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**SELECTED CURRENT TAX DEVELOPMENTS  
REGARDING LLCs AND PARTNERSHIPS**

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## **A. SELECTED CURRENT TAX DEVELOPMENTS REGARDING LLCs AND PARTNERSHIPS.**

**1. *Bankruptcy/108; Estate of Martinez v. Commissioner*, T.C. Memo 2004-150 (June 22, 2004); *Price v. Commissioner*, T.C. Memo 2004-149 (June 22, 2004); *Mirarchi v. Commissioner*, T.C. Memo 2004-148 (June 22, 2004); *Gracia v. Commissioner*, T.C. Memo 2004-147 (June 22, 2004).** The bankruptcy of a partnership that included a discharge of liability of partners that had personal liability for the debts of the partnership qualified as a discharge in a title 11 case for the purposes of section 108.

**2. Section 752 and Disregarded Entities/EG-128767-04 (Aug. 11, 2004).** The proposed regulations provide that in determining the extent to which a partner bears the economic risk of loss for a partnership liability, payment obligations of a disregarded entity are taken into account for purposes of section 752 only to the extent of the net value of the disregarded entity as of the date on which the partnership determines the partner's share of partnership liabilities pursuant to Treas. Reg. §§ 1.752-4(d) and 1.705-1(a).

**3. Section 108(e)(8)/Partnership Debt Satisfied with Partnership Capital or Profits Interest/American Jobs Creation Act of 2004 ("AJCA").** Effective for cancellations of indebtedness occurring on or after October 22, 2004, AJCA amended Section 108(e)(8) to provide that, when a partnership transfers a capital or profits interest in the partnership to a creditor in a satisfaction of partnership debt, the partnership generally recognizes cancellation of indebtedness income in the amount that would be recognized if a debit were satisfied with money equal to the fair market value of the partnership interests. This income will be allocated among the partners who held interest in the partnership immediately prior to the satisfaction of the debt.

This new legislation raises several issues. IRC Section 108(e)(6) was not also amended by AJCA. Section 108(e)(6) provides that if a debtor corporation acquires its indebtedness from a shareholder's contribution to capital, such corporation shall be treated as having satisfied the debt with an amount of money equal to the shareholder's adjusted basis in such debt. Based on a December 19, 2005 draft of Section 108 comments submission from individual members of the ABA tax section partnerships and LLC committee, it appears that the working group will recommend that Section 108(e)(6) should not be amended by Congress to extend to partnerships, given that Section 108(e)(6) was promulgated in response to certain case law that arose in the corporate arena and no analogous case law exists with respect to partnerships ("108 Working Group"). Another issue that has arisen following the promulgation of the amendment to Section 108(e)(8) is how to allocate any COD income to the partners. The 108 Working Group in its draft submission recommends that such COD income be allocated to partners who held interests in the debtor partnership immediately before the discharge pursuant to the statutory language of Section 108(e)(8) regardless of any alternative method of allocating such income otherwise permitted or required by Section 706(d).

**4. Limitation on Deductions Allocable to Property Used by Governments or Other Tax-Exempt Entities/AJCA/Section 470.** AJCA added new Section 470, which imposes a limit on a U.S. partner's ability to deduct losses from partnerships with tax-exempt or foreign partners. This limitation was added to prevent U.S. taxpayers from obtaining tax benefits generated in so-called "sale in lease out" ("SILO") transactions. Section 470 prohibits the deduction of losses related to "tax-exempt use property," which includes tangible property leased to a tax-exempt entity *and any property owned by a partnership that has a tax-exempt partner (including foreign partners) which employs any profit or loss allocation not considered a "qualified allocation" under Section 168(h)(6)(B).* Consequently, U.S. partners may lose the ability to currently deduct losses from these partnerships. Partnerships claiming low income housing credit or rehabilitation credits are excluded from this characterization. Section 470 is effective for leases entered into after March 12, 2004. The effective date of Section 470 with respect to property-owning partnerships treated as owning tax-exempt real estate by reason of Section 168(h)(6) is unclear. It is uncertain whether this result is intended.

