Journal of Taxation (WG&L)

SHOP TALK

More on the 1% Minimum Ownership Interest Standard in Safe Harbors: A Drafter Responds

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com; Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com; and Adam M. Cohen , 555 17th Street, Suite 3200, Denver, Colorado 80202, ACohen@hollandhart.com.

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An email your Shop Talk editors received from a Michigan tax practitioner in response to our May 2020 column has gotten us thinking. About a number of things that we ordinarily think of less than 1% of the time. And not solely involving technical tax matters.

In our recent article, "Revisiting the 1% Minimum Ownership Interest in Safe Harbors," 132 JTAX 38 (May 2020), we discussed one aspect of Rev. Proc. 2020-12, 2020-11 IRB 511, which deals with allocations of the tax credit for carbon capture projects under Section 45Q. That revenue procedure is the latest in a line of IRS guidance that indicates the IRS National Office is not entirely comfortable with partners' interests being less than 1%. We wondered aloud whether tax advisors and IRS auditors might come away with the sense that any partner holding anything less than a 1% interest in a partnership is not to be regarded as a partner for tax purposes because their interest is too tiny.

That article provides our readers with historical background on the IRS/Treasury's tax treatment of teensy partnership interests-long a topic of interest to your Shop Talk editors. *See, e.g.,* Shop Talk, "How Small Can a Partner's Interest Be?," 83 JTAX 126 (August 1995) and "No IRS Guidance Likely on How Small an LLC Member's Interest Can Be," 87 JTAX 191 (September 1997). Back then, the broad language of the check-the-box regulations was thought to have generally eliminated the need to have a minimum percentage amount of ownership, so long as a state-law partnership or LLC exists. For an historical summary of the so-called 1% standard that pre-dated the check-the-box regs, we referenced Rev. Proc. 74-17, 1974-1 CB 438, section 3.01 and Rev. Proc. 89-12, 1989-1 CB 798, section 4.02.

Rev. Proc. 74-17 ushered in the so-called "1% standard" for obtaining a favorable tax status letter ruling. That revenue procedure set forth certain guidelines that the IRS would apply in determining whether the formation of a limited partnership is for the principal purpose of reducing taxes. One of its preconditions was that the interests of all the general partners, taken together, in each material item of partnership income, gain, loss, deduction, or credit be equal to at least 1% of each such item at all times during the existence of the partnership. The IRS backed down somewhat in Rev. Proc. 89-12, stating that a favorable partnership tax status letter ruling could be granted under the so-called Kintner Regulations (301.7701-1 through -3, as they existed prior to the check-the-box regulations) even if the general partners' interests were as low as 0.2% (where, among other things, there was at least $250 million of capital being contributed to the partnership by the limited partners). The same "less than 1%" standards were later extended to the member-managers of an LLC seeking a partnership tax status letter ruling. *See* Rev. Proc. 95-10, 1995-1 CB 501, section 4.03; Shop Talk, "The 1% Standard: Back From the Dead?," 120 JTAX 317 (June 2014).

In Rev. Proc. 74-17, the IRS sought to assure taxpayers and their representatives that "[t]he rules stated above are to be applied only in determining whether ruling and determination letters will be issued and are not intended as substantive rules for the determination of partnership status and are not to be applied as criteria for the audit of taxpayers' returns." 1974-1 CB, at 439. Although these were only advance ruling requirements, many practitioners felt that the 1% standard was inviolate, for purposes of the Kintner Regulations, and fully expected them to be the audit standard as well.

We observed in our May 2020 Shop Talk article that, in determining how small a partner's interest can be, while still being respected (not disregarded) for income tax purposes, the entity itself often had a huge stake in the answer. If the sole general partner had a zero

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percent interest (at least for tax purposes) in the limited partnership, the Service well might contend there was no unincorporated entity for tax purposes under the regulations, with the entity being classified as an association taxable as a corporation-a potentially catastrophic result.

The check-the-box regs have been around for 23 years now, and there is no definitive authority yet as to how miniscule the members' interests may be (while the members are still being treated as partners for tax purposes).

The preamble to the check-the-box regulations states that the determination of whether an organization has more than one owner must be based on all the facts and circumstances. (*See* TD 8697, 12/17/96, Part B, "Discussion of Comments on the General Approach and Scope of the Regulations.") Informal indications from high-ranking IRS officials speaking a few years later did not provide meaningful guidance, as they discussed the question as requiring a "facts and circumstances" analysis, and to this day we remain unaware of any substantive guidance on point since the issuance of the check-the-box regulations. There have been cases where fractions of 1% have gone uncriticized, uncommented upon, or unnoticed, and implicitly approved. There have been some other cases where the outcome of the case is premised on the member with the decimal ownership interest being recognized as a partner for tax purposes. But the cases are not so definitive as to put the questions to rest. *See, e.g.,* Shop Talk, "How Small Can a Partner's Interest Be: Is 0.1% (or 0.01%) the 'New' 1%?," 114 JTAX 186 (March 2011), discussing the Tax Court's opinion in *Historic Boardwalk Hall, LLC,* 136 TC 1 (2011), 2011 WL 9078, rev'd and rem'd on other grounds 110 AFTR2d 2012-5710 , 694 F.3d 425 (CA-3, 2012) (cert. denied), where one can infer that a general partner interest of only 0.1% may be recognized for tax purposes, and *Jordan,* 74 AFTR2d 94-6275 , 863 F. Supp. 270 (DC N.Car., 1994), where the taxpayer-limited partner was entitled to a 0.18260% interest in the partnership, which itself was a pass-through partner in a number of joint ventures. *See also Brumbaugh*, TCMemo 2015-65 , RIA TC Memo Para. 2015-065, where one can infer a 0.02% ownership interest in an entity taxable as a partnership will be recognized. *See* Shop Talk, "Taxpayer's 0.02% Partnership Interest Won't Be Disregarded (at Least at Another Taxpayer's Request!)," 122 JTAX 282 (June 2015).

