

**ALI-ABA Video Law Review  
Limited Liability Entities – 2010:  
New Developments in Limited Liability Companies  
and Limited Liability Partnerships**

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## **I. Recently Enacted Legislation.**

**A. Section 457A - Nonqualified deferred compensation plans of nonqualified entities.** Section 457A is a provision of the tax extenders and Alternative Minimum Tax Relief Act of 2008, which was enacted on October 3, 2008. In general, Section 457A represents yet another Code provision aimed at addressing perceived tax abuses associated with nonqualified deferred compensation plans. (*See, e.g.*, § 409A and § 409(p)). As a general rule, Section 457A provides that any compensation that is deferred under a nonqualified deferred compensation plan of a “nonqualified entity” is included in gross income when there is no substantial risk of forfeiture of the rights to such compensation. For this purpose, the term “nonqualified entity” means (a) any foreign corporation unless substantially all of its income is either (i) effectively connected with the conduct of a trade or business in the United States, or (ii) subject to a comprehensive foreign income tax; and (b) any partnership unless substantially all of its income is allocated to persons other than (i) foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and (ii) organizations which are exempt from tax under Title 26 of the Code. However, deferred compensation is not includible in gross income if the amount of the compensation is not determinable, in which case additional taxes apply to such compensation at the time the amount of such compensation becomes determinable and is includible in gross income.

IRS Notice 2009-8, 2009-4 IRB 1 (January 8, 2009), provides interim guidance under § 457A. The Interim Guidance addresses how to determine whether “substantially all” of a partnership’s income for a taxable year is allocated to persons other than foreign persons with respect to whom such income is not subject to comprehensive foreign income tax and exempt organizations. For this purpose, “substantially all” of a partnership’s income is treated as allocated to eligible persons with respect to a taxable year only if at least 80% of the gross income of the partnership for such taxable year is allocated to persons other than such foreign person or exempt organizations. In general, the determination of whether an entity is a nonqualified entity is made as of the last day of each of the service provider’s taxable years in which the nonqualified deferred compensation is no longer subject to a substantial risk of forfeiture and remains deferred. Whether a partnership is a nonqualified entity as of the last day of the service provider’s taxable year is determined based on the allocations of gross income by the partnership for the partnership’s taxable year ending with or within the service provider’s taxable year. To the extent a deferred amount is included in income under Section 457A before the amount is paid to the service provider, the amount is not includible in income when the amount is paid to the service provider.

If a deferred amount under a nonqualified deferred compensation plan is not determinable at the time that the compensation is otherwise includible in gross income under § 457A, then such amount is includible in gross income when the deferred amount becomes determinable. However, in the case of such deferred amount that is treated as not determinable at the time the compensation is otherwise includible in gross income under § 457A, additional taxes are imposed on such amounts when ultimately included in the service performer’s income. Specifically, the tax for the taxable year in which such compensation is includible in gross income is increased by the sum of (a) an amount equal to 20% of the amount of the compensation, and (b) the amount of interest at the underpayment rate under § 6621 plus one

percentage point on the underpayments that would have occurred had the deferred compensation been includible in gross income for the taxable year in which first deferred or if later the first taxable year in which the deferred compensation is not subject to a substantial risk of forfeiture.

Section 457A applies to amounts deferred that are attributable to services performed after December 31, 2008. In the case of any amount deferred to which § 457A would not otherwise apply solely by reason of the fact that the amount is attributable to services performed before January 1, 2009, to the extent the amount deferred is not included in gross income in a taxable year beginning before 2018, that amount deferred is includible in gross income in the later of (a) the last taxable year beginning before January 1, 2018 or (b) the first taxable year in which there is no substantial risk of forfeiture of the right to the amount deferred.

**B. Deferral of Debt Forgiveness Income on Reacquisition of Debt (Code § 108(i)).** In general, a debtor must include debt forgiveness (or discharge) in income. There are a number of exceptions to this rule including, among others, debtors in Title 11 bankruptcy, insolvent debtors, certain student loans, certain farm debt, and certain real property business debt. Generally, where discharge of debt is excluded from gross income under any of these existing exceptions to the general rule of inclusion, taxpayers generally must reduce certain tax attributes including net operating losses, business credits, minimum tax credits, capital loss carryovers and basis in property by the amount of the forgiven debt. In the case of an insolvent debtor, the amount of debt discharge cannot exceed the amount by which the debtor is insolvent (on a fair market value basis). In general, the amount of forgiven (or discharged) debt is equal to the difference between the adjusted issue price of the debt being cancelled and the amount of the debt that is paid.

The foregoing rules generally apply to the exchange of an old obligation for a new obligation including a deemed exchange that occurs by way of a “significant modification” of debt instrument pursuant to Treas. Reg. §1.1001-3. Also, a debtor that repurchases its debt instrument for an amount that is less than the “adjusted issue price” of such debt instrument realizes income equal to the excess of the adjusted issue price over the repurchase price, subject to the foregoing exceptions. In addition, debt acquired by a person who is related to the debtor (as described in § 267(b) or § 707(b)) is treated as if were acquired directly by the debtor. Consequently, if a person related to the debtor purchases the debt for less than its adjusted issue price, the debtor recognizes income (subject to the foregoing exceptions).

Act § 1231(a) of the American Recovery and Reinvestment Tax Act of 2009 provides taxpayers with a new election applicable to debt discharges in tax years ending after December 31, 2008. This new provision, contained in § 108(i) of the Code, allows a taxpayer to elect to have debt discharge income from the reacquisition of a qualifying debt instrument. For debt discharges in tax years ending after December 31, 2008, a taxpayer may elect to have debt discharge income from the reacquisition of an applicable debt instrument after December 31, 2008 and before January 1, 2011 included in gross income ratably over five tax years beginning with (i) for repurchases occurring in 2009, the fifth tax year following the tax year in which the repurchase occurs, and (ii) for repurchases occurring in 2010 the fourth tax year following the tax year in which the repurchase occurred.

One benefit of the deferral election under new § 108(i) is that it does not require attribute reduction. Consequently, in certain circumstances, the election may be more beneficial than the exclusion provided for bankruptcy, insolvency or qualified real property indebtedness. Since COD is determined at the partnership level, some partners may want COD income because they can eliminate or defer it. Others may prefer gain from a sale or exchange on account of favorable tax rates. Still others may prefer to defer the gain pursuant to § 108(i). This may raise difficult issues for the partnership.

Section 108(i) does not apply to all debt forgiveness transactions. These rules apply to any debt instrument issued by a C corporation or any other person in connection with the conduct of a business. The COD income must arise in connection with a “reacquisition” of an “applicable debt instrument.” A “reacquisition” is defined as any “acquisition” of “an applicable debt instrument” by (i) the debtor that issued, or is otherwise the obligor under, such debt instrument, or (ii) a person related to the debtor within the meaning of § 108(e)(4). For this purpose an “acquisition... shall include” an acquisition of a debt instrument for cash, the exchange of a debt instrument for another debt instrument, the exchange of corporate stock or partnership interest for a debt instrument, the contribution of a debt instrument to the capital of the issuer, and the complete forgiveness of a debt instrument by a holder of such instrument

Revenue Procedure 2009-37, 2009-36 IRB 309 provides exclusive procedures for making the election under Section 108(i):

1. Taxpayers may elect to defer COD income from “reacquisitions” of “applicable debt instruments” include ratably over a 5-year period beginning with—
  - for reacquisitions in 2009, 5th taxable year after the year of reacquisition;
  - for reacquisitions in 2010, 4th taxable year after the year of reacquisition.
2. An “applicable debt instrument” means—
  - any debt instrument issued by a C corporation; or
  - any debt instrument issued by any other person in connection with a trade or business
3. A debt instrument is any bond, debenture, note, certificate, or other instrument or contractual arrangement constituting debt under IRC § 1275(a)(1)
4. “Reacquisition” means any acquisition of the debt by the debtor or a related person (as defined under IRC § 108(e)(4)), including—
  - an acquisition of the debt for cash or other property;
  - the exchange of the old debt for new debt, including a deemed exchange resulting from a modification of the terms of the old debt (Treas. Reg. § 1.1001-3);
  - the exchange of the debt for corporate stock or a partnership interest;
  - the contribution of the debt to the capital of a corporation; or
  - the complete forgiveness of the debt.

- Rule also presumably applies to partial forgiveness of debt. [CONFIRM]

5. If, as part of a reacquisition, new debt is issued for old debt and the new debt has original issue discount, the issuer is not allowed any deduction with respect to the portion of the OID that no deduction is allowed to the issuer with respect to the portion of the original issue discount that—

- accrues before the 1st taxable year in the 5-taxable-year period in which income from the discharge of indebtedness is includible in income, and
- does not exceed the income from the discharge of indebtedness with respect to the debt instrument being reacquired, and

6. The aggregate amount of deductions disallowed under this rule are allowed as a deduction ratably over the 5-taxable-year period.

7. If the amount of the OID accruing before the 1st taxable year exceeds the income from the discharge of indebtedness with respect to the applicable debt instrument being reacquired, the deductions shall be disallowed in the order in which the original issue discount is accrued.

8. Deemed debt for debt exchanges. For purposes of these OID rules, if a new debt instrument is issued by an issuer and the proceeds of the new debt are used directly or indirectly to reacquire an applicable debt instrument of the issuer, the new debt is treated as issued for the old debt. If only a portion of the proceeds from the new debt instrument are so used, the rules apply to the portion of any OID on the new debt that is equal to the portion of the proceeds from the debt used to reacquire the old debt.

9. Taxpayers that elect deferral under these rules may not apply the bankruptcy, insolvency, qualified farm indebtedness, or QRPBI exclusions to income from the discharge of the debt for the taxable year of the election or any subsequent taxable year.

10. Deferred COD income is accelerated upon—

- death
- liquidation or sale or substantially all assets (including in a title 11 or similar case)
- cessation of taxpayer's business
- circumstances similar to the above
- for taxpayers in pass-thru entities, sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity.

11. In case of partnerships, deferred COD income is allocated to partners in partnership immediately before the discharge in the manner it would have been included in distributive shares under IRC § 704(b) in absence of election. [704(c)-like principles?]

12. Decrease in partner's share of liabilities as a result of discharge is not taken into account for purposes of IRC § 752 at time of discharge to extent it would cause partner to

recognize gain under IRC § 731. Any decrease in partnership liabilities so deferred is taken into account by partner at same time and to the extent remaining in the same amount as deferred COD income.

13. In case of S corporations, deferred income is shared pro rata only among shareholders that are shareholders immediately before reacquisition transaction

14. To elect deferral, include statement identifying applicable debt instrument with timely filed original return for year of reacquisition. Treasury has granted automatic 12-month extension to elect. See Rev Proc 2009-37. Election is irrevocable.

15. For pass-thru entities, election made by pass-thru entity. For partnerships, this contrasts with general IRC § 108 exclusions, which apply at partner level, and creates potential problems for partners that may have different tax attributes or desire different treatment (e.g., exclusion under general rules rather than deferral).

16. Newly issued guidance addresses partnership problem by allowing partial elections. See Rev Proc 2009-37.

- Taxpayers may elect deferral for any portion of COD income realized on reacquisition. May elect different portions of COD income from each debt instrument reacquired.
- Partnerships that elect to defer less than all of the COD income from reacquisition may determine in any manner the portion, if any, of a partner's COD income amount that is the deferred amount and the portion if any that is included. For example, one partner's deferred amount may be zero while another partner's deferred amount may equal the partner's COD income amount (or any portion thereof). A partner may exclude from income the partner's included amount under 108(a), if applicable.

17. New guidance also allows taxpayer to specify for an applicable debt instrument an amount greater than amount identified as deferred in event IRS subsequently concludes that taxpayer understated amount of COD income. Additional amount of COD income may be described as entire additional COD income or as a percentage of additional COD income..

18. New guidance also allows taxpayer to make a protective elections if it concludes that transaction does not result in realization of COD income. If IRS later determines that there is COD income, protective election is treated as valid, irrevocable election, and taxpayer may be required to report COD income even if statute of limitations has expired for year in which COD income was realized.

19. New guidance indicates that forthcoming regs will provide that

- Deferred COD income increases E&P in taxable year it is realized and not in taxable year or years it is included in gross income
- OID deductions deferred will generally decrease E&P in taxable year or years in which deduction would be allowed without regard to the deferral.
- CODI and OID deductions that are deferred increase or decrease adjusted current earnings under IRC § 56(g)(4) in taxable year or years income or deduction is includable or deductible in determining taxable income.
- RIC and REITs, COD income deferred generally increases E&P in taxable year or years in which COD income is includable in gross income and not in year realized.
- Deferred OID deductions generally decrease E&P in year or years OID deductions are deductible.

## **II. Proposed Legislation.**

### **A. Carried Interests (House Approved Extenders Bill - H.R. 4213)**

#### **1. Current Law – Profits Interests**

(a) Rev. Proc. 93-27 and Rev. Proc. 2001-43 provide that, potentially without an 83(b) election, a partnership interest that is not entitled to any distribution upon an immediate liquidation of the partnership and that is given for services (and meets certain other criteria) may be given and received without tax consequences to the partnership, the historic partners or the recipient. Perhaps more importantly, upon disposition of the partnership's assets, an individual holder of a profits interest may report her allocable share of the partnership's capital gain as capital gain on her own return.

(b) Proposed compensatory partnership interest regulations provided that a grant of a partnership interest for services was taxable at its fair market value on grant (or, if no 83(b) election is made, upon the elimination of transfer restrictions and any substantial risk of forfeiture). A proposed revenue procedure allowed for an election to determine this value based on rights upon an immediate liquidation of the partnership (thus, preserving the current treatment of profits interests).

#### **2. Prior Legislative Proposals and the President's Proposals.**

Proposed carried-interest legislation would tax net income from certain profits interests as ordinary income and also subject such ordinary income to self employment tax (the latter of which means for high tax bracket taxpayers an additional 2.9% tax).

Over the last several years, three bills were introduced by House Democrats into the 110th Congress that would have treated net income from certain profits interests and capital interests, including gain on the disposition of those interests, as ordinary income. In general,

such legislation would have applied to private equity funds and real estate partnerships. In 2008, the House again passed carried interest legislation (which was contained in the proposed legislation for temporary AMT relief), but the carried interest legislation was not considered by the Senate.

The President's Budget Proposals for both 2010 and 2011 support carried interest legislation. The President's 2011 proposal has not been reduced to draft legislative language, however, it appears to apply broadly to so called "services partnership interests" (defined generally as a carried interest held by a person who provides services to the partnership) and so-called "disqualified interests" held by service performers. A disqualified interest is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (*i.e.*, essentially an anti-abuse provision designed to avoid end-runs around the carried interest proposal by designing other instruments that mimic the economics of a carried interest). The President's proposal exempts from carried interest treatment, partnership interests received for "invested capital" which meets what will likely be complex and subjective tests of whether the interest is in substance issued in exchange for capital and not for services. Basically, the President's proposal appears somewhat consistent with the various legislative proposals introduced by House Democrats, except perhaps that it is broader in that it appears to apply to all partnerships regardless of the types of assets/business held or carried on by such partnership. The President's proposal would be effective for taxable years beginning after December 31, 2010.