Notice 2005-29, released in March, 2005 announced that the IRS will not apply Section 470 to partnerships or other pass-through entities for taxable years beginning on or before January 1, 2005, for property that is treated as tax-exempt use property solely as a result of the application of Section 168(h)(6). Notice 2006-2, released December 16, 2005, extends this transition relief to taxable years beginning before January 1, 2006.

**5. Deduction for Qualified Production Activities Income/AJCA/New Section 199.** AJCA added new Section 199, which allows eligible taxpayers to claim a deduction equal to nine percent (after full phase-in after 2009) of the lesser of (i) a taxpayer's "qualified production activities income" or (ii) taxable income. IRC § 199(a)(1). In 2005 and 2006, the deduction percentage is three percent, and for 2007-2009, the deduction percentage is six percent. The deduction is limited to fifty percent of wages paid to employees during the taxable year. IRC § 199(b). Note that compensation paid to partners in a partnership is not "wages". This deduction applies to taxable years beginning after December 31, 2004.

Qualified production activities income is defined as the taxpayer's "domestic production gross receipts" over the sum of (i) allocable costs of goods sold, (ii) other allocable expenses, and (iii) apportioned expenses. IRC § 199(c)(1). "Domestic production gross receipts" is defined to include, among other items, gross receipts derived from "construction performed in the United States." IRS Notice 2005-14 provides guidance as the application of Section 199 to pass-thru entities. In general, in the case of an S Corporation, partnership, estate or trust, or other pass-thru entities, Section 199 is applied at the partner, shareholder or similar level. The guidance states that the Service and Treasury Department believe that Congress intended Section 199 to be applied in a manner consistent with the economic arrangement of the owners of a pass-thru entity. Service and Treasury Department believed that this objective can be accomplished by allowing each owner to compute its Section 199 deduction by taking into account its distributive or proportionate share of the items allocated or attributable (in accordance with special rules set forth in Notice 2005-14) to the pass-thru entity's

activities described in Section 199(c)(4) (qualified production activities), provided the items are not otherwise disallowed by the Code.

Section 3.04(11) of the Notice provides guidance as to the meaning of the term “construction performed in the United States” which is contained in IRC § 199(c)(4). In general, Notice 2005-14 provides that gross receipts from the rental of the real property that the taxpayer constructs are not derived from construction, but are instead compensation for the use or forbearance of property. Accordingly, in the case of construction, qualifying gross receipts do not include gross receipts from the lease or rental of constructed real property. However, qualifying gross receipts may include the proceeds of a sale, exchange or other distribution of real property constructed in the United States (whether or not the property is sold immediately after construction is completed) if all other requirements of Section 199(c) are met. Qualifying gross revenue also includes compensation received for construction services performed in the United States, again assuming all other requirements of Section 199(c) are met.

Proposed regulations under Section 199 were released on November 4, 2005. The preamble to the proposed regulations confirm that Section 199 applies at the owner level in a manner consistent with the economic arrangement of the owners of the pass-through entity. Under the proposed regulations, each owner competes its Section 199 deduction by taking into account its distributive or proportionate share of the pass-through entity’s items (including items of income and gain, as well as items of loss and deduction not otherwise disallowed by the Code), cost of goods sold allocated to such items of income, and gross receipts included in such items of income. The proposed regulations clarify that the owner of a pass-through entity need not be engaged directly in the entity’s trade or business in order to claim a Section 199 deduction on the basis that owners share of the pass-through entity’s items.

The proposed regulations also contain several other special rules with respect to the application of Section 199 to pass-through entities.

#### **6. Disguised Sale of Partnership Interests/Proposed Reg. § 1.707-7.**

Treasury released proposed regulations relating to the treatment of transactions between a partnership and its partners as disguised sales of partnership interests between the partners under IRC § 707(a)(2)(B). In general, a transfer of money, property or other consideration, including the assumption of a liability by a purchasing partner to a partnership and a transfer of consideration by the partnership to a selling partner constitute a sale of the selling partner’s interest in the partnership to the purchasing partner if, based on all the facts and circumstances, the transfer by the partnership would not have been made but for the transfer to the partnership, and in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent upon the entrepreneurial risks of partnership operations. Proposed Reg. § 1.707-7(a).