In our May 2020 article, we noted that some guidance has come in the form of three revenue procedures dealing with income tax credits that are allocable to partners. *See* Rev. Procs. 2007-65, 2007-45 IRB 967; 2014-42, 2014-3 IRB 415, and 2020-12, 2020-11 IRB 511. (We refer our readers back to that article for a more detailed discussion, including arguments for supporting the proper threshold as being less than 1%, and our ongoing concerns that the 1% threshold will become an audit standard (and not merely a safe harbor).) None of those (or other) revenue procedures explains why the 1% standard was selected as a condition for qualification for the safe harbor; there is nothing in recent case law involving rehabilitation (or other) tax credits that uses or refers to such a line of demarcation for credit qualification.

In our May article, we asked, is the 1% standard in these tax credit revenue procedures a throwback to Rev. Proc. 74-17? We observed in our January 2008 Shop Talk article that we didn't foresee the 1% standard creeping back into the law or rulings process under the check-the-box regulations in determining an unincorporated entity's tax status. *See also* Lipton, "New Rehabilitation Credit Safe Harbor-Limiting Historic Boardwalk Hall," 120 JTAX 128 (March 2014). We were wrong-at least with respect to the rulings process.

The multitude of partnership tax status ruling requests under the Kintner Regulations that log-jammed the Service's Rulings Branch in the 1970s and 1980s helped initially shape the question of how small a general partner's interest could be in an entity characterized as a partnership, while the general partner is still being recognized by the IRS for tax purposes.

Your Shop Talk editors have been piecing together the evolution of the 1% standard. Here's our story: several years after the Kintner Regulations were issued, it was rumored that, as a condition of obtaining the insurance policy-like benefits of a partnership tax status letter ruling, the IRS would require the interests of all of the general partners, taken together, of a limited partnership to be at least 5% of each item of partnership income and loss of the partnership. Forty-six years ago, this column reported this rule of thumb. *See* Shop Talk, "IRS's New Unofficial Partnership Ruling Guidelines," 40 JTAX 256 (April 1974). Two months later, in conjunction with the issuance of Rev. Proc. 74-17, 1974-1 CB 438, this column helped put that rumor to bed. *See* Shop Talk, "Discrepancy in Limited Partnership Ruling Guideline," 40 JTAX 384 (June 1974). *See also* Willis, Partnership Taxation (1976), vol. 2, §57.09 (stating the 5% minimum interest in profits or losses that was once thought to be an unwritten requirement of the Service apparently was not a very specific requirement and may not have been applied in many situations). (We once before recited this back story to our readers. *See* Shop Talk, "The 1% Standard: Back from the Dead?," 120 JTAX 317 (June 2014).)

Pursuant to section 3.01 of Rev. Proc. 74-17, the so-called "1% standard" for obtaining a favorable tax status letter ruling came into being. Under Rev. Proc. 74-17, one pre-condition is that the interests of all the general partners, taken together, in each material item of partnership income, gain, loss, deduction, or credit be equal to at least 1% of each such item at all times during the existence of the partnership.

In any event, that 1% "gold standard" remained in place as the minimum percentage interest for 15 years, until the IRS ruled in Rev. Proc. 89-12, 1989-1 CB 798, section 4.02, that a favorable partnership tax status letter ruling could be granted under the Kintner Regulations even if the general partners' interests were as low as 0.2% (where, among other things, there was at least $250 million of capital being contributed to the partnership by its limited partners). *See generally* Howard, "Partnership Rulings Eased by New Limited Liability, Net Worth Tests," 70 JTAX 334 (June 1989). The same "less than 1%" standards were

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extended to the member-managers of an LLC seeking a partnership tax status letter ruling. *See* section 4.03 of Rev. Proc. 95-10, 1995-1 CB 501.

Rev. Proc. 74-17 imposed two additional conditions. First, section 3.02 provides that the aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.

Second, section 3.03 of Rev. Proc. 74-17 states that a creditor who makes a nonrecourse loan to the limited partnership must not have or acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor. (As we discuss below, these additional conditions were critical to Rev. Proc. 74-17 seeing the light of day.)