Carried interest legislation faces strong opposition in the Senate. Nonetheless, current political and economic realities suggest that enactment of carried interest legislation in 2010 or 2011 remains a very significant possibility. The real battleground may turn out to be:

- Over the scope of any such enacted legislation (e.g. whether it will apply to such industries as real estate, energy, high tech, etc or whether it will not go too much further in scope than the investment services industry); and
- Whether previously issued carried interests are grandfathered.

**3. Latest Proposal: H.R. 4213** – The House approved version of the Tax Extenders Act of 2009 ("Extenders Bill") contained proposed carried interest legislation. The version of the Extenders Bill approved by the Senate on March 10, did not contain carried interest legislation. Acting House Ways and Means Committee Chair Sander M. Levin, told reports on March 9 that he hoped to hold a formal conference committee to work out the differences. Congressman Levin indicated that he wants to pay for the Extenders Bill in part by treating carried interests as ordinary income rather than capital gains which is projected to raise \$24.6 billion over 10-years. In general, the carried interest provisions contained in the Extenders Bill as approved by the House take the same approach as the 2009 House Bill (H.R. 1935).

(a) H.R. 4213 would amend Section 83 as follows:

- the fair market value of partnership interest issued in connection with the performance of services for or on

behalf of the partnership would be treated as the liquidation value of such interest (i.e., it would be valued for purposes of measuring the service performer's income upon receipt of such interest at more than its true fair market value, because liquidity and control discounts will be disregarded), and

- the recipient of the interest is treated as having made a Section 83(b) election unless she affirmatively elects not to have Section 83(b) apply.

(b) The House approved Extenders Bill would also add new IRC Section 710 (effective for tax years ending after December 31, 2009, with no grandfather rules for existing interests). New Section 710 would contain a maze of special rules applicable to holders of so-called "investment services partnership interests" (ISPIs). Except to the extent that the partnership qualifies as a qualified interest (*supra* at p. 11), the treatment of the ISPI holder would include:

(i) K-1 income would be ordinary income,

(ii) K-1 losses ordinary losses. Losses are only allowed to an ISPI if the taxpayer previously had net income from the ISPI. Suspended losses do not reduce basis in the partnership interest and are carried forward.

(iii) Disposition gain on the disposition of an ISPI is ordinary income and must be recognized notwithstanding any other income tax provision. The JCT Explanation states that gain on the disposition of an ISPI is recognized notwithstanding any other income tax provision, such as nonrecognition or deferral rules. (*See* Staff of the Joint Committee on Taxation, *Technical Explanation of the Tax Extenders Act of 2009*, (JCX-60-09), page 183). Thus, dispositions of ISPIs in intra-group transactions, intra-family transactions, and other transactions that might ordinarily be tax free or tax deferred could result in recognition of ordinary income. In regard to the disposition of an ISPI when a portion of such ISPI is a qualified capital interest, the JCT Explanation states:

On the disposition of an investment services partnership interest, any portion of which is a qualified capital interest, a special rule provides that a proportionate amount of the gain or loss on disposition is not subject recharacterization as ordinary. Under this special rule, the proportionate amount of the gain or loss is determined generally by the ratio of the gain or loss on liquidation of the partner's qualified capital interest to the gain or loss on liquidation of the partner's entire investment services partnership interest (as if the liquidation occurred immediately before the disposition). (*See* Staff of the Joint Committee on Taxation, *Technical Explanation of the Tax Extenders Act of 2009*, (JCX-60-09), pages 183-184).

(iv) If property is distributed with respect to an ISPI, the recipient must report the built-in gain in such property as ordinary income (unless otherwise

required to be picked up by the partnership as taxable income) and the recipient must treat the property as a distribution of money but the recipient obtains the property with a fair market value basis.

(v) Any amount treated as ordinary income or loss would be taken into account in determining net earnings from self-employment.

(vi) Income or gain with respect to certain other interests, including interests in entities, that are held by a person who performs directly or indirectly, investment management services for the entity will be recharacterized as ordinary income. This rule applies if (1) a person performs (directly or indirectly) investment management services for any entity, (2) a person holds a disqualified interest with respect to the entity, and (3) the value of the interest (or payments thereunder) is substantially related to the amount of realized or unrealized income or gain from the assets with respect to which the investment management services are performed. For this purpose, a disqualified interest in an entity means (1) any interest other than debt, (2) convertible or contingent debt, (3) an option or other right to acquire either of the foregoing, or (4) the derivative instrument entered into (directly or indirectly) with the entity or an investor in the entity. A disqualified entity does not include a partnership interest. However, an option to acquire a partnership interest may be a disqualified interest. Except as provided in regulations or other guidance, stock in a taxable corporation (C corporation or foreign corporation) or in an S corporation is generally not regarded as a disqualified interest, except to the extent that such equity interests constitute arrangements that are “economically similar” to an ISPI. For example, if a hedge fund manager holds stock of a Cayman Islands corporation that is in turn a partner in a hedge fund partnership, the manager performs investment management services for the hedge fund, and the value of the stock (or dividends) is substantially related to the growth and income in hedge fund assets for which the manager provides investment services, then the gain in the value of the stock, and dividends, are treated as ordinary income for the performance of services. The fact that the services are performed for the hedge fund, rather than directly for the Cayman Islands corporation in which the manager has a disqualified interest, does not change this result under the provision. Thus, the gain is not eligible for capital gains treatment, and the dividend is not eligible for the special rate on qualified dividends, but rather both are subject to tax at ordinary income rates.

(c) Definition of an ISPI

(i) At the time the interest is acquired, the person acquiring the interest (or any person related thereto) must be reasonably expected to provide (directly or indirectly) a substantial quantity of certain services (“Bad Services”) with respect to certain types of assets (“Bad Assets”).

(ii) “Bad Services” are advising as to investing in, purchasing or selling certain assets; managing, acquiring or disposing of those assets; arranging financing with respect to those assets and any activity in support of the other “Bad Services.”

(iii) “Bad Assets” are securities (including interests in partnerships), commodities, real estate held for rental or investment and options or derivatives with respect to the other “Bad Assets.” The JCT Explanation of the House approved Extenders

Bill provides that a partnership interest for this purpose includes any partnership interest that is not otherwise treated as a security for purposes of the provision. For example, assume that a private equity fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm. A commodity for this purpose means a (1) commodity that is actively traded, (2) notional principal contract with respect to such commodity, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. (See Staff of the Joint Committee on Taxation, *Technical Explanation of the Tax Extenders Act of 2009*, (JCX-60-09), page 179)

The JCT Explanation of the House approved Extenders Bill also provides two examples of how partner services can invoke the application of proposed new Section 710:

The provision does not apply to services other than those giving rise to an investment services partnership interest. For example, assume that three individuals form a partnership to operate a biotechnology business; two each contribute \$1 million in cash, and the third contributes his personal services as a research scientist. In the following year, the business profits of the partnership are \$300,000, and the partnership agreement provides that each of the three partners' distributive share is \$100,000. The profits are ordinary income to the partners under present law, so the provision does not affect the income tax rate applicable to the partners. In the following year, the third partner sells his partnership interest. Because the third partner's services do not consist of the services described above, the gain on sale of the partnership interest is not subject to recharacterization under the provision. As another example, assume instead that a partnership of three individuals is formed to manage investments in specified assets. The first two individuals contribute \$1 million each and the third contributes his personal services advising the partnership as to the advisability of investing in particular specified assets, and managing, acquiring, arranging financing for, and disposing of such assets. In the following year, the profits of the partnership are \$300,000, and the partnership agreement provides that each of the three partners' distributive share is \$100,000. Because the third partner's share of profits is subject to recharacterization under the provision, when the third partner sells his partnership interest in the following year, the gain is recharacterized as ordinary income under the provision. (See Staff of the Joint Committee on Taxation, *Technical Explanation of the Tax Extenders Act of 2009*, (JCX-60-09), page 180)

(d) Qualified Capital Interest (QCI) Exception

(i) If (1) allocations are made with respect to a QCI held by a partner that also has an ISPI and (2) the allocations made with respect to other QCIs held by partners who do not provide "Bad Services" and who are not related to the partner that has a QCI and an ISPI are (a) made in the same manner as such allocations are made to the QCI held by the ISPI-partner and (b) significant compared to the allocations made to the QCI held by the ISPI-partner, then the normal partnership rules apply.

(ii) If the ISPI-partner has a QCI and disposes of the interest, the partner can use the normal partnership rules on a portion of the interest. The portion of the interest is determined based on a deemed liquidation of the partnership and the portion of the gain or loss that would have been allocable to the QCI as compared to the entire gain or loss that would have been allocable to the interest as a whole.

(iii) A QCI is the *portion* of the interest *attributable* to (1) the fair market value of money or property contributed in exchange for the interest, (2) amounts includible in income under section 83 upon receipt of the interest and (3) the net income from the interest. The QCI is reduced by distributions with respect to such interest for tax years to which the provisions apply and by net losses from the interest.

Although not described in H.R. 4213, the JCT Explanation also describes the tax treatment of the purchaser of a qualified capital interest. Specifically, the JCT explanation clarifies that although the purchaser succeeds to the transferor's qualified capital account, the purchaser's qualified capital account is not measured by reference to the amount paid for the interest:

In the case of the transfer of an investment services partnership interest in a fully taxable transaction, the transferee partner accedes to the amount of the qualified capital account of the transferor partner. Unlike the basis rules of section 743 in the case of a transfer of a partnership interest, only the amount of the transferor's qualified capital interest is treated as the transferee's qualified capital interest. A qualified capital interest does not include any amount paid to a person other than the partnership; for example, such an interest does not include the price of a partnership interest acquired by purchase from another partner. It is intended that the rules similar to the rules of section 197(f)(9) apply. (See Staff of the Joint Committee on Taxation, *Technical Explanation of the Tax Extenders Act of 2009*, (JCX-60-09), page 181)

(e) Elimination of Avoidance Techniques

(i) One cannot obtain a QCI if the interest is acquired *in connection with* the proceeds of any loan made or guaranteed, directly or indirectly, by any other partner, the partnership or any person related to any other partner or the partnership.

(ii) If a non-ISPI partner (or a person related to a non-ISPI partner) makes a loan to the partnership, that loan is treated as part of the invested capital of such partner. Thus, making it much more difficult for the ISPI-partner(s) to obtain qualifying allocations. In this regard the JCT Explanation provides:

In addition, for this purpose, any loan or other advance to the partnership made or guaranteed, directly or indirectly by a partner not providing services to the partnership is treated as the capital interest of that partner, for purposes of determining the amount of the service providing partner's qualified capital interest (but not, however, for purposes of comparing allocations to the service providers qualified capital allocations to qualified capital interests of nonservice-providing unrelated partners). Income and loss treated as allocable to capital interests of partners are adjusted accordingly.

For example, if investors in a private equity fund that is a partnership contribute capital primarily as debt rather than as equity, while the manager of the fund contributes only equity so that his capital interest appears to be a large percentage of the total equity contributed, the provision treats the partnership debt to the investors as the investors' capital interests for this purpose. The percentage of total capital interests that is attributable to the fund manager in this example is determined taking into account this debt as well as the equity contributed to the fund, so the manager's capital interest is a smaller percentage of total capital interests than if only equity contributions were taken into account. (See Staff of the Joint Committee on Taxation, *Technical Explanation of the Tax Extenders Act of 2009*, (JCX-60-09), page 183).

(f) Elimination of Avoidance Using Other Types of Interests

(i) If someone provides "Bad Services," directly or indirectly, for an entity, holds a disqualified interest with respect to such entity and the value of the interest is substantially related to the income or gain (whether or not realized) from the "Bad Assets," the income or gain with respect to the interest is ordinary.

(ii) Disqualified interests are interests other than debt, convertible or contingent debt, options or other rights to acquire the foregoing or derivatives. Disqualified interests do not include partnership interests, stock in a taxable corporation (i.e., a domestic C corporation or a foreign corporation where substantially all of its income is ECI to a U.S. trade or business or is subject to a comprehensive foreign income tax) or (subject to IRS guidance) stock in an S corporation. However, the JCT Explanation explains that "it is not intended that the exception for stock in an S corporation or domestic C corporation permit avoidance of the general rule relating to partnership interests through establishment of economically similar arrangements." (See Staff of the Joint Committee on Taxation, *Technical Explanation of the Tax Extenders Act of 2009*, (JCX-60-09), page 185).

(g) New 40% Penalty. Underpayments of tax attributable to the disqualified interests will be subject to a 40% penalty. Prior carried interest legislation imposed a *strict liability* penalty. Unlike prior carried interest legislation, however, H.R. 4213 allows for a reasonable cause exception, provided that the relevant facts are adequately disclosed, there is or was substantial authority for the treatment, and the taxpayer reasonably believed that the tax treatment more likely than not was proper.

(h) Regulatory Authority Treasury would have the authority to issue regulations as necessary or appropriate to carry out the purpose of the carried interest provisions. The JCT Explanation provides:

It is expected that these regulations will, among other things, address the effects, if any, of the provision on whether income is U.S. or foreign source (or is sourced with a U.S. possession); how income is characterized for purposes of the foreign tax credit limitation rules; whether income is subject to tax by the United States by reason of Sections 897 and 1445 (sale of U.S. real property) or is exempt from U.S. tax under Section 892 (income of foreign governments); whether income is effectively connected with the conduct of a trade or business within the United States; and whether income is subject to

current U.S. tax under the passive foreign investment company or subpart F rules. The intent of the provision is generally not to change the result under these rules, to the extent that is consistent with not providing an opportunity to avoid the recharacterization of income as ordinary under the provision and not creating an opportunity for exclusion or deferral of otherwise includable amounts. For example, it is not intended that the provision be utilized to effect a recharacterization as untaxed foreign source ordinary income from personal services the amount of any otherwise taxable (or withholdable) U.S.-source dividend, effectively connected income, U.S. real property gain, or similar income or any otherwise taxable subpart F inclusion or passive foreign investment company inclusion.

It is not intended that solely the recharacterization of income as ordinary under the provision cause income of a REIT that otherwise meets the requirements of section 856(c)(2)(3) or (4) to fail to meet the requirement of those paragraphs. Similarly, it is not intended that solely the recharacterization of income as ordinary under the provision cause income not otherwise treated as unrelated business income of an exempt organization to fail to meet provisions of Section 512(b) that are otherwise satisfied.

It is not intended that income or loss characterized as ordinary under the provision be taken into account in determining net investment income for purposes of the investment interest limitation of section 163(d)./ it is not intended that opportunities to avoid or defer income inclusion be created by the recharacterization of income or loss as ordinary under the provision.

**B. Proposed Codification of Economic Substance Doctrine. Heads-up! Both the President's Proposed Budget for Fiscal Year 2011 (as it did for 2010) and the Extenders Bill as approved by the Senate on March 10, 2010 propose to Codify the Economic Substance Doctrine.**

1. **Background.** The common-law “economic substance” doctrine generally denies tax benefits from a transaction that does not meaningfully change a taxpayer’s economic position, other than tax consequences, regardless of whether the transaction satisfies the literal requirements of the Internal Revenue Code. The courts have applied the economic substance doctrine with increasing frequency. (*See* V below). However, they have not applied the doctrine uniformly. Some courts require both (i) a meaningful change to the taxpayer’s economic position (referred to as “objective” economic substance), and (ii) a substantial non-tax business purpose, while other courts require only one of the two factors to satisfy the economic substance doctrine. Still other courts consider objective economic substance and business purpose to be only two factors in a general investigation into whether a transaction has economic effects other than tax benefits.