The proposed regulations include presumptive safe harbors similar to those in the existing regulations. For example, transfers made within two years are presumed to be a sale, while transfers made more than two years apart are not presumed to be a sale. Proposed Reg. §§ 1.707-7(c), (d). Also, a transfer of money, including marketable

securities to a selling partner in liquidation of that partner's entire interests in the partnership is presumed not to constitute a disguised sale. Proposed Reg. § 1.707-7(e). Similarly, a transfer of money to and by a service partnership is not treated as a sale and thus no disclosure is necessary. Proposed Reg. § 1.707-7(g). In regard to liabilities, the proposed regulations generally follow the approach of the existing regulations with respect to the treatment of liabilities when the partnership assumes a partner's liability and vice versa (*i.e.*, it is treated as an exchange of consideration). Proposed Reg. §§ 1.707-7(j)(2), (3). Deemed contributions to and distributions from a partnership under Section 752 resulting from reallocations of partnership liabilities among partners are not treated as transfers of consideration. Proposed Reg. § 1.707-7(j)(1). An anti-abuse rule addresses cases in which these rules do not adequately capture the substance of an integrated set of transactions. Proposed Reg. § 1.707-7(j)(8). Disclosure requirements are contained in Proposed Reg. § 1.707-7(k); and Proposed Reg. § 1.707-8(a), (c). The effective date of the proposed regulations is to transactions with respect to which all transfers considered part of a sale occur on or after the date these regulations are published as final regulations.

**7. Mandatory Basis Adjustment on Transfers of Partnership Interests With Substantial Built-In Loss/AJCA/Section 743.** AJCA amendments to Section 743 provide that the basis adjustment upon the transfer of a partnership interest shall be mandatory if the partnership has a substantial built-in loss after the transfer. For this purpose a partnership as a substantial built-in loss relating to a transfer of a partnership interests if the partnership's adjusted basis in its property exceeds the fair market value of the property by more than \$250,000. (Analogous rules apply under Section 734(d) upon a distribution of property if there is a "substantial basis reduction.") An exception is provided for electing investment partnerships under which the electing investment partnerships are not treated as having a substantial built-in loss for any transfers occurring while the election described below is in effect. Electing investment partnerships are subject to a loss limitation rule, instead of the basis reduction. Thus, where there is a transfer of an interest in an electing investment partnership, the transferee partner's distributive share of losses (without regard to gains) from the sale or exchange of partnership property is not allowed except to the extent that it is established that the losses exceed the loss if any "recognized" by the transferor or any prior transferor to the extent not fully offset by a prior disallowance under this rule on the transfer of the partnership interests. This means that where there are successive transfers, the transferee partner's distributive share of the losses is not allowed, except to the extent that it is established that the losses exceed the loss recognized by the transferor (or earlier transferor to the extent not fully offset by an earlier disallowance under this rule). The amount of the loss that is disallowed under this rule is reduced toward a transferee partner who received property distributions from the partnership by the amount of any basis reductions in the distributive property under Code Section 732(a)(2) rule that limits the basis of the distributive property to the partner's basis and his partnership interests. These rules will be applied without regard to any partnership termination resulting from a sale or exchange of a fifty percent or greater partnership interests under Section 708(b)(1)(B). An electing investment partnership is a partnership that satisfies the following conditions:

- (1) Partnership elects to have these rules apply (Section 743(e)(6)(A)),
- (2) The partnership would be an investment company under Section 3(a)(1)(A) of the Investment Company Act of 1940 but for an exemption under paragraph (1) or (7) of Section 3(c) of such Act,
- (3) Such partnership has never been engaged in a trade or business,
- (4) Substantially all of the assets of the partnership are held for investment,
- (5) At least ninety-five percent of the assets contributed to such partnership consists of money,
- (6) No assets contributed to such partnership had an adjusted basis in excess of fair market value at the time of contribution,
- (7) All partnership interests in such partnership are issued by such a partnership pursuant to a private offering for the date which is twenty-four months after the date of the first capital contribution to such partnership,
- (8) The partnership agrees that such partnership has a substantive restrictions on each partner's ability to cause a redemption of the partner's interests, and
- (9) The partnership agreement of such partnership provides for a term that is not in excess of fifteen years.

