to FLP interests violate horizontal equity by subjecting the FLP assets to a lower estate and gift tax than if they were transferred directly. He suggests that they violate vertical equity because only taxpayers with larger estates can afford to pay to form an FLP. Despite the intuitive appeal of that argument, further investigation suggests that FLPs can have economic significance, and the analysis of the discounts in FLP interests must account for differences in FLPs.

Even though family members hold FLPs, they may disagree about the ultimate disposition of the FLP assets. If they fail to agree, the discounted value of an FLP interest could reflect its actual value because the member cannot readily liquidate the interest and cannot unilaterally control the disposition of the FLP assets. That difference is very real in many situations, but Coverdale appears to brush it aside by assuming that FLP members will always vote in unison. Unfortunately, Coverdale provides nothing to support his conclusion about unified families. In fact, he reports that only 2 percent of the estates between $1.5 million and $2 million reported an FLP, and only 12.4 percent of estates with more than $20 million reported one. Those numbers suggest that the total percentage of estates that report FLPs is well below 10 percent, a fairly minuscule amount. The low use rate suggests that perhaps members of wealthy families prefer the direct transfer of assets and the payment of a higher estate tax instead of owning property jointly through cumbersome FLPs. Smaller estates would, of course, have no use of FLPs because they can pass assets tax free if the value of the assets is less than the unified estate tax credit. Those with sufficient assets to warrant the use of an FLP would have the resources to pay for one, so FLPs do not give the largest estates a benefit that other estates cannot enjoy.

FLPs find their place in estate and gift tax planning, but the notion of discounting the value of FLP interests raises a broader issue. If courts can justify discounting the value of an FLP interest, they should also consider discounting the income allocated (but not distributed) to a partner who lacks control and cannot easily liquidate his partnership interest. If the partnership does not distribute the income allocated to that partner, that income is subject to the same factors that courts rely on to grant FLP discounts. Horizontal equity would appear to justify subjecting shares of allocated, but undistributed, income to discounts that are similar to those granted in the estate and gift context. That topic is worthy of serious consideration. If courts cannot get to minority and marketability discounts of income allocated to minority members of tax partnerships, they should not be able to grant discounts for estate and gift tax purposes. The same principles should govern both situations.

Kevin A. Lucid, Note, ‘It’s a Tax Thing: The Misnamed ‘Heightened Scrutiny’ Standard for Evaluating Family Limited Partnerships,’ 26 Quinnipiac Prob. L. J. 403 (2013). In this student note, Kevin A. Lucid describes the IRS’s mostly unsuccessful attempt to bring assets back into an estate from an FLP using section 2036(a). Lucid explains that despite a so-called heightened scrutiny standard, several taxpayers have been able to demonstrate a bona fide transfer of assets to an FLP and avoid having the full value of the assets included in their estates. Unfortunately, even though academics and others dislike the discounts granted for FLP interests, taxpayers appear to have the upper hand in valuation disputes if transfers to FLPs and transfers of FLP interests are properly structured.
Nick Zemil, Note, ‘Testing a Partnership’s Contribution of Appreciated Real Property to Determine Developer or Investor Status,’ 32 Va. Tax. Rev. 841 (2013). The character of property contributed to a charity can affect the amount of the deduction that the contributor can take for the contribution. For example, a contributor generally may deduct the fair market value of contributed property, but a developer can deduct only an amount equal to the basis of the contributed property if the disposition of the property would result in ordinary income to the developer. In this student note, Zemil does an admirable job of discussing the factors courts consider to determine whether property results in ordinary income on its disposition. He also concludes that courts would apply the test at the partnership level if the tax partnership contributed the property. The article serves as a good reminder of an issue that could trip up unwary tax partnerships that are considering a charitable contribution.

Conclusion
Student-edited academic journals continue to be a good source of top-quality tax-partnership articles. The 2013 articles provide excellent insight into many important topics. Undoubtedly 2014 will produce additional insight into this important area of the law. The authors, editors, and publishers who present these articles do a great service to the profession.

29 See section 170(e)(1)(A).

Position Announcement

Executive Director, National Tax Association

The Executive Director is responsible for carrying out the policies and procedures established in NTA Bylaws and by the actions of the Board of Directors.

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- Strategic planning
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- Organization of the annual conference and spring symposium
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- Preparing and monitoring the budget
- General financial oversight and communication with the officers, board, and general membership
- Oversight of the general operations of the National Tax Journal in cooperation with the editors

Advanced degree in economics, law, accounting, public policy, or related field and 10 years of professional experience required. Additional requirements include an established record of tax policy research or experience in tax administration, experience with budget management, and excellent communication skills. Desired qualifications include fundraising and development, personnel management, conference planning, website design, and active participation in a membership organization as a board member or officer.

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