2. **President’s Proposal.** The Administration proposes to codify the economic substance doctrine. Under the President’s proposal, a transaction would satisfy the economic substance doctrine only if (i) it changed in a meaningful way (apart from federal tax effects) the taxpayer’s economic position, and (ii) the taxpayer has a substantial purpose (other than a federal tax purpose) for entering into the transaction. Under the President’s proposal a transaction would not have economic substance solely by reason of a profit potential unless the

present value of the reasonably expected pre-tax profit is substantial in relation to the present value of the net federal tax benefits arising from the transaction. The proposal would allow the Treasury Department to publish regulations to carry out the purposes of the proposal.

The President's proposal would also impose a 30-percent penalty on an understatement of tax attributable to a transaction that lacks economic substance, reduced to 20-percent if there were adequate disclosure of the relevant facts in the taxpayer's return. The proposed penalty would be imposed with regard to an understatement due to a transaction's lack of economic substance in lieu of other accuracy-related penalties that might be levied with respect to the tax understatement, although any understatement arising from a lack of economic substance would be taken into account in determining whether there is a substantial understatement of income tax under current law.

The IRS could assert and abate the economic substance penalty. The proposal would also deny any deduction for interest attributable to an understatement of tax arising from the application of the economic substance doctrine.

The President's proposal, if enacted, would apply to transactions entered into after the date of enactment. The denial of interest deduction component would be effective for taxable years ending after the date of enactment with respect to transactions entered into after such date.

**3. Extenders Bill (S. Amdt. 3336 to H.R. 4213).** Section 421 of the Extenders Bill (as amended by Senate Amendment 3336 and as approved by the Senate on March 10) would also codify the economic substance doctrine. This proposed legislation is similar to the President's Proposal.

**4. Impact.** Codification of the economic substance doctrine would, in the authors' opinions, impact the planning of many transactions far beyond the classic tax shelter transactions. By way of example, in addition to all of the other vagaries associated with partnership allocations that meet the substantial economic effect rules of Section 704(b), it is unclear whether the codified economic substance rules would also apply.

**C. The President's 2011 Individual Tax Proposals:**

Effective December 31, 2010 for incomes above \$200,000 (individual), \$250,000 (married filing jointly):

- Reinstated tax rates to 36% and 39.6%
- Reinstated 20% capital gains rate
- Increased dividend rate to 20%
- Restored phase-out of personal exemptions and phase-out of itemized deductions
- Capped itemized deductions at 28% rate
- Permanent 2009-level individual AMT relief

- Additional .9% Medicare health insurance tax in wage income
- 2.9% Medicare health insurance tax on investment income.

**D. President’s Proposals Re: Modification of Valuation Discounts.**

Under current law, the fair market value of property transferred, whether on the death or during the life of the transferor, generally is subject to estate or gift tax at the time of the transfer. Sections 2701 through 2704 of the Internal Revenue Code were enacted to prevent the reduction of taxes through the use of “estate freezes” and other techniques designed to reduce the value of the transferor’s taxable estate and discount the value of the taxable transfer to the beneficiaries of the transferor without reducing the economic benefit to the beneficiaries. Generally, Section 2704(b) provides that certain “applicable restrictions” (that would normally justify discounts in the value of the interests transferred) are to be ignored in valuing interests in family-controlled entities if those interests are transferred (either by gift or on death) to or for the benefit of other family members. The application of these special rules results in an increase in the transfer tax value of those interests above the price that a hypothetical willing buyer would pay a willing seller, because Section 2704(b) generally directs an appraiser to ignore the rights and restrictions that would otherwise support significant discounts for lack of marketability and control.

In the Administrations view, judicial decisions and the enactment of new statutes in most states, in effect, have made Section 2704(b) inapplicable in many situations by recharacterizing restrictions such that they no longer fall within the definition of an “applicable restriction.” In addition, the Internal Revenue Service has identified additional arrangements designed to circumvent the application of Section 2704.

The Administration’s proposal would create an additional category of restrictions (“disregarded restrictions”) that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transfer’s family. Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations. Disregarded restrictions would include limitations on a holder’s right to liquidate that holder’s interest that are more restrictive than a standard to be identified in regulations. A disregarded restriction also would include any limitation on a transferee’s ability to be admitted as a full partner or to hold an equity interest in the entity. For purposes of determining whether a restriction may be removed by member(s) of the family after the transfer, certain interests (to be indentified in regulations) held by charities or others who are not family members of the transferor would be deemed to be held by the family. Regulatory authority would be granted, including the ability to create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of Section 2704 if certain standards are met. This proposal would make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions.

### III. Disregarded Entities.

**A. PLR 200953005.** Loan to disregarded LLC that is secured by 100% of the LLC membership interests, is Qualified Real Property Business Indebtedness for purposes of Section 108(a)(1)(D).

**B. Section 1031 EAT Can Acquire Partnership Interest where Rev. Rul. 99-6 will Apply.** PLR 200909008 (February 27, 2009) ruled that an exchange accommodation title holder formed pursuant the requirements of Rev. Proc. 2000-37 can acquire a partnership interest in a partnership where the sole other partner is the taxpayer intending to acquire the interest as replacement property in a reverse § 1031 exchange. The PLR relies on Rev. Rul. 99-6 to qualify the interest received as real property upon its acquisition to complete the taxpayer's exchange.

The PLR noted that the EAT would be treated as a partner in the partnership (with the other partner being the taxpayer structuring the § 1031 exchange) until the time that the EAT transferred such partnership interest to the taxpayer to close out the § 1031 exchange transaction.

**C. Receipt in 1031 Exchange of 100% of the Interests of all Partners in a Partnership Holding Real Property by Taxpayer's Disregarded Entity does not disqualify 1031 Exchange.** In private letter ruling 200807005, the Service ruled that the taxpayer's receipt through its disregarded entity of 100% of the interests of a multi-partner partnership that holds qualifying like-kind exchange property, will be treated as the receipt of property by the taxpayer that is like-kind to the real property disposed of by the taxpayer. This private letter ruling applied Situation 2 of Revenue Ruling 99-6, 1991-1 C.B. 432, wherein partners C and D were equal partners in CD partnership structured as an LLC. C and D sold their entire interests in CD Partnership to E an unrelated person (who thus acquired 100% of all of the interest in CD Partnership). After the sale, the business was continued by the LLC which was solely owned by E. Revenue Ruling 99-6 concludes that the CD Partnership terminated under Section 708(b)(1)(A) when E purchased the entire interests of C and D in the CD Partnership. Revenue Ruling 99-6 characterizes the transaction for C and D differently than the characterization of the transaction for E. From C and D's standpoint, they are characterized as having sold their partnership interests. Consequently, it is important to realize that C and D would not be able to treat their relinquished partnership interests in the multi-partner CD Partnership as qualifying 1031 exchange property.

In contrast to the transaction in which C and D are treated as having engaged (i.e. sale of their partnership interests), E is treated as having acquired all of the former CD Partnership's assets. Thus, when E purchased the entire interests of C and D in CD Partnership, CD Partnership was deemed to have made a liquidating distribution of assets to C and D. Immediately following this distribution, E is deemed to acquire, by purchase, all of former CD Partnership's assets.

Therefore, applying Revenue Ruling 99-6 to the situation in Private Letter Ruling 200807005, as long as the assets of the acquired partnership/LLC are eligible like-kind property under Section 1031, the acquisition of 100% of the interests in such a partnership/LLC by the taxpayer who has disposed of 1031 eligible like-kind exchange property, did not disqualify an otherwise eligible 1031 exchange.

*Caveat:* Whether a respective state will accord tax-deferred like-kind exchange treatment to a transaction such as that described in this private letter ruling, is subject to the applicable state law.

**D. Valuation discount allowed for transfer of membership interests in disregarded LLC to trusts.**

In *Pierre v. Commissioner*, 133 T.C. 2 (2009), the taxpayer transferred assets to a wholly owned disregarded LLC, then (12 days later) transferred the membership interests in the LLC to two trusts that were established for her children. The transfer to the trusts were undertaken in part as gifts and in part as sales. In valuing the LLC membership interests for purposes of the gifts and the sales, the taxpayer applied a 30% discount to the value of the LLC's underlying assets. The IRS asserted a gift tax deficiency based on its position that the transfers should be treated as transfers of the underlying assets and thus no discounts should be allowed. The court held that LLC cannot be disregarded for purposes of determining the price that a willing buyer and a willing seller would establish for the purchase and sale of the LLC membership interests. The court reasoned that state law determines the rights that are transferred and the check-the-box regulations cannot override the determination of property rights under state law. It should be noted that Judge Halpern issued a lengthy and well reasoned dissenting opinion.

This result in the *Pierre* case (in the gift tax world) should be contrasted with *Pope & Talbot*, 104 TC 574(1995), *aff'd* 162 F3d 1236 (CA-9, 1999) and TAM 200443032 where for income tax purposes (Section 311(b)) discounts were denied in somewhat analogous circumstances

**E. Employment Taxes.**

**1. *Leedreau LLC v. Commissioner*, T.C. Summ. Op. 2009-195.** Petitioner was the sole owner of a disregarded LLC. The LLC failed to file employment tax returns and pay employment taxes with respect to the 2005 and 2006 tax years. The Tax Court held that the individual sole owner of the LLC was liable for the employment taxes because the LLC was disregarded as an entity separate from its sole owner.

**2. Final regulations will impose employment-tax liability on DREs.** (Treas. Reg. 301.7701-2(c)(2)(iv), (e)(5)). On August 15, 2007, the Treasury Department issues final regulations that will eliminate disregarded-entity status for purposes of federal employment taxes. *See* TD9356 [RIN 1545-BE43]. Effective, January 1, 2009 a disregarded entity became regarded for employment-tax purposes, and thus become liable for employment taxes on wages paid to the disregarded entity's employees and responsible for satisfying other employment-tax obligations (e.g., backup withholding under IRC § 3406, making timely deposits of employment taxes, filing returns, and providing Forms W-2). The owner of the disregarded entity will no longer be liable for employment taxes or satisfying other employment tax obligations with respect to the employees of the disregarded entity. The disregarded entity will continue to be disregarded for other federal tax purposes.

**3. Pre-2009 Cases Holding Owner Directly Liable for Employment Taxes.** The Sixth Circuit Court of Appeals, in *Litriello v. United States*, 99AFTR 2d 2007-2210

(6th Cir. 2007), affirmed the lower court's decision upholding the validity of the check-the-box regulations as a reasonable interpretation of IRC § 7701, which was determined to be ambiguous when applied to hybrid entities such as limited liability companies. The United States Supreme Court has denied certiorari in *Frank A. Littriello v. United States, et. al.*, 484 F.3d 372 (6th Cir. 2007), DOC 2007-9567 or 2007 TNT 73-16; S.Ct. Bkp. No. 07-851. The Second Circuit Court of Appeals, in *McNamee v. Dept. of the Treasury*, 99 AFTR 2d 2007-2871 (2d Cir. 2007), affirmed the validity of the check-the-box regulations and upheld IRS's determination that the sole member of an LLC disregarded as a separate entity was personally liable for the LLC's employment-tax liabilities.

**F. Member's Profits from its Wholly-owned LLC (Treated as a Disregarded Entity for Federal Income Purposes) were Subject to Levy.** In ILM 200835030 (7/18/08), Chief Counsel advised that the single owner's share of the net profits held by the LLC could be levied upon to collect the owner's tax liabilities. The CCA considered whether the single owner's right to receive income from the LLC was "property" or a "right to property" under Ohio law. Based upon an analysis of Ohio law, Chief Counsel concluded that the owner's right to share in the profits and losses of the LLC and to receive distributions was property under Ohio law.

**G. CCA-102393-08 (October 23, 2008 — Husband and Wife LLC in Community Property State).** LLC was established in community property state by husband and wife. Rev. Proc. 2002-69 permits an LLC owned solely by husband and wife in a community property state to treat the entity as a partnership and file a partnership return. If the LLC and husband and wife as community property owners treat the entity as disregarded, Rev. Proc. 2002-69 provides that the IRS will accept that treatment for federal tax purposes.

In this case, the entity had not filed an income tax return, and the question was how the Service should treat the entity for purposes of collection of employment taxes. The CCA reasoned that the election under Rev. Proc. 2002-69 is optional, and that if no election is made the classification of the LLC defaults to the "check the box" regulations, Treas. Reg. § 301.7701-3. Consequently, the CCA concludes that if there are two owners of the business, it is automatically by default a partnership. Therefore, since no returns have been filed and the husband and wife had not made an election under Rev. Proc. 2002-69, the business would be considered a partnership.

**H. Rescission and Disregarded Entity.** In PLR 200843001 (July 2, 2008), X had been granted an extension of time to file Form 8832 to be treated as a disregarded entity. X's original sole owner was Corporation A. A sold a specified percent of the X common stock to B. Subsequently, the sale of stock was rescinded. Both the sale of the stock and the rescission occurred during the same taxable year. Citing Rev. Rul. 80-58, the PLR concluded that since the parties were returned to the *status quo ante*, and since the rescission occurred in the same year as the initial transaction, rescission treatment for tax purposes was applicable. The Service further ruled that assuming X makes a valid entity classification election to be treated as a disregarded entity at all relevant times, and provided the election was not otherwise changed, the rescission of the stock sale will not be treated as the liquidation of a partnership.

#### IV. Allocations; At Risk.

**A. Castle Harbour.** On remand from the Second Circuit Court of Appeals, the district court held that Section 704(e) is not limited to family partnerships so that the Dutch banks were equity partners in the partnership. The Second Circuit Court of Appeals had reversed and remanded the district court's decision in *TIFD III-E, Inc. v. United States*, 459 F. 3d 220 (2d Cir. 2006), *rev'g and remanding*, 342 F. Supp. 2d. 94 (D. Conn. 2004). The appellate court held that the foreign partners were not bona fide equity participants with a meaningful stake in the risks or success of the partnership business, but remanded the case to district court for consideration of the application of Section 704(e).

#### Facts.

- General Electric Capital Corporation (“GECC”) owned a fully depreciated fleet of aircraft leased to commercial carriers. After setbacks in the airline industry, GECC wished to reduce its risk by raising immediate cash against the planes rather than awaiting the now less-certain rental income. Selling the aircraft was not an option, nor was nonrecourse debt.
- GECC formed a partnership (Castle Harbour) to which it transferred, among other things, the leased aircraft. The planes were worth approximately \$530 million and were subject to \$258 million of nonrecourse debt (net value of \$272 million). Two Dutch banks contributed \$117.5 million in cash.
- Through a complicated arrangement of allocations, distributions, and guaranteed payments (payment of which was guaranteed by GECC), the Dutch banks were effectively assured of getting back their initial investment over 8 years plus an approximately 9% return. Their share of upside/downside after that was effectively limited to 1%.
- Operating income (excluding disposition gains) was allocated 98% to the Dutch banks. Book depreciation, which was based on the planes' gross asset value at the time of the contribution, equaled close to 70% of gross rental income. But because the planes had been fully depreciated for tax purposes, there was no corresponding tax deduction. The partners opted to use the traditional method for making IRC § 704(c) allocations (something that would presumably be inappropriate today under the antiabuse rule in Treas. Reg. § 1.704-3(a)(10)). Thus the Dutch banks were “ceiling limited” (i.e., there was insufficient tax depreciation to match their allocation of book depreciation). As a result, the Dutch banks were allocated far more taxable income than book income. Under the US-Netherlands Tax Treaty, however, the Dutch banks were not subject to US tax. Thus, by allocating 98% of the income from fully tax-depreciated aircraft to the Dutch banks, GECC avoided an enormous tax burden, while shifting little book income.
- In 2001, IRS issued two notices of final partnership administrative adjustments with respect to the partnership reallocating approximately \$310 million of taxable income away from the Dutch banks to GECC, which if sustained would have required GECC to pay an additional \$62 million in taxes.