The electing investment partnership election is irrevocable in the absence of IRS consent to such revocation. In general, electing investment partnerships include venture capital firms, buy-out firms and funds-of-funds. At least one venture capital industry group has requested that Treasury issue guidance in order to clarify that venture capital funds, buy-out funds and funds-of-funds can qualify as "electing investment partnerships" even if they make equity investments in businesses structured as flow-through entities, such as LLCs.

Also, an exception from this newly legislated mandatory basement adjustment rule is provided for a so-called "securitization partnership", which, in general, is a partnership its sole business activity of which is to issue securities which provide for a fixed principal amount in which are primarily serviced by the cash flows of a discreet pool of receivables or other financial assets that by their terms convert into cash. If the sponsor of the pool reasonably believes that the receivables and other financial assets comprising the pool are not acquired so as to be disposed of.

IRS Notice 2005-32 (April 18, 2005) contains interim rules and procedures for partnerships to comply with these mandatory basis adjustment rules of Section 734 and Section 743 as amended. The Notice also provides interim procedures for electing investment partnerships and their partners to comply with Section 743(e) and Section 6031(f).

**8. Partnership Contributions to Partner's Health Savings Account ("HSA")/Notice 2005-8.** Notice 2005-8 provides guidance on a partnership's contributions to a partner's HSA (and also an S corporation's contributions to a two-percent shareholder-employee's HSA). Section 1201 of the Medicare Prescription Drug, Improvement and Modernization Act of 2003, added Section 223 to the Internal Revenue Code to permit eligible individuals to establish HSA's for taxable years beginning after December 31, 2003. Generally, contributions made to an HSA, within permissible limits, by or on behalf of a taxpayer who is an eligible individual are deductible by a taxpayer under Section 223(a). The deduction is an above-the-line deduction under Section 62(a)(19). If an employer makes a contribution within permissible limits, to an HSA on behalf of an employee who is an eligible individual, the contribution is excluded from the employee's gross income and wages. (*See* Section 106(d)). A partnership may also contribute to a partner's HSA.

Notice 2005-8 clarifies the tax treatment of a partnership's contribution to a partner's HSA that are treated as distributions to the partner under Section 731. Such contributions by the partnership are not contributions by "an employer to the HSA of an employee". *See* Reg. Rule 69-184, 1969-1 C.B. 256. Such contributions by a partnership to a partner's HSA are not deductible by the partnership and do not affect the distributive shares of partnership income and deductions. *See* Reg. Rule 91-26, 1991-1 C.B. 184. The contributions are reported as distributions of money on Schedule K-1. The distributions are not included in the partner's net earnings from self-employment under Section 1402(a). The partner, if an eligible individual as defined in Section 223(c)(1), is entitled under Sections 223(a) and 62(a)(19) to deduct the amount of the contributions made to the partner's HSA during the taxable year as an adjustment to gross income on his or her federal income tax return.

Contributions by a partnership to a partner's HSA for services rendered to the partnership are treated as guaranteed payments under Section 707(c), are deductible by the partnership under Section 162 (if the other requirements of that section are satisfied) and are includable in the partner's gross income. Such contributions by a partnership to a partner's HSA that are treated as guaranteed payments, are reported as guaranteed payments on Schedule K-1. Because such contributions are guarantee payments for services rendered to the partnership, the contributions are included in the partner's net or self-employment under Section 1402(a) on the partner's Schedule SE (Form 1040). The partner, if an eligible individual is defined in Section 223(c)(1) is entitled under Section 223(a) and 62(a)(19) to deduct the amount of the contributions.

**9. Organization and Syndication Fees/AJCA/Section 709.** Section 709(b) was amended to provide that taxpayers shall be allowed a deduction for the first \$5,000 of partnership organizational expenses. However, this deduction is reduced by the

amount by which such organizational expenses exceed \$50,000. Further, the remainder of such organizational expenses must be amortized ratably over the 180-month period beginning with the month in which the partnership business begins. If the partnership is liquidated before the end of the 180-month period, any unamortized organization expenses may be deducted to the extent allowable under Section 165.

**10. New Deferred Compensation Rules/AJCA/Section 409A.** New Section 409A dramatically changes the structure and operation of deferred compensation plans, and even imposes a twenty percent additional tax on deferred amounts that do not meet the new requirements imposed by the Act. In December, 2004, Treasury issued its first round of guidance (Notice 2005-1). New Section 409A generally applies with respect to amounts deferred after December 31, 2004. However, it can be applicable to deferred amounts that were invested as of December 31, 2004, regardless of when the deferral election was made, and in that respect had significant potential for retroactive application. IRS Notice 2005-1 clarifies that nothing needed to be done by the end of 2004 to comply with the new law, and explains how to implement the new requirements during 2005. Notice 2005-1 also provides other guidance that will assist plan sponsors in complying. Proposed Regulations under 409A were issued October 4, 2005.

In general, new Section 409A provides that all amounts deferred under a non-qualified deferred compensation plan are currently includible in gross income to the extent that they are not subject to a substantial risk of forfeiture, unless the plan meets certain new restrictions as to timing of deferral elections and distribution elections, permissible distribution events, acceleration of payments and subsequent deferral elections. A twenty percent additional tax on the payment recipient and interest at a heightened rate in addition to tax at ordinary income tax rates is imposed on payments recipients with respect to whom there is a failure to comply with the requirements of Section 409A. (For a more detailed discussion of the application of 409A to partnerships and LLCs, see Maxfield, "Section 409A and Partnerships," ALI-ABA-Limited Liability Entities, March 16, 2006.)

**11. Mixing Bowls and Mergers/Rev. Rul. 2004-43, 2004-18 I.R.B. 842; Rev. Rul. 2005-10; Notice 2005-15, 2005-7 I.R.B. 1.** Revenue Ruling 2004-43 held that new Section 704(c) gain or loss is created when assets are contributed by the transferring partnership to the continuing partnership in an assets-over-merger. Revenue Ruling 2004-43 also held that Section 704(c)(1)(B) applies to the newly created Section 704(c) gain or loss in property contributed by the transferring partnership to the continuing partnership in an assets-over-partnership merger but does not apply to reverse Section 704(c) gain or loss resulting from re-valuation of property in the continuing partnership. In addition, Revenue Ruling 2004-43 held that for purposes of Section 737(b), net pre-contribution gain includes the newly created Section 704(c) gain or loss in property contributed by the transferring partnership to the continuing partnership in an assets-over-partnership merger, but does not include reverse Section 704(c) gain or loss resulting from re-valuation of property in the continuing partnership.

A number of commentators argued that Revenue Ruling 2004-43 was not consistent with the current regulations under Section 704(c)(1)(B) and 737, and that the conclusions in the ruling should not be applied retroactively. In response to these comments, the IRS issued Revenue Ruling 2005-10 which revoked Revenue Ruling 2004-43. *However*, The IRS also issued Notice 2005-15 in which they announced new regulations would be issued under Sections 704(c)(1)(B) and 737 implementing the principles of the ruling. The IRS noted that the regulations will apply the principles of revenue ruling 2004-43 to distributions of property following assets-over-partnership mergers. The new regulations will apply to distributions of property with newly created Section 704(c) gain or loss whether or not that gain or loss is treated as reverse Section 704(c) gain or loss as the result of a revaluation by the transferor partnership. The regulations will also apply to distributions of property with original Section 704(c) gain or loss that existed upon contribution to the transferor partnership. However, the regulations will provide that if the transferor partnership in an assets-over-merger holds contributed property with original Section 704(c) gain or loss, the seven-year periods in Sections 704(c)(1)(B) and 737 do not restart with respect to that gain or loss as a result of the merger. The regulations will also provide that Section 704(c)(1)(B) does not apply to newly created 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over-partnership merger involving partnerships owned by the same owners in the same proportions. In addition, the regulations will provide for purposes of Section 737, net pre-contribution gain does not include newly created Section 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over-partnership merger involving partnerships owned by the same owners in the same proportion.

These new regulations will be effective for distributions by partnerships made after January 19, 2005.

The American Bar Association-Section of Taxation in recently submitted comments urges the government not to adopt the approach of Revenue Ruling 2004-43. The ABA asserts that no new Section 704(c) gain should be created in an assets-over merger, consistent with existing regulations.