Before the district court, the government argued that (1) the partnership was formed with no nontax purpose, making its formation a “sham” transaction to be disregarded; (2) even if the arrangement had a business purpose, the Dutch banks were, for tax purposes, only lenders to the partnership, not partners, and could not therefore be allocated any income; and (3) even if Castle Harbour were respected as a partnership for tax purposes, the income allocations violated the “overall tax effect” rule of section 704(b).

The district court rejected all three arguments. First, the court found that, while the transaction created significant tax savings for GECC, it had both a nontax economic effect (viz., in return for a significant share of the partnership’s operating income, the Dutch banks contributed \$117.5 million, which was used by a subsidiary of the partnership to purchase aircraft and retire GECC debt) and a nontax economic motivation (viz., GECC entered into the transaction to raise capital and demonstrate its ability to do so to investors, rating agencies, and GECC senior management on its fleet of aging aircraft).

Second, the lower court found that the Dutch banks had a real stake in the transaction as equity owners because their return was tied directly to the performance of the aircraft leasing business. The court distinguished the Dutch bank from the foreign banks in *ASA Investerings Partnership v. Commissioner*, 85 AFTR 2d 2000-675 (D.C. Cir. 2000), which were guaranteed an exact amount of return regardless of the business’s performance.

Finally, the court rejected the government’s application of the “overall-tax-effect” rule, finding that the Dutch banks’ interest in the partnership was 98% (rather than 18%, as the government argued based on the Dutch banks’ relative capital contributions) and thus the overall-tax-effect rule was inapplicable because there was no difference between the allocation made and each partner’s actual interest in the partnership. In addition, even if it were applicable, the overall-tax-effect rule would have no effect because reassignment of income based on the partners’ interests in the partnership would result in the same allocation being made.

On appeal, the Second Circuit reversed and remanded the lower court’s decision, concluding, among other things, that the lower court erred by relying on the sham-transaction test to the exclusion of the totality-of-the-circumstances test set forth by the Supreme Court in *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). Application of the *Culbertson* test clearly showed that the Dutch banks’ interest was overwhelmingly in the nature of a secured lender’s interest that would neither be harmed by poor performance of the partnership nor enhanced by extraordinary profits. The banks were effectively assured by virtue of GECC’s personal guaranty of the partnership obligations and other protections that their initial investment would be reimbursed at a specified rate of return, and the provisions of the operating agreement purporting to give the banks unlimited upside potential were illusory in the face of other provisions that allowed GECC to limit the banks’ share in any unexpectedly large profits. While the banks’ interest was not totally devoid of indicia of an equity participation in a partnership, those indicia were either illusory or insignificant in the overall context of the banks’ investment. The Dutch banks were therefore not bona fide equity participants with any meaningful stake in the risks or success of the partnership business.

The court concluded by suggesting that, had the Dutch banks’ interest been greater than 1% (query how much greater), they may have been respected as equity partners:

We recognize that if the Dutch banks had a sufficiently sizable share in the profit potential of the partnership, they might appropriately be deemed equity participants for tax purposes, notwithstanding the guaranteed repayment of their initial investment at an agreed rate of return. *See Hunt v. Commissioner*, 59 T.C.M. (CCH) (1990) (noting that a bona fide equity interest can exist even where a minimum return is guaranteed.) On different facts a difficult question would arise whether an investor's right to a share of profits was sufficient to make its interest a bona fide equity participation for tax purposes notwithstanding the secured guaranty of the return on its principal plus interest. This was not such a case. Here the banks were accorded the *appearance* of a meaningful interest in the potential profits of the partnership, which was effectively nullified by the taxpayer's ability to limit their participation in such profits to an insignificant amount.

The Second Circuit Court of Appeals remanded the case to the District Court for consideration of whether Section 704(e) has any effect on the issues at hand. On October 7, 2009, the U.S. District Court for the District of Connecticut issued its opinion in connection with the remand on the Section 704(e) issue. *TIFD III-E Inc., v. U.S.*, Civil Action Nos. 3:01cv1839-1840 (SRU) (D. Conn. Oct. 7, 2009). Section 704(e)(1) provides that "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." The District Court found that Congress did not limit Section 704(e) to family limited partnerships and instead had a broad scope. Under Treasury Regulations, for Section 704(e) purposes, "a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." Treas. Reg. § 1.704-1(e)(1)(v). The District Court held that the Dutch Banks did indeed hold such interests. The District Court further held that, consistent with the regulations, the capital interests were acquired in a bona fide transaction and not as part of a tax sham for tax avoidance, and that capital was a material income-producing factor in the Castle Harbor partnership. Accordingly, the District Court concluded that Section 704(e) applied and that Dutch Banks were partners for federal income tax purposes. The District Court also analogized the interests held by the Dutch Banks to preferred stock that is frequently treated as equity in corporations. The court went further in holding that even if the taxpayers failed the *Culbertson* test, if they passed muster under Section 704(e)(1), they should still prevail.

**B. *Va. Hist. Tax Cred. Fund 2001 LP v. Commissioner*, T.C. Memo. 2009-295. Investors in partnership formed for the purpose of allocating state tax credits to the Investors were in fact partners in the partnership.**

In *Va. Hist. Tax Cred. Fund 2001 LP v. Commissioner*, T.C. Memo. 2009-295, the taxpayers became partners of certain partnerships for the purpose of participating in a Virginia state tax credit program. The program allowed Virginia historic rehabilitation income tax credits to be allocated to partners disproportionate to the partnership's allocation of profits and losses. Under the partnership agreements, certain partners (the "Investors") with small interests in partnership profits and losses were allocated large shares of the state tax credits. The IRS asserted that the partnerships were in substance selling tax credits and had failed to report the gain from these alleged sales. The IRS's first argument in support of its position was that the

Investors were not partners for federal tax purposes, thus the contributions of capital and the allocation of tax credits, was in substance a sale of the tax credits.

With regard to the first IRS argument, the court reviewed the evidence of the partners' intent with respect to the partnerships and whether the partners had a valid business purpose. In analyzing whether the Investors were partners, the court relied on *Culbertson v. Commissioner*, 337 U.S. 733 (1949) and *Commissioner v. Tower*, 327 U.S. 280 (1946). Under *Culbertson* and *Tower*, in order to determine if a partnership exists, the court must determine whether the parties intended to join together in good faith with a valid business purpose. In finding that the Investors intended to become partners in the partnerships, the court reviewed the agreements among the partners, the conduct of the parties in executing the agreements, the trial testimony of the parties and of disinterested professionals, and the relationship of the parties including their respective abilities and capital contributions.

In examining the business purpose of the transaction, the court stated that “[t]he form of a transaction will not be given effect where it has no business purpose or operates simply as a device to conceal the true character of a transaction. *See Gregory v. Helvering*, 293 U.S. 465, 469-470 (1935).” The IRS position was that the transaction lacked a business purpose because the Investors did not make their contributions in anticipation of receiving profits from the partnership, but instead were only interested in receiving state tax credits. The court held that the Investors had a business purpose because of the considerable economic benefit they would receive from state tax savings. The court reasoned that purpose of reducing non-federal taxes was a valid business purpose as long as the reduction of non-federal taxes was greater than the reduction of federal taxes. In this case, any federal tax consequences were incidental.

The IRS also argued that the transactions where a purchase and sale of tax credits based on substance over form. The court stated that “[t]he Supreme Court has held that we should honor the parties' relationships where there is a genuine multiple-party transaction with economic substance that is compelled or encourages by regulatory or business realities, is imbued with Federal tax-independent considerations, and is not shaped solely by Federal tax avoidance.” The court held that the Investors' contributions to the partnerships and their allocation of state tax credits reflected their substance. The court based its holding on the realities of the Virginia Program (tax credits could not be freely transferred so partnership structures were required), the lack of federal tax avoidance, the intent of the partners to pool their contributions to facilitate investment, and the fact that the Investors bore sufficient risks related to their investments.

Also at issue in the case was whether the capital contributions followed by allocations of state tax credits were disguised sales, and whether the six year limitations period in section 6229(c)(2) was applicable. The court rejected the IRS's disguised sale argument because it concluded that the substance of the transactions reflect valid contributions and allocations rather than sales. Because the court held that the transactions were not sales, there was not an omission of from income sufficient to trigger the six year limitations period.

**C. Prop. Reg. 1.706-4. Determination of Distributive Share When a Partner's Interest Changes.**

On April 14, 2009 the IRS issued Proposed Regulation 1.706-4 regarding the determination of a partner's distributive share of partnership items where the partner's interest in the partnership undergoes a change. Under the proposed regulations, the partnership and the partners must use the same method (i.e. interim closing or proration) and convention for all variations in the partners' interests with each taxable year. Under the proposed regulations, the partnership must split the partnership year into segments for the periods before and after changes in partners' interests and allocate partnership items under the chosen method to the segments. Generally, an interim closing is required, however, proration may be used by agreement of the partners. However, extraordinary items must be allocated among the partners in proportion to their interests at the beginning of the calendar day of the day on which they are taken into account. The two conventions for determining segments are the Calendar Day Convention and the Semi-Monthly Convention. Under the Calendar Day Convention, the segment ends on the close of the day upon which a partner's interest in the partnership changes. Under the Semi-Monthly Convention, variations occurring during the 1st through 15th days of a calendar month will cause the applicable segment to close as of the last day of the preceding month. Variations occurring during the 16th day through the last day of the month will cause the applicable segment to close at the end of the 15th calendar day of that month.

**D. Effect of deficit restoration obligation on LLC member's at-risk amount.**

The Sixth Circuit Court of Appeals in *Hubert Enterprises, Inc. v. Commissioner*, 99 AFTR 2d 2007-2528 (6th Cir. 2007), vacated and remanded the Tax Court's decision, 125 T.C. 72 (2005), that a deficit restoration obligation did not increase the taxpayers' "at-risk" amount under IRC § 465, because any liability was contingent on the liquidation of the taxpayers' interests and no liquidation occurred during the years at issue. On appeal, the parties pointed out that the applicable test in the Sixth Circuit to determine whether a taxpayer is "personally liable" for purposes of IRC § 465 is if, in the worst case, she will be the "payor of last resort." See *Emershaw v. Commissioner*, 949 F.2d 841 (6th Cir. 1991). The court found that the Tax Court failed to engage in the worst-case analysis called for by the payor-of-last-resort test and did not address whether economic circumstances beyond the taxpayers' control might force liquidation of their interests, thus causing the DRO to operate in a manner that might cause the LLC members to become liable for a portion of the LLC's obligations.

On remand to the Tax Court, the Tax Court held on February 28, 2008 that the DRO did not render the LLC members payors of last resort under applicable law. Consequently, the Tax Court further held that the members (or more precisely in this case, the member owning a 99% interest in the LLC) may not take into account the LLC's recourse debt, because such member was not personally liable for the repayment of that debt under §465(b)(ii)(A).

The Court found that the respective member was not a payor of last resort as to the LLC's recourse debt in a worst case scenario. In such a scenario, the LLC would default on the debt without any assets to repay any of the debt. However, the LLC's default did not mean that the recourse creditor could simply turn to the member who was subject to the DRO to collect any part of the debt. The member's obligation under the DRO required in part that the respective member liquidate its interest in the LLC. The LLC's default on its payment of its recourse debt

did not trigger a liquidation of the member's membership interest in the LLC. Nor, in a worst case scenario could the LLC's recourse creditor recover directly from the member or compel a dissolution of the LLC so as to force a liquidation of such member's interest in the LLC. The Operating Agreement stated that the LLC shall be liquidated upon its dissolution and that dissolution occurs only as provided by the Wyoming LLC Act. Under the Wyoming LLC Act, the dissolution of a limited liability company occurs only upon the happening of one of three events, none of which was the LLC's default on the payment of a debt. Consequently, the LLC's default on its obligation to repay the recourse notes would not entitle the LLC's recourse creditor to compel the dissolution of the LLC. The DRO also would not apply to the member if the LLC defaulted on its debt and the member had a positive capital account following a liquidation of the member's interest in the LLC. The Court reasoned that given that the DRO requires additional capital contribution only when a member had a deficit capital account following the liquidation of such member's interest in the LLC and that no creditor of the LLC could compel a liquidation of the member's interest in the LLC, the respective member was not a payor of last resort because such member is not personally liable for the repayment of any of the LLC's recourse debt within the meaning of §465(b)(ii)(A). At base, this decision is grounded in the Tax Court's conclusion that the member was not personally liable for the repayment of any of the LLC's recourse debt because the member's obligation to contribute additional funds to the LLC was not unavoidable in that the member could avoid contributing additional capital under the DRO simply by not liquidating.

## V. Economic Substance.

### A. **Proposed Codification of Economic Substance Doctrine.** *See II.B. above.*

**B. Stobie Creek Investments.** In *Stobie Creek Investments LLC v. U.S.* (Ct. Fed Cl, 2008), the court successfully argued the economic substance doctrine in order to disregard a complex transaction involving an option strategy that was otherwise held by the court to comply with the literal requirements of the Internal Revenue Code. Citing *Coltec Industries v. U.S.* 454 F.3d 1340 (Fed. Cir. 2006) the court of claims in *Stobie Creek* enumerated five principles that must be considered in analyzing a transaction or series of transactions under the economic substance doctrine: (1) a taxpayer may not reap tax benefits from a transaction that lacks economic reality; (2) a taxpayer bears the burden of proving that a transaction is imbued with economic substance; (3) the economic substance of a transaction must be viewed from an objective standpoint; (4) the transaction which gave rise to the alleged tax benefit is the one to be examined; and (5) arrangements or transactions that do not affect the economic interests of independent third parties deserve close scrutiny.

After an extensive analysis of the experts' testimony on behalf of both parties, the court held that the transactions lacked economic substance because there was not a reasonable opportunity for profit. The court also concluded that the transactions in *Stobie Creek* did not satisfy the test of economic substance as set forth by the U.S. Supreme Court in *Frank Lyon Co., v. U.S.*, 435 U.S. 561 (1978), wherein the U.S. Supreme Court stated that: "where ... there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features," the transaction will be respected. 435 U.S. at 583-84. The *Stobie Creek* court also held that the transactions failed under the step transaction doctrine.

The court distinguished the recent opinion issued in *Sala*, 552 F.Supp. 2d at 1185, which involved a foreign currency investment program similar to that employed in *Stobie Creek*.

**C. *Maguire Partners, et. al., v. United States* 104 AFTR 2d 2009-7839 (DC CA, December 11, 2009)** Partner of a partnership entered into “Call-Option Spread” transaction. The transaction involved the sale of a short option, and the purchase of a long option and a promissory note. The partner contributed the options and the promissory note to a partnership and the partnership contributed the options and promissory note to another partnership. The parties claimed capital contributions and basis in their partnership interests equal to the amount that was paid for the long option and the promissory note, without reduction for the obligation of the short option. The court held that the transactions lacked economic substance, where subject to the step transaction doctrine, and that short options must be counted as a liability for section 752 purposes.

**D. *Sala v. United States*, 2008 U.S. 552 F. Supp. 2d, 1167 (D. Colo. 2008).** In *Sala* the taxpayer invested in a foreign currency investment program. The taxpayer purchased short and long foreign currency options. The taxpayer transferred the options and an additional amount of cash to the S corporation. The S corporation then contributed the assets to a partnership. The S corporation took a basis in its partnership interest that equaled the \$8 million cash and the value of the long options, but not the short options (based on the legal doctrines set forth in *Helmer v. Comm’r*, 34 T.C. M (CCH) 727 (1975)). When the partnership was liquidated shortly thereafter, the S corporation received cash and foreign currency contracts with a basis that was substantially higher than the value of such contracts. The S corporation sold such foreign currency contract and triggered a significant tax loss, which the taxpayer used to offset other income.

The IRS disallowed the tax loss based on the economic substance doctrine, the step transaction doctrine and the retroactive application of Treas. Reg. § 1.752-6. The court held that the transaction did not lack economic substance, that the step transaction doctrine was not applicable, and that the IRS may not retroactively apply Treas. Reg. § 1.752-6. The court held that the taxpayer did enter into the transaction with the intent to make a profit. Finally, the court concluded that the transactions, as executed, entitled the taxpayer to take the loss.

**E. *Kornman & Associates, Inc. v. U.S.*, 208 U.S. App. Lexis 10295 (5th Cir. March 12, 2008).** In *Kornman*, a trust entered into a short-sale transaction involving treasury notes (*i.e.*, the trust borrowed the T-Notes from a third party and then sold the notes on the open market). The sale generated \$102.5 million cash. Because the trust engaged in a short-sale, it had an obligation to replace the borrowed T-Notes. The trust transferred the brokerage account to a limited partnership in return for a partnership interest. The partnership subsequently sold the partnership interest to a third party for a promissory note in the amount of \$1.8 million. The trust reported a basis in the partnership interest of \$104.5 million (not taking into account the \$102.5 million obligation to replace the borrowed T-Notes, treating such obligation as contingent and not a liability for purposes of § 752, and therefore, claimed a loss of \$102.7 million. Economically, the purchase price of \$1.8 million did obviously take into account the trust’s obligation to replace the borrowed T-Notes, as the purchaser assumed such obligation from the trust. Both the lower court and the appellate court held that the obligation to replace the borrowed T-Notes is a liability for purposes of § 752, and therefore it should have been included

in the basis of the partnership interest. The inclusion of such amount in basis would have reduced the loss to approximately \$200,000. The court relied on Rev. Rul. 88-77, 95-26 and 94-45 in its conclusion that the obligation to replace the borrowed T-Notes is a liability for purposes of § 752.

**F. Economic Substance and Partnership Anti-Abuse Rules addressed in Countryside Decision.** In *Countryside v. Comm’r*, T.C. Memo. 2008-3 (Jan. 2, 2008), two individual partners owned the majority of the interests in a real estate limited partnership called Countryside (“Countryside Partnership”) which owned real property that the Partnership planned to sell, which would result in a large capital gain. The two individual partners (“W” and “C”) started with a low basis in their Partnership interests and in the real property. The result of the transactions in question were that the two individual partners (W and C) ended up owning 99% of a new partnership (CLPP) which was the holder of privately issued notes from a third party issuer, in exchange for their interests in the Countryside partnership. Subsequent to this exchange/redemption, the Countryside partnership sold its real estate and paid off its bank debt, including the bank debt incurred in order to purchase the privately issued notes which were distributed in partnership form to the two then former individual partners.

In sum, the transaction was structured as follows: In 2000, Countryside Partnership owned real property (“Real Property”) which it sold in April, 2001. W and C were two individual partners who collectively owned the vast majority of Countryside’s partnership interests. Late in 2000, Countryside Partnership redeemed W’s and C’s interest in Countryside by distributing to them its 99% interest in a newly formed LLC taxable as partnership (“CLPP”) which held a 99% interest in a second newly formed LLC taxable as a partnership (“MP”). MP owned four privately issued promissory notes in the aggregate principal amount of \$11.9 million purchased with: (1) an \$8.5 million bank loan to Countryside, the proceeds of which were contributed by it to CLPP, which then contributed \$8.5 million to MP, and (2) a \$3.4 million bank loan directly to MP. The notes were neither listed nor traded on an established financial market. On the distribution to W and C, each was relieved of his share of Countryside Partnership’s liabilities, although each retained indirectly, his share of MP’s liabilities. W and C reported no recognized gain in connection with the distribution. Countryside Partnership made a Section 754 election and as a result was able to step-up its basis in the Real property pursuant to Section 734. MP apparently did not make a Section 754 election, and as a result was not required to reduce the basis of its assets (the privately issued promissory notes) pursuant to Section 734.

The IRS alleged: (1) CLPP, MP and all of the transactions effected in late 2000 should be disregarded as without economic substance and there was, in substance, a cash distribution of over \$11 million from Countryside to W and C, or alternatively a distribution of “marketable securities” as defined in Section 731(c)(2) that therefore should be considered a distribution of money for purposes of Section 731(a)(1); and (2) Countryside is not entitled to step-up its basis in the Real Property.

W (a participating partner) moved for partial summary judgment on the issue of whether he and C are required to recognize gain on the year 2000 distribution to them (*i.e.*, whether they are deemed to have received money). W conceded, for purposes of the summary judgment

motion that CLPP and MP may be disregarded which results in a deemed distribution of the notes from CS to W and C.

In a lengthy tax court memorandum opinion granting summary judgment in favor of the taxpayer, it was held:

1. Because of the deemed distribution of the notes to W and C (1) accomplished a legitimate business purposes (to enable W and C to convert their interests in Countryside Partnership into interest-bearing promissory notes), and (2) resulted in a change in their economic position; the transactions which enabled them to accomplish that result in a tax-efficient manner may not be disregarded for lack of economic substance.

2. The IRS failed to demonstrate that there is a genuine issue of material fact regarding the status of the notes as non-marketable securities.

3. Countryside's deemed distribution of the notes to W and C resulted in non-recognition of gain to them under Sections 731(a)(1) and 752.

Observations: This is an important case. The doctrine of economic substance is an increasingly important doctrine in the lives of practitioners who necessarily must wrestle with the balance between proper tax planning in order to legally minimize their client's tax liability in transactions that cross the grey (and evolving) line between transactions that possess economic substance and those that do not.

As noted above, W (one of the participating partners) conceded that the liquidating distribution by Countryside partnership in redemption of W's partnership interest in Countryside was structured to defer tax by distributing to W and C property rather than cash, and that tax avoidance was the sole motivation for the formation of CLPP and MP, and further that the bank loans and the purchase of the private notes, were all in furtherance of that plan. For purposes of the summary judgment motion, because W also conceded that CLPP and MP could be disregarded, the question before the tax court was whether the bank loans and deemed purchase and distribution of the private notes, must be disregarded for lack of economic substance with the result that the liquidating distribution to W must be treated as equivalent to a cash distribution to W and C (despite their literal qualification for non-recognition of gain under Section 731(a)(1). The Tax Court engaged in a thorough analysis of cases dealing with economic substance, starting with the Bedrock case of *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) wherein the United States Supreme Court famously said:

“The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means by which the law permits, cannot be doubted.... But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.”

In evaluating whether the liquidating distribution to W and C lacked economic substance, the Countryside court cited the economic substance analysis contained in the recent federal circuit decision in *Coltec Industries, Inc. v. United States*, 454 F.3d 1340, 1353-1354 (Fed. Cir. 2006), which states:

“The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.”

In *Countryside*, the Tax Court also observed that cases applying the economic substance doctrine “recognized that there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose in order to create a tax benefit (which is illegitimate).”

Drilling down a little further, the *Countryside* decision also cites *ACM Partnership v. Comm’r*, 157 F.3d 231, 248 n. 31 (3d Cir. 1998), for the proposition that “where a transaction objectively affects the taxpayer’s net economic position... it will not be disregarded merely because it was motivated by tax considerations.”

In *Countryside*, the transactions that the IRS sought to disregard, (the bank loans and the deemed purchase of the private notes by the Countryside partnership, and their distribution to W and S, the Countryside partnerships majority partners), were the means employed by W and C and agreed to by the Countryside partnership, to allow W and C to withdraw from the partnership before the anticipated sale of the Real Estate to the third-party buyer. The court held that while the employed means were designed to avoid recognition of gain to W and C, those means served a genuine, non-tax, business purpose; *i.e.*, to convert W’s and C’s investments in the Countryside partnership into ten-year promissory notes, two economically distinct forms of investment. The Tax Court concluded that all of the parties to the transaction had legitimate business purposes, and the manner in which those parties accomplished those purposes cannot be disregarded and converted by the IRS into a transaction (an exchange by W’s and C’s interest in Countryside Partnership for cash) that never occurred simply because the transaction that did occur was tax motivated or had a favorable tax effect. The Tax Court in *Countryside* further concluded that since the transaction changed W’s and C’s economic positions as well as the economic positions the Countryside partnership and its remaining partners (who through Countryside increased their collective percentage ownership in the Real Estate to 100%), the transactions had economic substance.

The Tax Court also addressed the IRS’s assertion that the transactions in question violated the partnership anti-abuse regulations under Treas. Reg. § 1.701-2. The Court held that the transaction in question did not violate the Section 701 anti-abuse regulations.

It should also be noted that there are three other docketed cases covering the same larger transaction. In Tax Court Docket No. 22023-05, the question is whether Countryside’s Section 754 election should be respected so as to allow Countryside Partnership to step up its basis in the Real Estate after the distribution of its interest in CLPP to W and C. This case, which concerns Countryside Partnership’s 2001 sale of the Real Estate was stayed pending the

outcome of the motion of the above-described Tax Court Memorandum decision in *Countryside*. Also, two cases docketed in the Court of Federal Claims, one for CLPP and one for MP address whether the formation of CLPP and MP had economic substance. These cases concern the 2003 redemption by the issuer of the privately issued notes to MP. Such redemption occurred in 2003, and was not at issue in the above-described TCM decision.

**G. Nonrecognition rules not applicable to distribution of property acquired solely for distribution to partner in liquidation of interest.** Chief Counsel Advice 200650014 (9/7/2006) concluded that the nonrecognition rules of IRC §§ 731 and 732(b) did not apply when a partnership acquired residential real estate bearing no relation to the partnership's business activities solely for the purpose of immediately distributing the real estate to a partner in liquidation of the partner's interest.

Facts.

- Due to ongoing disagreements among the partners, taxpayer and most other partners liquidated their interests. Under a redemption agreement, the partnership purchased a house and distributed it to the taxpayer, whose outside basis in the partnership was zero.
- A significant portion of the house was purchased with funds borrowed from taxpayer's relative, and the taxpayer immediately repaid this loan by taking out a mortgage against the house. The house was unrelated to the partnership's business.
- Taxpayer claimed that the total distribution of money on the liquidation did not, under IRC § 731, include the fair market value of the distributed house, in which the taxpayer took a zero basis.

The CCA concludes that a carryover basis was inappropriate for a unique parcel of residential property that was unrelated to the partnership's business activities and selected by the distributee and acquired by the partnership immediately before the distribution solely for the purpose of the distribution. The CCA also noted that the facts were consistent with a finding that the partnership was never the owner of the house for tax purposes. A significant portion of the purchase price was provided by funds borrowed from taxpayer's relative. The taxpayer subsequently took out a mortgage against the house and paid the proceeds to the partnership, which repaid taxpayer's relative. The redemption agreement also provided that if the taxpayer did not pay all expenses associated with the transaction and repay the partnership the amount of the borrowed funds within a stated period of time, the house would be sold, the partnership reimbursed for expenses and liquidated damages, the relative lender repaid, and the remaining funds distributed to taxpayer.

The CCA concluded in the alternative that if the house were properly considered partnership property, the transaction should be recast under the partnership anti-abuse rules, which authorize the Commissioner to recast a transaction for federal tax purposes if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. The CCA noted that if the taxpayer had purchased the house directly, its tax liability would have been greater than it was, since the taxpayer would

have recognized gain on the cash used by the partnership (excluding the borrowed funds) to purchase the house. It also found significant the fact that all the partners were related to one another. By attempting to characterize the distribution of the fair market value of the house as a distribution of property other than money, the parties used the rules of subchapter K inappropriately to eliminate income or gain to the taxpayer.

Finally, the CCA suggested attacking the transaction under the step-transaction and economic-substance doctrines.

Observation: The CCA is arguably inconsistent with the subsequent summary judgment decision in *Countryside v. Comm'r*, T.C. Memo. 2008-3, Doc 2008-61, 2008 TNT 2-15. See, IV A., above.

**H. Self-Employment Tax on Income Diverted to S Corporation; Lack of Economic Substance.** In *Jarrett v. Comm'r*, T.C. Summ. OP.2008-94; (July 31, 2008) the court held that transactions designed to run payments to the petitioners for tax return preparation services rendered to third parties through a newly formed S corporation by simply reporting such income as earned by a newly formed S corporation was not respected. The taxpayer's objective was to filter such income through an S corporation and thereby convert it from earned income (on which self-employment taxes would be due) into unearned income (on which no self-employment taxes would be due). The court held that the alleged payments between the petitioners and the newly formed S corporation lacked economic substance and should be disregarded. A twenty-percent accuracy penalty was imposed pursuant to § 6662(a), and such penalty was upheld by the court.

**I. IRS Examining Motives Behind "Partnership Blocker" Transactions.** IRS Notice 2009-7 released by the IRS on December 29, 2008 designates as transactions of interest some arrangements in which a taxpayer interposes a domestic partnership in a controlled foreign corporation structure to ostensibly prevent the inclusion of subpart F income. The notice indicates that the IRS is concerned that taxpayers are taking the position that these structures result in no income inclusion under § 951. The notice states that taking such a position "is contrary to the purpose and intent of the provisions of subpart F of the Code."

## **VI. Mixing Bowls; Guaranteed Payments; Disguised Sales.**

**A. U.S. District Court of New Jersey applies substance over form analysis to recast purported 721 capital contribution of assets to partnership and transfer of loan proceeds to transferring partner as a disguised sale under 707(a)(2)(B).** *G-I Holdings, Inc, et al* 105 AFTR 2d 2010-697 (DC NJ), 12/14/2009. After applying a *Culbertson* analysis to concluded that the relationship of the parties constituted a partnership for federal income tax purposes, the court concluded that the substance of the transactions at issue produced tax results inconsistent with their form in the underlying document. The court held that as a matter of substance the taxpayer's transfer of \$450M of assets to the partnership are properly viewed as a direct transfer of money or other property by a partner to a partnership within the meaning of Section 707(a)(2)(B)(i). The court further found that loan proceeds of \$450M paid by a bank to such transferring partner on the same date constituted an indirect transfer of money or other property by the partnership to a partner, within the meaning of Section 707(a)(2)(B)(ii). The

Court found that the bank payment was structured to function as a payment to such partner in substance, and that when viewed together, the transfers to the partnership and the payment to the partner, are properly characterized as a sale of property pursuant to Section 707(a)(2)(B)(iii).