**12. Section 704(b)/Creditable Foreign Tax Expenditures/T.D. 9121; Reg-139792-02.** These Temporary Regulations address concerns identified by Notice 2004-19, 2004-11 I.R.B. 606, including the results of certain transactions that are inconsistent with the stated purpose of the tax credit provisions. The Temporary Regulations amend the section 704(b) regulations to provide specific rules for the allocation of creditable foreign tax expenditures (“CFTE”). Under those rules, allocations of CFTEs cannot have substantial economic effect. Therefore, allocations of CFTEs must be allocated in accordance with the partners’ interest in the partnership (“PIP”). An allocation will be deemed to be in accordance with PIP if the allocation satisfied a new safe harbor (“Safe Harbor”). If the allocation of CFTEs does not meet the Safe Harbor requirements, only in unusual circumstances would the allocation of CFTEs be in accordance with PIP.

**13. Incorporation of a Partnership/Rev. Rul. 2004-59, 2004-24 I.R.B. 1050.** If an unincorporated state law entity that is classified as a partnership for federal

tax purposes converts into a state law corporation under a state law formless conversion statute, the following is deemed to occur: the partnership contributes all its assets and liabilities to the corporation in exchange for stock in such corporation, and immediately thereafter, the partnership liquidates distributing the stock of the corporation to its partners.

**14. U.S. Taxation of Foreign Partners in Service Partnership/P.L.R. 200420012 (Jan. 30, 2004).** German residents who are partners in a law firm organized as a partnership under the laws of Germany are taxable in the U.S. on their distributable shares of partnership income, if any, attributable to state individual's performance of independent personal services at the law firm's New York office, without regard to whether the German residents perform services in the U.S.

**15. Investment Company/P.L.R. 200420020 (Feb. 6, 2004).** The contribution of the stock of a parent corporation to a limited partnership will not be treated as a transfer to an investment company, so shareholders will recognize no gain or loss upon the contribution.

**16. Private Foundation; Self-Dealing With Respect to Partnership Investment/P.L.R. 200420029 (Feb. 19 2004).** A private foundation's initial or additional investments in a partnership, either upon its formation or any time after it is formed, didn't (under the Facts of the ruling) result in or constitute acts of self-dealing under Code section 4941(d)(1)(A).

**17. Family Partnership/Senda v. Commissioner, T.C. Memo 2004-160 (July 12, 2004), affirmed** (8th Cir., January 6, 2006).

The taxpayers' transfer of stock to two family limited partnerships, coupled with petitioners' transfers of limited partnership interests to their children (or in trust therefor), constituted indirect gifts of the stock to the children (or to the trusts) within the meaning of section 2511.

**18. Partnerships and Section 1045/Prop. Treas. Reg. § 1.1045-1.** The Treasury promulgated proposed regulations describing the conditions under which a partner may defer gain under section 1045. Section 1045 deals with the rollover of gain from the sale of qualified business stock to another investment in qualified business stock. *See also*, NYSBA comments submitted January 21, 2005.

**19. T.D. 9137.** Regulations involving partnership contracts accounted for under the long-term contract method of accounting are finalized.

**20. Partnership Continuation/Harbor Cove Marina Partners Partnership v. Commissioner**, 123 T.C. No. 4 (2004). Where a state law issue continued to exist as to whether the partnership continued which may result in the partnership reporting income in a year after the year in which it has claimed to have terminated, the partnership had not yet terminated for tax purposes.

**21. Simplification of S Corporation Election for Eligible Entities.** T.D. 9139, REG-131786-03 amended Treas. Reg. § 301.7701-3(c)(1)(v) to provide that if an eligible entity makes a timely and valid election to be an S corporation under section 1362(a)(1), it is treated as having made an election to be classified as an association taxable as a corporation under Treas. Reg. § 301.7701-3.

**22. Disregarded Entity; Two Members/Rev. Rul. 2004-77, 2004-31, I.R.B. 119.** If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either a disregarded as an entity separate from its owner or an association taxable as a corporation.

**23. Election Out of Sub-K/Notice 2004-53, 2004-33 I.R.B. 1.** The Internal Revenue Service and the Treasury Department request comments regarding the application of the conditions provided in Treas. Reg. § 1.761-2(a)(2) and whether those conditions should be revised, modified or clarified. Treas. Reg. § 1.761-2(a)(2) currently provides that a group may elect out of the application of Subchapter K if (i) the investment property is owned as co-owners, (ii) the participants reserve the right separately to take or dispose of their shares of any property acquired or retained, and (iii) the participants do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell or exchange the investment property of the group, although each separate participant may delegate authority to purchase, sell or exchange the participant's share of any such investment property for a period of not more than one year.