**B. “Assets-over” mergers and anti-mixing-bowl rules. Proposed regulations under IRC §§ 704(c)(1)(B) and 737 implementing the principles of Rev. Rul. 2004-43 were issued on August 22, 2007. Once finalized, the regulations will be effective for distributions occurring after 1/19/2005 (Reg. 143397-05, (8/22/07)).**

Note that the basis of the assets transferred from a merged partnership to the resulting post-merger partnership are not recomputed, but are instead carried over to the resulting post-merger partnership. In contrast, the economic capital accounts of the partners in both partnerships are typically adjusted to reflect the fair market value of all of the assets of both partnerships immediately following the merger. The partners in the merged partnership receive an interest in the resulting post-merger partnership in a liquidating distribution. The partners’ bases in the merged partnership interest become the tax basis of their post-merger partnership interests.

Also note that if the basis of property contributed to a partnership by a partner is different from the properties’ fair market value (“FMV”) at the time of contribution, then certain rules apply to such built-in gain or loss, including: if the partnership distributes the contributed property to one or more partners other than the contributing partner, within seven years of the contribution, then the contributing partner recognizes gain in an amount equal to the built-in gain.

If real property, other than the property contributed by a partner, is distributed to such partner, she will recognize built-in gain equal to the lesser of: (a) the excess of the FMV of the property over the adjusted basis of the partner’s interest in the partnership immediately before the distribution (reduced, but not below zero, by any money and marketable securities received), or (b) the partners’ so-called “net pre-contribution gain” under Section 737(b).

The proposed regulations implement the principals articulated in revenue ruling 2004-43. The proposed regulations under Treas. Reg. §1.704-4(c)(4) and §1-737-2(b) provide that in an assets-over merger, §§704(c)(1)(B) and 737 do not apply to the transfer by a partnership (the transfer or partnership) of all of its assets and liabilities to another partnership (the transferee partnership), followed by a distribution of the interests in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.

The proposed regulations, however, provide that §704(c)(1)(B) applies to a subsequent distribution by the transferee partnership of §704(c) property contributed in the assets-over merger by the transfer or partnership to the transferee partnership. The proposed regulations also provide that §737 applies when a partner of the transferor partnership receives a subsequent distribution of property (other than money) from the transferee partnership.

The proposed regulations provide that for property contributed to the transferor partnership (original contribution), the amount of original §704(c) gain or loss is the difference between the property’s fair market value and the contributing partner’s adjusted basis at the time

of contribution to the extent such difference has not been eliminated by §704(c) allocations, prior revaluations or in connection with the merger.

Under the proposed regulations, the seven-year period will not restart with respect to the original §704(c) gain or loss as a result of the merger. Accordingly, a subsequent distribution by the transferee partnership of property with original §704(c) gain or loss is subject to §§704(c)(1)(B) and 737 if the distribution occurs within seven years of the contribution of the property to the transferor partnership (original contribution). However, with respect to new §704(c) gain or loss, the regulations provide that the seven-year period in §§704(c)(1)(B) and 737 begins on the date of the merger. Thus, a subsequent distribution by the transferee partnership of property with *new* §704(c) gain or loss is subject to §§704(c)(1)(B) and 737 if the distribution occurs within seven years of the merger.

The proposed regulations further provide that no original §704(c) gain or loss will be recognized under §704(c)(1)(B) or §737 if the property that was originally contributed to the transferor partnership is distributed to the original contributor. If property has new §704(c) gain or loss, then a subsequent distribution of such property within seven years of the merger to one of the former partners of the transferor partnership is subject to §704(c)(1)(B) only to the extent of the other former partners' shares of such gain or loss.

In addition, the proposed regulations provide an identical ownership and a de minimis change in ownership exception to §§704(c)(1)(B) and 737 with regard to assets-over partnership mergers. Under the identical ownership exception, §704(c)(1)(B) will not apply to, and §737 net pre-contribution gain will not include, new §704(c) gain or loss in any property contributed in an assets-over partnership merger where the ownership of both partnerships is identical. The same rules apply where the change in ownership is de minimis. For purposes of the de minimis exception, a difference in ownership is de minimis if 97% of the interest in book capital, items of income, gain, loss, deduction and credit and share of distributions and liabilities of the transferor partnership and transferee partnership are owned by the same owners in the same proportions.

The proposed regulations will be generally effective for any distributions of property after January 19, 2005, if such property was contributed in an assets-over merger after May 3, 2004.

On August 12, 2009, the IRS issued Notice 2009-70, 2009-34 IRB 255, requesting comments as to the application of certain aspects of the merger Proposed Regs....

**C. Partnership's transfer of property in satisfaction of guaranteed payment taxable under IRC § 1001.** Rev. Rul. 2007-40, 2007-25 IRB 1, holds that a partnership's transfer of partnership property to a partner in satisfaction of a guaranteed payment under IRC § 707(c) is a sale or exchange under IRC § 1001 and not a distribution under IRC § 731. Thus the nonrecognition rule of IRC § 731(b) does not apply to the transfer..

**D. Treasury Withdraws Proposed Regs under Section 707(a)(2)(B) regarding Disguised Sale.** Section 707(a)(2)(B) provides that pursuant to regulations, if transfers of property between a partner or partners and a partnership when viewed together, are properly characterized as a sale or exchange of property, such transfer shall be treated as either

transactions between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners. The provision was adopted as a result of Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions.

In response to requests, on November 26, 2004, Treasury published a notice of proposed rule making under § 707(a)(2)(B) (REG-149519-03) relating to disguised sales of partnership interests. The proposed regs sought to amend the existing regs for disguised sales of property by adding rules for disguised sales of partnership interest and by revising the rules relating to disguised sales of property. After considering the written comment received on the proposed regs, Treasury decided to withdraw them. Announcement 2009-4; 2009-8 IRB 597 (February 23, 2009), provides that until new guidance is issued, any determination of whether transfers between a partner or partners in a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in the legislative history and case law. The notice of proposed rule making that was published in the Federal Register on November 26, 2004 is withdrawn.

## **VII. TEFRA and Other Procedural Matters.**

**A. New Partnership final, Temporary and Proposed Regulations Define Omission from Gross Income for Purposes of Six-Year Statute of Limitations (TD 9466 and REG – 108045-08, 9/24/09).** These new rules purport to resolve a continuing issue as to whether an overstatement of basis in a sold asset results in an omission from gross income for purposes of the extended six-year statues of limitations under Section 6229(c)(2). The Service is attempting to apply these regulations retroactively. *See Salman Ranch Ltd.*, 104 AFTR 2d 2009-5640 (CA-F.C., 2009). The Regulations purport to apply retroactively to tax years with respect to which the six-year statue had not expired before September 24, 2009. Courts have disagreed as to whether a six-year statue of limitations applies outside the trade or business context to substantial omissions of gross income due to basis overstatements. The IRS issued these new regulations in response to recent losses in the Ninth and Federal Circuits on when the six-year statute of limitations applies. *See Bakersfield Energy Partners, LP v. Commissioner*, 568 F.3d 767 (9<sup>th</sup> Cir 2009) and *Salman Ranch Ltd. v. U.S.*, 573 F.3d 1362 (Fed. Cir. 2009). These courts followed the U.S. Supreme Court’s decision in *The Colony Inc. v Commissioner*, 357 U.S. 28 (1958) which held that a taxpayer does not “omit” an amount from gross income within the meaning of the predecessor to Section 6501(e)(1)(A) by overstating its basis in property. The regulations purport to reopen tax years that taxpayers had considered to be closed.

**B. Partner Level Defenses to Penalties May Not be Raised in Partnership Proceedings. In *New Millennium Trading LLC, AJF-1 LLC v. Comm’r*, 131 T.C. No. 18 (December 22, 2008), the court applied Treas. Reg. 301.6221-1T(c) and (d) which provide as follows:**

(c) Penalties determined at the partnership level (partnership taxable years ending after August 5, 1997). Any penalty ... that relates to an adjustment to a partnership item shall be determined at the partnership level. Partner level defenses to such items can

only be asserted through refund actions following assessment and payment. Assessment of any penalty ... that relates to an adjustment to a partnership item shall be made based on partnership level determinations ...

(d) Partner-level defenses. Partner-level defenses to any penalty ... that relates to an adjustment to a partnership item, may not be asserted in the partnership-level proceeding, but may be asserted through separate refund actions following assessment and payment ... Partner-level defenses are limited to those that are personal to the partner or are dependant upon the partner's separate return, and cannot be determined at the partnership level. Examples of these determinations are whether any applicable threshold under payment of tax has been met with respect to the partner or whether the partner has met the criteria of § 6664(b) ...

The Tax Court upheld the validity of these regulations, and found them applicable to the penalties at issue. Consequently, the partner level defenses to such penalties could not be raised in the partnership proceedings, but, instead needed to be raised by the taxpayer pursuant to separate refund actions later filed under § 6230(c). The court stated:

We agree with respondent that a partner cannot raise partner-level defenses in an TEFRA proceeding. When considering the determination of penalties at the partnership level, the court can consider the defenses of the partnership but not partner-level defenses of individual partners.

**C. Section 6229 not a separate statute of limitations but a minimum period that may extend limitations period under IRC § 6501.** Following the Tax Court in *Rhone-Poulenc Surfactants and Specialties, L.P. v. Commissioner*, 114 T.C. 533 (2000), the Federal Circuit held in *AD Global Fund, LLC v. United States*, 99 AFTR 2d 2007-1259 (Fed. Cir. 2007), that IRC § 6229(a) is not a separate statute of limitations for assessing taxes on partnership items but merely a minimum period that may extend the regular statute of limitations under IRC § 6501.

#### Facts.

- IRS issued notice of final partnership administrative adjustment (FPAA) for partnership's 1999 tax year more than three years after partnership filed its 1999 return but within three years after individual partner filed its return.
- The partnership, by and through a notice partner, moved for summary judgment alleging that IRC § 6229(a) provides a separate statute of limitations.

The court recognized its interpretation may extend the regular statute of limitations under IRC § 6501(a) for assessments to individual partners but concluded that it did not alter the statutory scheme of determining partnership items in one partnership-level proceeding before assessing individual partners for partnership items. *See also Schumacher Trading Partners II v.*

*United States*, 98 AFTR 2d 2006-5712 (Fed. Cl. 2006) (IRC § 6501 controls if its limitations period expires after expiration of IRC § 6229 limitations period; IRC § 6229 merely establishes alternative minimum period within which IRS may issue FPAA for assessing tax attributable to partnership item.); *Grapevine Imports Ltd. v. United States*, 97 AFTR 2d 2006-2936 (Fed. Cl. 2006) (same).

**D. Partner-level proceedings where statute is extended can adjust partnership and affected items for closed partnership years only if Form 872 refers to partnership items.** At issue in *Ginsburg v. Commissioner*, 127 T.C. 75 (2006), was a notice of deficiency issued to indirect partners for 1995 disallowing flow-through losses from a TEFRA partnership. The partnership's 1995 tax year was closed. The partners had signed Forms 872 under IRC § 6501(c)(4) extending the period to assess tax for 1995 to any time on or before 6/30/2005. The extensions did not reference partnership items.

The court found that the items sought to be adjusted were not “partnership items,” which may be adjusted only in a partnership-level proceeding (no FPAA was issued), but rather “affected items,” which can be determined only on the basis of factors unique to each partner. Because IRS had previously accepted the partnership's 1995 return as filed, the court concluded it had jurisdiction to review the adjustments to that extent. *See, e.g., Roberts v. Commissioner*, 94 T.C. 853, 860 (1990) (holding that court has jurisdiction over affected items when government accepts partnership return as filed, because that fulfills requirement that there be an “outcome of a partnership proceeding” before assessment of affected items).

The court held, however, that the notice of deficiency was untimely, since the period for assessing tax attributable partnership and affected items had run. The statute was open for the taxpayers only by virtue of the extensions, but the extensions failed to extend the limitations period under IRC § 6229 because they did not expressly provide that they applied to tax attributable to partnership items. *See* IRC § 6229(b)(3) (providing that agreement under IRC § 6501(c)(4) shall apply with respect to the period described in IRC § 6229(a) only if it expressly provides that the agreement applies to tax attributable to partnership items).

IRS had argued, based on *Rhone-Poulenc* (see V.A., above), that when the period of limitations under IRC § 6501 is open, reliance on IRC § 6229 is unnecessary. The court, however, found IRS's reliance on *Rhone-Poulenc* misplaced. When the FPAA was issued in *Rhone-Poulenc*, the period for assessing tax was still open under IRC § 6501(e) (6 year statute in cases involving substantial omissions of gross income). In *Ginsburg*, IRS never issued an FPAA but accepted the partnership's 1995 return as filed. The period for assessing any partnership item relating to the partnership's 1995 tax year had expired, and the period for assessing tax due from taxpayers was open solely by reason of the agreements to extend the period for assessing tax under IRC § 6501(c)(4). Thus, if the statute has run on partnership-level proceedings, a partner-level proceeding *where the statute has been extended* can adjust partnership and affected items only if partnership items are referred to in the Form 872.

**E. Federal Court of Claims Ruled that Trial Court in TEFRA Partnership Level Proceeding Does Not Have Jurisdiction to Determine Partner-Level Penalties or Rule on Partner-Level Defenses.** *Stobie Creek Investments, LLC and JFW Enterprises, Inc v. U.S.*

No. 1:05-cv-00748 (Ct. Fed Cl, 2008), Order on Motion to Confirm Jurisdiction. *cf. Klamath Strategic Investment Fund v. U.S.*, 472 F. Supp. 2d 885 (E.D. Tex. 2006).

**F. Tax Matters Partner of LLC.** In CCA-916830-08 (September 16, 2008), Chief Counsel advised that if no other member of an LLC taxable as a partnership is a manager, then all members are deemed to be member-managers eligible to be designated as TMP. However, if any other member is a manager under state law and the designated member is not, then the designation as TMP is invalid. *See*, Treas. Reg. § 301.6231(a)(7)-2(b)(3).

**G. Heads-Up to Added Disclosure Required on Partnership Return (Form 1065).** The 2008 Form 1065 contains a number of new questions which will require partnerships to disclose additional information about the partnership and its activities, and also about the partners in the partnership. Among the information required to be disclosed is:

- whether at any time during the year any partner was a disregarded entity;
- whether any foreign or domestic corporation, partnership or trust owned directly or indirectly an interest of 50% or more of the profit, loss or capital of the partnership (taking into account constructive ownership);
- whether the partnership engaged in a so-called “swap-and-drop,” “drop-and-swap” or § 1031 exchange;
- whether the partnership had any debt that was cancelled, was forgiven, or had terms modified so as to reduce the principal amount of the debt; and
- information about certain tax elections.

Information required in connection with filing a partnership return is consistent with a trend in other areas of partnership taxation which require the partnership (including LLC or other unincorporated entity taxed as a partnership) to obtain substantial information about its direct and indirect partners. Consideration should be given to drafting a provision into the partnership agreement which requires the partners to provide to the partnership such information as the partnership may deem reasonably necessary to comply with applicable law. It is unknown whether the solicited information with respect to § 1031 exchange, swap-and-drop and drop-and-swap transactions signal an IRS plan to audit more of such § 1031 exchange transactions with respect to the held for investment or business requirement of § 1031.

**H. Partnership Failure to File Penalty Increased.** The monthly multiplier for failure to file penalty applicable to partnership return is increased from \$86.00 to \$89.00 pursuant to Code § 6698(b)(1). This provision applies to returns filed after December 31, 2008.