**24. Disregarded Entities as Partners; Impact Under TEFRA Partnership Provisions/Rev. Rul. 2004-88, 2004-32 I.R.B. 165.** A partnership that has a disregarded entity as a partner is not eligible for the small partnership exception to the TEFRA partnership provisions. A disregarded entity that is a general partner of a partnership may be the tax matters partner of the partnership.

**25. Classification/T.D. 9153; REG-124872-04 (Aug. 11, 2004).** Once the classification of a business entity has been determined, a determination will generally need to be made regarding whether it is a domestic or foreign entity. It is a domestic entity if it is created or organized in the United States or under the laws of the United States or of any state. It is a foreign entity only if it is not domestic. The temporary regulations in this document revise Treas. Reg. § 301.7701-5 to clarify that a dually chartered entity is domestic if it is organized as any form of entity in the United States, regardless of how it is organized in any foreign jurisdiction. An entity that is classified as a corporation because of its form of organization in a foreign country is considered a domestic corporation if it is also organized as some form of entity in the United States, regardless of what form the entity takes in the United States (*e.g.*, corporation, limited liability company, or partnership).

**26. LIFO Sting Tax With Respect to Electing S Corporations Holding Interests in Partnerships With LIFO Inventory/Final Reg. 1.1363-2.** These

regulations provide that a C corporation that holds an interest in a partnership holding LIFO inventory must include the lookthrough LIFO recapture amount in its gross income where the corporation either elects to be an S corporation or transfers its interest in the partnership in a nonrecognition transaction. These regulations are generally effective for S elections and transfers made on or after August 13, 2004. This Regulation overrules *Coggin Automotive Corp. v. Comm'r*, 292 F.3d 1326 (11th Cir. 6/6/02).

**27. New Proposed “Substantiality” Regs. Under Section 704(b) Testing the Substantiality of an Allocation in the context of a Tiered Partnership Structure.**

Section 704(b) of the Code places significant limitations on the general flexibility of Subchapter K of the Code to permit taxpayers to conduct joint business activities through flexible economic arrangement without incurring an entity-level tax. Specifically, Section 704(b) provides that a partner’s share of income, gain, loss, deduction or credit shall be determined in accordance with the partner’s interest in the partnership (determined by taking into account all facts and circumstances) if the allocation to a partner under the partnership agreement of income, gain, loss, deduction or credit does not have substantial economic effect. Treasury Regulation Section 1.704-1(b)(2)(i) provides that the determination of whether an allocation of income, gain, loss or deduction to a partner has substantial economic effect involves a two-part analysis. First, the allocation must have economic effect within the meaning of Treasury Regulation Section 1.704-1(b)(2)(ii). Second, the economic effect of the allocation must be substantial within the meaning of Treasury Regulation Section 1.704-1(b)(2)(iii).

In general, for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. In other words, in the event that there is an economic benefit or burden that corresponds to the allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden. *See*, Treasury Regulation Section 1.704-1(b)(2)(ii)(a). Treasury Regulation Section 1.704-1(b)(2)(iii)(a) provides as a general rule that economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. On April 21, 2004, Temporary Regulations (TD 9121) relating to the proper allocation of partnership expenditures for foreign taxes were released. In the preamble to those regulations, the government indicated the concern that some partnerships are taking the position that, in determining if the economic affect of a partnership allocation is substantial; they need not consider the tax consequences to an owner of the partner that results from the allocation.

The government feels this position is inconsistent with the policies underlying the substantial economic effect rules, because it would allow a partnership to make tax-advantaged allocation if the tax advantages of the allocations accrue to an owner of a partner rather than to the partner itself. On November 17, 2005, the government released proposed regulations providing rules for testing the substantiality of an allocation under Section 704(b) where the partners are look-through entities or members of a consolidated group. These proposed regulations also provide additional guidance on the affect of other provisions, such as Section 482, upon the tax treatment of a partner with respect to the partner’s distributive share under Section 704(b), and revise the existing rules for

determining the partners' interests in the partnership. In general, the proposed regulations provide that the interaction of a partnership allocation with the tax attributes of owners of look-through entities must be taken into account when testing the substantiality of the allocation to a partner that is a look-through entity. The regulations are generally proposed to apply for partnership taxable years beginning on or after the date on which the final regulations are published in the federal register.