**I. Section 6231 Proposed Regulations on Converting Partnership Items to Non-partnership Items.** On February 12, 2009, Treasury released proposed regulations under § 6231 that allowed the IRS to convert partnership items to non-partnership items when the application of the unified partnership audit and litigation procedures of §§ 6221 thru 6234 (TEFRA) with

respect to certain tax avoidance transactions interferes with the effective and efficient enforcement of the Internal Revenue laws. The regulations affect taxpayers who have engaged in a listed transaction through an entity subject to the TEFRA partnership procedures.

### **VIII. Family-Owned Partnerships.**

**A. Proposed Legislation. See II. above.**

**B. Transfer of assets to a family limited partnership was a bona fide sale for full and adequate consideration, thus the contributed assets were not included in the decedent's estate under Section 2036(a)(1).** *Estate of Charlene B. Shurtz, v. Commissioner*, T.C. Memo. 2010-21 (February 3, 2010).

**C. Gifts of LP Interests to Adult Children Held Not to be gifts of Present Interests which qualified for annual exclusions under 2503(b).** In *Price v. Commissioner*, T.C.M. 2010-2; Nos' 9611-06, 9642.06. the issue was whether gifts that taxpayers made of LP interests to their adult children during 2000, 2001 and 2002 qualified for annual exclusions as provided by section 2503(b). The LP agreement generally prevents any partner restricted transfer and assignment of partnership interests as follows:

Prohibition Against Transfer. Except as hereinafter set forth, no partner shall sell, assign, transfer, encumber or otherwise dispose of any interest in the partnership without the written consent of all partners; provided, however, a limited partner may sell or otherwise transfer his or her partnership interest to a general or limited partner, or to a trust held for the benefit of a general or limited partner.

Assignment. Any assignment made to anyone, not already a partner, shall be effective only to give the assignee the right to receive the share of profits to which is assignor would otherwise be entitled...

The partnership agreement further provided that in the event of an assignment of an LP interest, the partnership and non-transferring partners each had the option to purchase the partnership interest for its fair market value, that the term of the partnership was 25 years (unless earlier terminated by a vote of partners holding a two-thirds interest, and that the partnership has no obligation to make any distributions.

Citing the Tax Court's decision in *Hackl v. Commissioner*, 118 T.C. 279, 294 (2002), *aff'd* 335 F.3d 664 (7<sup>th</sup> Cir. 2003) where the court had rejected the notion that a gift that takes the form of an outright transfer of an equity interest in a business is necessarily a gift of a present interest, the court in *Price* reasoned that in order to establish entitlement to an annual exclusion under 2503(b), a taxpayer must "establish that the transfer in dispute conferred on the donee an unrestricted and noncontingent right to the immediate use, possession, or enjoyment (1) of property or (2) of income from property, both of which alternatives in turn demand that such immediate use, possession, or enjoyment be of a nature that substantial economic benefit is derived therefrom."

The tax court in *Price* rejected the taxpayer's contention that *Hackl* was incorrectly decided and/or distinguishable from the facts of *Price* in ways helpful to the taxpayer. The court

held that the combination of no unilateral right to withdraw capital, the fact that the donees were apparently not even limited partners but mere assignees, the prohibition on sale to a third party, and the discretionary nature of all distributions preclude a finding that the gifts of the LP interests conferred on the donees an unrestricted and noncontingent right to immediately use, possess or enjoy either the property itself or the income from the property. The Court therefore held that the taxpayers are not entitled to exclusions under section 2503(b) for their gifts of partnership interests.

**D. *Bianca Gross v. Comm’r, T.C. Memo 2008-221 (2008).*** The principal issue for decision was whether the taxpayer’s transfer of securities to a family limited partnership constituted indirect gifts of a portion of those securities to other members of the partnership. The Tax Court rejected the Service’s determination to treat the widowed taxpayer’s contributions of securities to the FLP as indirect securities gifts to partners/daughters. The Service had argued that partnership formation and securities transfers occurred in such a timeframe that meant the daughters must have received securities, rather than partnership interests. The Court rejected this argument, noting that the partnership formation was complete under applicable state law, and the capital contributions were complete before the time that the taxpayer made transfers of FLP interests to her daughters.

**E. *Hurford v. Comm’r, T.C. Memo 2008-278 (Dec. 11, 2008).*** In *Hurford v. Comm’r*, before her death, decedent sold her assets to three newly formed family limited partnerships (“FLPs”) through private annuity agreements. This is a textbook example of how failure to carefully adhere to sound estate planning procedures, both from a technical standpoint and from a standpoint of respecting formalities, can be a recipe for disaster. The subject assets were included in the decedent’s estate without discounts, under a variety of theories, including §§ 2035(a), 2036(a)(1), and that the private annuity was not bona fide and for adequate and full consideration.

**F. *Hallman v. Comm’r, 130 T.C. No. 12 (2008).*** In *Hallman*, the Tax Court held that the taxpayers’ transfer of stock to a FLP in advance of gifts of limited partnership interests to their children was not an indirect gift of the stock to the children, even though the transfers of the stock to the partnership and gifts of FLP interests were only separated by roughly one week. The Court concluded that since the taxpayer’s bore a real economic risk of change in value of the partnership for the six days that separated the transfer of shares to the partnership and the gift, the Court concluded that the formation and funding of the partnership and the subsequent gift should not be treated as occurring simultaneously.

The Court reduced the minority/control discount and lack of marketability discount claimed by the taxpayer (allowing control/marketability discount of 11.2% to a 1999 gift, 13.4% to a 2000 gift and 5% to a 2001 gift) and lack of marketability discount (allowing 12.5% marketability discount).

**G. *Mirowski v. Comm’r, T.C. Memo 2008-74 (March 26, 2008).*** In *Mirowski*, the Tax Court determined that neither § 2036(a) nor § 2038(a) applied to asset transfers that decedent made to her single-member LLC shortly before death. The Court also held that neither § 2036(a) nor § 2038(a) applied to property transfers of fractional interests in a single-member LLC that decedent transferred to daughters or their trusts days before her death. The Court

found that the parties never agreed or intended that decedent would retain income from or possession or enjoyment of transferred interests within the meaning of § 2036(a)(1), and that decedent did not otherwise retain any § 2036(a)(2) designation right, and that she held no power to alter, amend, revoke or terminate within the meaning of § 2038(a)(1).

**H. Gift of Interests in Disregarded Entity.** See Pierre discussion *infra* at III.D.

**IX. Miscellaneous.**

**A. Membership Interest in LLC is not an “interest in a limited partnership as a limited partner” under Section 469(h)(2).** According to Tax Notes Today (March 11, 2010), An IRS official said March 10 that the government is rethinking how to treat pass activity loss limitations for limitation company members in light of the IRS losses in the cases below. Treasury Regulation 1.469-5T currently sets forth seven tests that individuals can use to establish material participation in an activity for pass activity loss rules. However, “limited partners” are restricted to meeting only three of these tests. The IRS litigating position (see the cases below), has been that LLC members are limited partners for purposes of these rules. According to the TNT article, the recent IRS “acquiescence in result only” in the *Thompson* case signals the governments decision that it won’t be litigating these cases any more, that the IRS has a guidance project in progress and expects to have guidance out by the end of the year.

**1.** In *Newell v. Commissioner*, **T.C. Memo. 2010-23**, the taxpayer owned a 33% membership interest in a California LLC that engaged in the business of owning and operating a golf course, restaurant, and country club facility. The taxpayer was the LLC’s managing member. The IRS disallowed the taxpayer’s deduction of his share of the LLC’s losses by taking the position that the losses were passive losses from an activity in which the taxpayer did not materially participate. The IRS based its argument on Section 469(h)(2) and Temp. Reg. 1.469-5T(e) which presume that a taxpayer does not materially participate with respect to an interest as a limited partner in a limited partnership. Based on *Garnett v. Commissioner*, 132 T.C. 19 (2009) the court held that the taxpayer did not hold a limited partnership interest and that the LLC interest comes within the general partner exception of Temp. Reg. 1.469-5T(e)(3)(ii). Under that exception, a partnership interest is not treated as a limited partnership interest if the partner also holds an interest in the partnership as a general partner.

**2.** In *Garnett v. Commissioner*, **132 T.C. 19 (2009)**, the taxpayer, directly and indirectly, owned interests in LLPs and LLCs that were treated as partnerships for federal tax purposes.(the “Partnerships”). The Partnership’s generated losses that were deducted by the taxpayer. The IRS asserted that the taxpayer’s interests in the Partnerships were limited partnership interests under Section 469(h)(2) and Temp. Reg. 1.469-5T(e) and disallowed the loss deductions by characterizing them as passive activity losses. Under the temporary regulations, limited partner holding a limited partnership interest is treated as not materially participating in the limited partnership’s activities, unless the partner can satisfy one of the three regulatory tests for material participation set forth in Temp. Reg. 1.469-5T(a)(1), (5), (6). The court examined the differences between limited partnerships, LLPs, and LLCs. An owner of a limited partnership interest in a limited partnership cannot participating in management of the partnership without losing limited liability, however, there is no such restriction for LLP partners

or LLC members. The IRS argued that the sole relevant factor for determining that an interest is a limited partnership interest under Section 469(h)(2) is whether the owner of the interest has limited liability. The court, however, examined the legislative history of Section 469(h)(2) and Temp. Reg. 1.469-5T(e)(3), and held that the “general partner exception” provided in Temp. Reg. 1.469-5T(e)(3)(ii) applies to the LLP and LLC interests. The court reasoned that the right to participate in management afforded to LLP partners and LLC members made those interests more akin to general partnership interests. Under Temp. Reg. 1.469-5T(e)(3)(ii) a partnership interest will not be treated as a limited partnership interest if the partner also a general partnership interests in the partnership.

3. In *Thompson v. U.S.*, 104 AFTR 2d 2009-5381 (Ct. Fed. Cl. 2009), the taxpayer owned 99% of the membership interests in an LLC directly and the remaining 1% indirectly through an S corporation. The LLC was treated as a partnership for federal tax purposes. The taxpayer deducted losses from the LLC on his individual return. The IRS disallowed the losses by recharacterizing them as passive activity losses. The IRS asserted that the taxpayer’s LLC interests were limited partnership interests under Temp. Reg. 1.469-5T and thus the taxpayer could not be treated as materially participating in the activity. The court, however, held that the temporary regulation should not be applied to presume that an LLC member does not materially participate in the activity because “[o]nce Treasury Regulation § 1.469-5T(e)(3) is read in context and with due regard to its text, structure, and purpose, it becomes abundantly clear that it is simply inapplicable to a membership interest in an LLC.” The court’s reasoning was based on the fundamental differences between limited partnership and LLCs, and the fact that Section 469(h)(2) specifically refers to interests in a limited partnership as a limited partner. The court also reasoned that, even if the temporary regulation was applicable to LLC members, a membership interest in an LLC would best be characterized as a general partner’s interest under Temp. Reg. 1.469-5T(e)(ii). On March 9, 2010, the IRS acquiesced in result only.

4. See also *Sean Kieran Hegarty et ux. V. Commissioner*, T.C. Summ. Op. 2009-153 (Oct 6, 2009).

**B. Deliberative Process Privilege/*Proctor & Gamble Co. v. United States*, 105 AFTR 2d 2010-330 (Dec. 31, 2009).** The taxpayer donated certain artwork and technologies to charities. The IRS audited the taxpayer’s returns and disallowed certain deductions and credits related to the donations. In the ensuing refund litigation, the taxpayer requested that the IRS produce documents underlying the IRS’s appraisal of the artwork and technologies. The IRS asserted that the deliberative process privilege protected the documents related to the IRS’s appraisal from discovery. For the deliberative process privilege to apply to a document, the document must be pre-decisional and deliberative. Pre-decisional means that the document must have been created prior to the time that the agency’s final decision is issued. Deliberative means that the document reflects “the give-and-take of the consultative process.” The court held that notes of meetings containing largely factual information, and not deliberation and analysis, must be produced. The court also held that documents concerning the decision to hire outside consultants and/or appraisers, and agreements with outside firms, must be disclosed. On the other hand, the court held that notes of the audit team summarizing preliminary analysis, plans for subsequent action, and deliberations and communications up and down the chain of command, were protected from disclosure. Also protected from disclosure were draft interview

questions for the taxpayer's employees and third parties, agent activity logs containing discussions and deliberations between members of the examination team.

**C. Non-Corporate Limited Partner's Distributive Share of Interest Expense is Investment Interest.** Revenue Ruling 2008-12 holds that a non-corporate limited partner's distributive share of interest expense on debt allocable to the partnership's securities trading business is investment interest under Section 163(d)(1) if the limited partner does not materially participate in the trading activity. In Revenue Ruling 2008-12, a partnership trades securities for its own account and not for customers. A non-corporate taxpayer owned an interest in the partnership as a limited partner and did not materially participate in the partnership's trading activities. The Revenue Ruling notes that the partnership's trading business is not a passive activity under Section 469. Because the limited partner's distributive share of interest paid or accrued on the partnership's debt is allocable to the trading activity of the partnership, it is investment interest under Section 163(d)(3), and subject to the investment interest limitations of Section 163(d)(1). The revenue ruling explains that the partnership must separately state the interest expense because the degree of participation by each non-corporate partner could limit the deductibility of the interest expense allocable to the partnership's trading business

**D. Incidents of Ownership/2042.** In PLR 200947006 the IRS ruled that insurance proceeds received by partnership upon taxpayer's death won't be included in taxpayer's gross estate under Section 2042, where partnership will pay all premiums and taxpayer won't have power to change beneficiary, surrender or assign policy, or obtain loan against surrender value.

**E. Transfer for "Valuable Consideration" under § 101(a)(2) (PLR 200826009, December 20, 2007).** X partnership was engaged in the business of buying options on the real estate of homeowners pursuant to an options program. The options entitled X to a portion of the future appreciation, if any, of the homeowner's personal residence. X partnership has two partners, Y corporation and M (which holds through a disregarded entity).

Under the program, X will purchase call options from homeowners and (who are over a certain age and have a minimum life expectancy) with respect to their personal residences. Each option will allow X for an option premium to acquire the owner's home (upon the occurrence of certain events) at a strike price equal to the fair market value of the home, plus a specified percentage of any subsequent capital appreciation in the home less an acquisition cost charge capped at D percent of the fair market value of the home at the time that X exercises the option. X will make either an initial lump sum premium payment at the inception of the option contract or monthly payments to each of the homeowners. Upon the occurrence of either the homeowner's death or sale of the homeowner's personal residence, the option becomes immediately exercisable.

In order to protect itself against the risk that the homeowner may die before significant appreciation accrues in the value of the residence, X will acquire a life insurance policy from a commercial insurer on each individual homeowner and name itself as the beneficiary of the policy. X will pay all premium payments and costs on the policies. Upon death of a homeowner, the policy will pay directly to X.

Once all of the policies are acquired and options issued, partner M intends to sell its partnership interests to third party investor for cash. The X partnership agreement contained provisions designed to avoid a termination of X under § 708(b)(1)(B).

X will either hold the options until they are exercised or lapse, or will sell them. Upon exercise of an option, X will sell the related home and distribute the proceeds to the partners in accordance with their partner interests. Once the life insurance proceeds are paid, X will distribute the proceeds to investor in accordance with their partnership interests. X represented that it had no plan or intention to transfer life insurance policies to controlled entities in non-recognition transactions. X also represented that it had a valid “insurable interest” in each policy, and that X would not incur a termination pursuant to § 708(b)(1)(B).