**28. Section 751(b)/Hot Asset Rules.** IRS Notice 2006-14, 2006-8 IRB 1 requests comments on how to prevent the conversion of ordinary income into capital gain and addresses the shifting of ordinary income interest among partners. The government believes (correctly) that the current regulations under Section 751(b) are overly burdensome and complex. The IRS wants to update and simplify the regulations on partnership distributions treated as sale or exchanges, and wants comments on how best to determine a partner's share of "hot assets" and how to treat disproportionate distributions.

**29. Employment Taxation of Disregarded Entities.** Treasury Regulation Section 301.7701-2(c)(2) provides that a business entity that has a single owner and that is not a corporation for tax purposes is disregarded as an entity separate from its owners for all federal tax purposes. On October 19, 2005, the government released proposed changes to Treasury Regulation Section 301.7701-2.

Under existing Section 301.7701-2(c)(2), the single owner of a disregarded entity is treated as the employer of the disregarded entity's employees for federal employment tax purposes. Consequently, the single owner generally is responsible for complying with the employment tax obligations related to those employees. However, prior to the release of the proposed regulations, the IRS, in Notice 99-6 adopted an interim rule, which permitted reporting and payment of employment taxes with respect to the employees of a disregarded entity by either (1) the single owner (as those the employees of the disregarded entity were employed directly by such owner) under the owner's name and TIN; or (2) the disregarded entity, under its own name and TIN. This interim rule afforded taxpayers the flexibility to meet their employment tax obligations while respecting the advantages conferred by the limited liability company form.

The new proposed regulations represent a retreat from this flexibility, making the disregarded entity solely liable for the employment taxes on wages paid to its employees, the payment of employer's shares of those taxes, the timely deposit of those taxes and the filing of employment tax returns and employee wage statements.

**30. Defining "Liability" for Section 752 Purposes/Prop. Reg. 1.752-7.** Proposed Regulation Section 1.752-7 was finalized by T.D. 9207 (5/23/2005, corrected 7/8/2005). These Regulations contain an almost incomprehensible regime of rules designed to preclude duplication of losses through partnerships. These regulations attempt to do two things in the partnership arena: (1) define "liabilities" for purposes of Section 752-7 and (2) deal with a partnership's assumption of certain fixed and contingent obligations in exchange for a partnership interest in a way that prevents duplication or acceleration of losses with respect to these obligations. Proposed

Regulation 1.752-7 addresses the assumption by a partnership of a partner's fixed or contingent obligation to make payment that is not one of the following three types described in Regulation Section 1.752-1(a)(4)(i). If the partnership satisfies this type of liability while the partner remains in the partnership, the deduction with respect to the built-in loss associated with such liability is allocated to the partner from whom the obligation was assumed, reducing that partner's outside basis. Unlike new regulation 1.752-6, the regulations under 1.752-7 do not reduce the partner's outside basis when the partnership assumes a 1.752-7 liability, except for certain events that separate the partner from the partnership liability. In such case, and under certain circumstances, such former partner may be entitled to a loss or deduction with respect to such liability, when such loss or deduction is triggered at the partnership level.

**31. Final Regulations Under 1.752-6.** T.D. 9207 (5/23/2005) finalized the temporary regulations under 1.752-6 that addresses the "Son of Boss" tax shelter transactions.

**32. Partnership Equity for Services/Reg 105346-03, 70 F.R. 29675 (5/24/05) and Notice 2005-43, 2005-24 I.R.B. 1221.** These proposed revenue procedures provide long-awaited guidance as to the treatment of equity interests and options issued by partnerships in exchange for services. The new rules, if finalized in substantially the form as proposed, should facilitate the issuance of partnership equity for services. However, this guidance raises important questions in need of clarification. See Banoff, Carman and Maxfield, Proposed Regulations on Partnership Equity for Services: The Collision of Section 83 and Subchapter K, Journal of Taxation (August, 2005).