Held: The policies were “life insurance contracts” within the meaning of § 7702(a), the sale or exchange of membership interests in X partnership either by M or any of the investors will not result in a transfer for a “valuable consideration” under § 101(a)(2), provided there is not termination of the partnership under § 708(b)(1)(B).

#### **F. Publicly Traded Partnerships/“Qualifying Income”.**

**1. In CCA 200749012**, IRS Chief Counsel advised that income derived from the distribution and marketing of propane to end users at the retail level constitutes qualifying income under Section 7704(d)(1)(E). In that CCA, Chief Counsel noted that the IRS had previously received a request for a ruling that income from the rental of propane storage tanks would be considered “qualifying income” under Section 7704(d). However, Chief Counsel also advised in CCA 200749012 that the income from storage tank rentals is non-qualifying.

**2. In PLR 201005018** a publicly traded partnership owned a facility that it intended to lease to a lessee. The facility was a permanent structure designed to receive, store, and distribute an unspecified product at elevated temperatures. The IRS analyzed whether the facility was “real property” under Section 856 and Treas. Reg. 1.856-3(d) such that the lease payments would be considered real property rents and thus qualifying income under Section 7704(d). The IRS ruled that the facility is an inherently permanent structure that is not accessory to the operation of a business and constitutes real property for purposes of Section 865(d), therefore the rental income derived from the lease of the facility is qualifying income under Section 7704(d)(1)(C).

**G. Tax Termination Under 708(b)(1)(B) Did Not Preclude Reconstituted Partnership From Relying on Prior PLRs to Predecessor Partnership Regarding the Application of §45 Credits (Formerly §29 Credits).** This ruling serves as a reminder that transfers during a 12 month period of 50% or more of the interest in both capital and profits cause a tax termination of the partnership under §708(b)(1)(B), and that such tax termination can give rise to tax consequences or the reconstituted partnership. In this situation, the taxpayer received a previous private letter ruling (PLR 200430017). Such prior ruling related to the taxpayer/partnership’s qualification for tax credits under §45(K). After a review of the applicable facts, and the legislative history pertaining to §44(D) and §45(K), the Service concluded that the prior ruling obtained by the predecessor partnership will remain in full force and effect following the 708(b)(1)(B) termination. The import of this private letter ruling is that

the determination of whether a private letter ruling obtained by a predecessor partnership that is terminated pursuant to §708(b)(1)(B) will remain in full force and effect for the reconstituted partnership, may depend on the particular circumstances.

**H. Series LLC (PLR 200803004).** In private letter ruling 200803004, (October 15, 2007), the IRS ruled that an LLC's separate series would be treated as separate (and different types of) entities for federal income tax purposes. This private letter ruling involved a series LLC formed under the act of an unidentified state. At the time of the ruling, the LLC had three different types of series:

Type C – which was ruled to be separate entity which because it made the check-the-box election was classified as an association, taxable as a regulated investment company (because of the nature of its business)

Type D – which had only a single owner and did not make a check-the-box election was classified as a disregarded entity

Type P – which had multiple owners and did not make the check-the-box election was classified as a partnership

In the ruling the taxpayer made the following representations, among others:

- Each series will hold a separate pool of assets, liabilities and have a separate stream of earnings;
- The owners of a series may share in the income only of the series;
- The ownership interest of the owners of a series will be limited to the assets of that series upon redemption, liquidation or termination of such series;
- The payment of the expenses, charges and liabilities of a series will be limited to that series' assets;
- The creditors of a series are limited to the assets of that series for recovery of expenses, charges and liabilities;
- Each series will have its own investment objectives, policies and restrictions; and
- Votes of the owners of a respective series may be conducted by such series separately with respect to matters that affect only that particular series, except to the extent that the 1940 Act requires ownership interest of more than one series to be voted as a single class.

**I. Series LLCs (IRS Notice 2008-19; Rev. Rul. 2008-8).** Rev. Rul. 2008-8 addresses whether certain arrangements constitute insurance for federal income tax purposes. The “insurance” is provided through a “Protected Cell Company” utilizing cells which are not separate entities for state law purposes but which do account for their own income, expense, assets, liabilities and capital. These structures are often utilized in connection with a so-called

“series” LLC, with each series having a separate business purpose for investment objective. PLR 200803004, discussed above, held that under the facts of that PLR, an LLC’s separate series would be treated as separate (and different types of) entities for federal income tax purposes. Nonetheless, there is scant authority that addresses whether a series of a limited liability company constitutes a separate entity for federal tax purposes.

Notice 2008-19 proposed guidance that would include a rule to the effect that a cell of a Protected Cell Company would be treated as an insurance company separate from any other entity if the assets and liabilities of the cell are segregated from the assets and liabilities of other cells; and if based on the facts and circumstances, the activities of the cell would, if conducted by a corporation, result in its being classified as an insurance company under §§ 816(a) or 831(c). Notice 2008-19 requests comments on guidance concerning segregated arrangements that do not involve insurance. The American Bar Association, Section of Taxation submitted comments in response to Notice 2008-19 on January 5, 2009. The ABA comments request guidance on the classification of series limited liability companies for federal tax purposes. The ABA comments also propose that the guidance confirm that each series of an LLC will be treated as a separate “business entity” for purposes of Treas. Reg. § 301. 7701-2(a) assuming certain minimum requirements are met including that the respective series must (i) be formed under a statute having characteristics such as those contained in the Delaware Series Provision of the Delaware LLC Act and (ii) satisfy applicable recordkeeping and notice requirements so that liabilities of a particular series may only be enforceable against that Series’ assets.

**J. Series LLCs (Tax Notes Today, March 8, 2010)** reported that on March 5, Dianna Miosi, special counsel in the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) said at a tax conference that the IRS expects to release guidance on Series limited liability companies by June, or perhaps earlier. The guidance project will address whether series LLCs will be treated as separate entities for federal tax purposes or as part of an umbrella organization. If the guidance takes the separate entity route, Ms. Miosi indicated that there are several issues that should be considered. One involves employee benefit and employment tax issues (*i.e.*, who is the employer for federal tax purposes?). Other questions involve the form the guidance will take and whether it will apply to foreign entities or to domestic entities only.

**K. Management Fees (Rev. Rul. 2008-39).** In Rev. Rul. 2008-39 an individual limited partner (“LP” or “limited partner”) owns a limited partnership interest in upper tier partnership (“UTP”). UTP owns limited partnership interests in several lower tier partnerships (“LTP”). Each LTP is engaged in the business of trading in securities and such business constitutes a business within the meaning of § 162. UTP’s activities consist solely of acquiring holding and disposing of interests in LTPs and such activities without regard to the activities of LTPs, do not constitute a business within the meaning of § 162. Instead, UTP’s activities consist of holding limited partnership interests in LTPs for the production of income within the meaning of § 212. UTP and each LTP pay an annual management fee to their respective managers in consideration for management services performed for their benefit. Each management fee is computed as a specified percentage of the value of the net assets owned by UTP and each LTP as the case may be. The management fee paid or incurred by each LTP is an ordinary and necessary business expense within the meaning of § 162. The management fee paid or incurred by UTP, without regard to the activities of LTP, is an ordinary and necessary expense in carrying

on its investment activities. UTP's management fee is not paid or incurred by UTP on behalf of any LTP in connection with LTP's business. None of the management fees are properly capitalized under § 263. Under the terms of the partnership agreement of each LTP, UTP receives a distributive share of the items of income, gain, loss, deduction and credit of each LTP. Under the terms of UTP's partnership agreement, UTP's limited partners received a distributive share of UTP's items of income, gain, loss, deduction and credit.

Held: UTP's management fee is not an ordinary and necessary expense paid or incurred by UTP on behalf of its limited partners in carrying on their trade or business. The management fee paid or incurred by UTP constitutes an expense described in § 212. This expense is not taken into account in computing UTP's taxable income or loss described in § 702(a)(8). Instead, the management fee must be separately stated by UTP and separately taken into account by LP in computing LP's tax liability.

The management fee paid or incurred by LTP constitutes an expense described in § 162 and is taken into account in computing the LTP's taxable income or loss described in § 702(a)(8). UTP's distributive share of taxable income or loss of an LTP is taken into account in computing UTP's taxable income or loss described in § 702(a)(8). In computing LP's tax liability, LP takes into account LP's distributive share of UTP's taxable income or loss.

**L. Partnership Equity for Debt (§ 108(e)(8) – Proposed Regulations).** Proposed regulations relating to the application of § 108(e)(8) in connection with the determination of discharge of indebtedness income of a partnership transfers a partnership interest to a creditor in satisfaction of the partnership's indebtedness (debt-for-equity exchange). The regulations were issued on October 31, 2008. Section 108(e)(8) provides that for purposes of determining COD income of a debtor partnership, the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the interest transferred to the creditor. The amount by which the debt exceeds the fair market value of the transferred partnership interest is the amount of COD income required to be included in the distributive shares of the partners in the debtor partnership immediately before the discharge. The proposed regulations provide that for purposes of applying § 108(e)(8), the fair market value of a debt-for-equity interest is the liquidation value of that debt-for-equity-interest if (i) the debtor partnership determines and maintains capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv), (ii) the creditor, the debtor partnership and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange, (iii) the debt-for-equity exchange is an arm's-length transaction, and (iv) subsequent to the debt-for-equity exchange, neither the partnership redeems - nor any person related to the partnership purchases - the debt-for-equity interest as part of the plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of COD income by the partnership. If these conditions are not satisfied, all of the facts and circumstances are considered in determining the fair market value of the debt-for-equity interest for purposes of applying § 108(e)(8).

The proposed regs also provide that the non-recognition rule of § 721 generally should apply to the creditor's contribution of partnership debt (other than unpaid interest or accrued original issue discount) to the partnership in exchange for the partnership interest. However, the proposed regs provide that § 721 does not apply to the transfer of a partnership interest to a

creditor in satisfaction of the partnership's debt for unpaid rent, royalties or interest on debt (including accrued OID). Further, these proposed regs do not supersede the rules under § 453B relating to dispositions of installment obligations. The proposed regs provide that they do not apply to the transfer of a partnership interest in connection with the performance of services.

The proposed regs provide that the creditor's interest in the partnership interest received shall be determined under § 722. Section 722 provides that the basis of an interest in a partnership acquired by contribution of property shall be the amount of such money and the basis of the property to the contributing partner increased by any gain recognized. The proposed regs provide that a creditor should not recognize a loss in a debt-for-equity exchange subject to § 721 in which the liquidation value of the debt-for-equity interest is less than the outstanding principal balance of the debt. Rather, the proposed regs provide that the creditor's basis in the debt-for-equity interest received will be increased by the adjusted basis of the debt. Finally, the proposed regs provide that the creditor's holding period in the debt-for-equity interest shall include the creditor's holding period in debt pursuant to § 1223(1).

Observation: The government has received a number of comments with respect to these proposed regulations. One primary concern is the potential character whipsaw that partners may suffer if debt is converted to equity (including preferred equity). For example, nonrecourse debt exchanged for preferred partnership equity can give rise to ordinary income in the form of COD (note that in the case of partnership, insolvency and bankruptcy, exceptions are applied at the partner level) whereas if such forgiven amounts had been funded in the first place as preferred or common equity as opposed to debt, the losses and deductions allocated to such funding partner would have been the same, but without the harsh COD treatment to such partner and/or other partners that comes with funding such amounts as nonrecourse loans. One commentator has suggested that in order to mitigate unwarranted distortions in the tax treatment of such partners, the proposed regulations under § 1.108-8 should be modified to provide that for purposes of the regulation, a partnership interest received in exchange for contributed "partner nonrecourse debt" will be deemed to have a value equal to the sum of (a) the contributing partner's share of "partner nonrecourse debt minimum gain" associated with contributed debt and (b) the increase in the amount the contributing partner would receive with respect to his partnership interest if the partnership sold all of its assets for an amount equal to their fair market values (recognizing all minimum gain) and liquidated. (Letter from John C. McCoy to IRS dated January 20, 2009)

Another commentator requests that the government address the potential character whipsaw faced by a partner that holds both an equity interest and a creditor position at the moment the creditor's debt is exchanged for additional equity (*i.e.*, potential COD income and a capital loss). This commentator requests that the regulations be modified to clarify that in the case of such a dual status partner, the nontaxable exchange principles under § 721 will take priority over the recognition of income under § 108 with respect to the indebtedness held by the partner. (Letter from Joseph F. Schlueter to IRS dated January 29, 2009)

The proposed regs are proposed to be effective for exchanges occurring on or after final regs are published in The Federal Register.

**M. Partnership between Hospital Non-Profits.** In PLR 200902013 (October 17, 2008), the IRS ruled that a partnership between two non-profit hospitals which were both exempt

under § 501(c)(3) of the Code, did not adversely affect either organization's § 501(c)(3) status, nor did it adversely affect either of their current status as a hospital under §§ 509(a)(1) and 170(b)(1)(A)(iii).

**N. Worthlessness of a Partnership Interest.** In CCA-2008102716063350, Chief Counsel advised that because there is no equivalent of § 165(g) for partnership interests, worthlessness of a partnership interest is an ordinary loss if the partner received nothing in exchange. In CCA-2008102717274750, the IRS cited a number of cases to look at in connection with treating abandonment as an identifiable event establishing worthlessness. Among other cases, Chief Counsel cited *Echols v. U.S.*, 950 F.2d 209 (5th Cir. 1991) for the proposition that abandonment is only one of several factors the court may consider in searching for an identifiable event establishing worthlessness.

**O. Publicly Traded Partnerships.** Income from acquiring and licensing seismic data to oil and gas producers constitutes qualifying income under § 7704(d)(1)(E). In PLR 200909006 (Nov. 21, 2008), the Service ruled that income derived by a publicly traded partnership from its business of acquiring and licensing seismic data to oil and gas producers for use in their exploration for and production of oil and gas resources constituted "qualifying income" under § 7704(d)(1)(E) as income from the exploration of a mineral or natural resource.

**P. Late Section 754 Election. IRS ruled that a partnership was not entitled to relief under Treas. Regs. 301.9100-1 and 301.9100-3.** In PLR 201002026 a partnership requested permission to make a section 754 election after its return had been filed. Treas. Reg. 1.754-1(b) requires that an election under Section 754 must be made in a written statement filed with the partnership return for the taxable year in which a distribution of property or a transfer of a partnership interest occurred. Treas. Reg. 301.9100-1(c) allows the Commissioner to grant an extension of time to make certain elections. Treas. Reg. 301.9100-3, however, requires the taxpayer to establish that the taxpayer acted reasonably and in good faith, and that granting an extension of time to make an election will not prejudice the interests of the government. The IRS ruled that an extension should not be granted because the partnership did not satisfy the requirements of Treas. Regs. 301.9100-1 and 301.9100-3.

**Q. Valuation misstatement penalties not applicable where transaction is disregarded.** In *NPR Investments, LLC v. U.S.*, 105 AFTR 2d 2010-435 (E.D. Tex. 2010), the IRS asserted that NPR was liable for the 40% gross valuation misstatement and the 20% substantial valuation misstatement under Section 6662. NPR, however, argued that the penalties do not apply because it conceded that the underlying transactions were not undertaken with a profit motive and should thus be disregarded. The court held that penalties for valuation misstatements do not apply when the IRS totally disregards a transaction as lacking economic substance. The court did note, however, that rule in the Fifth Circuit differs from the rule of other circuits.