With the advent of the check-the-box regulations, a general partner's or managing-member's minimum percentage ownership interests in the entity that must be maintained without jeopardizing the entity's partnership tax status became far less certain and most likely smaller in amount. *See, e.g.,* Shop Talk, "How Small Can a Partner's Interest Be: More Evidence 0.1% (or Less) is the 'New' 1%," 117 JTAX 174 (September 2012); and Shop Talk, "No IRS Guidance Likely on How Small an LLC Member's Interest Can Be," 87 JTAX 191 (September 1997).

So where did that 1% standard come from? And why is it relevant, insofar as there is no discussion in the Kintner Regulations of a minimum percentage requirement? A year before Rev. Proc. 74-17 was issued, the IRS's top official gave notice that the use of partnerships to facilitate tax shelters was causing concern. IRS Commissioner Donald C. Alexander, in a speech to the Cleveland Tax Clinic on November

15, 1973, reportedly said the general partner of a limited partnership seeking tax classification as a partnership must "have at least a one percent interest in each material item of income, gain, loss, deduction and credit, at all times during the existence of the partnership." The Commissioner added, "[w]e feel that a partnership must have a viable general partner, which means that the general partner must have a real interest in the affairs of the partnership. The interest must be something more than a set fee for performing certain services. If the partnership venture is a success, the general partner should also share realistically in the profit-if it fails, the general partner should also share realistically in the loss." *See* Sexton and Osteen, "Classification as a Partnership or as an Association Taxable as a Corporation," 24 Proc. Ann. Tulane Tax Inst. 95, 141 (1974); "Points to Remember No. 5-Limited Partnerships: Interest of General Partners," 27 Tax Lawyer 349 (1974). The *Tax Lawyer* article noted that in the case of limited partnerships with a sole corporate general partner, the 1% requirement will be applied in addition to the numerical rules of thumb set forth in Rev. Proc. 72-13, 1972-1 CB 735.

With that background, and in response to our May Shop Talk column, we were glad to get another piece of the puzzle from attorney Jerrold (Jerry) Bigelman, of Bigelman Tax Law in Bingham Farms, Michigan. Mr. Bigelman recently wrote us the following:

> I worked in the Technical Branch at the National Office as a Tax Law Specialist from mid-1973 through the end of 1975.
>
> Most of the time in the section that handled partnership taxation and estates and trusts. So my life was involved with Revenue Procedures 74-17 and 72-13.
>
> And I have been a "74-17 - 1% General Partnership Interest Guy" all my life. (I don't know any better).
>
> You may not credit this-but I view violations of the 1% rule the same way I view those who use charitable organizations for mere deductions and who don't really have charity in their heart. Those same people would hoard bathroom tissue at the beginning of a world-wide pandemic, I think.
>
> Interesting fact that I recollect as to Rev. Proc. 74-17: When it first went up the line for approval at IRS it had only the section 3.01 rule as to a 1% general partner interest. Someone stopped it from going further saying that a Revenue Procedure with only the 1% rule was not substantial enough to present to the next person up the line for approval.
>
> So they added the section 3.02 rule as to equity capital (which had a large effect) and section 3.03 as to creditors (which no one cared about).

> Then they sent it all the way up the line for approval-and it was approved and issued.
>
> At any rate, your Shop Talk article made me feel like that young guy again-applying those Rev. Procs.

Mr. Bigelman's recounting of the origin of Rev. Proc. 74-17 and observations got us thinking . . . about several things:

1. Is the partnership form itself evil? Rev. Proc. 74-17 was intended to significantly reduce the use of limited partnerships as tax shelters. Commissioner Alexander's comments in 1973 indicate that tax shelter promoters were using the partnership form for mischief by so-called general partners who merely had an interest in set fees; the Commissioner said their interest "must be something more." However, Rev. Proc. 74-17 (and successor revenue procedures like Rev. Proc. 89-12 and *its* successors) have not caused tax shelters using limited partnerships (or LLCs taxed as partnerships) to become extinct. And neither attacks at the partnership level (resulting in the disregard of the partnership) nor at the partner level (e.g., the disregard of purported partners), both attacks being authorized by the partnership anti-abuse rules in Reg. 1.701-2, have eliminated the use of the partnership vehicle to facilitate tax-favored investments.

Does it follow that the partnership as a flow-through entity should be abolished for tax purposes? In 1986, the U.S. House of Representatives Committee on Ways and Means' Oversight Subcommittee held hearings on that topic, as a precursor to tax reform legislation then brewing (and ultimately enacted as the Tax Reform Act of 1986). Fortunately, Congress did not throw out the baby with the bathwater; partnerships retained their favorable pass-through tax treatment.

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2. What is "a real interest in the affairs of the partnership"? In his 1973 remarks, Commissioner Alexander referred to a limited partnership being recognized (for tax purposes) only if the general partner had "something more" than a set fee for performing services. Looking at these comments with 20/20 hindsight in 2020, was the Commissioner troubled that if the general partner/promoter would be receiving (solely) a fixed fee determined without regard to partnership income for services while having no interest in partnership profits, the general partner did not look or smell like a traditional general partner? If so, was the enactment in 1986 of Section 707(a)(2) (now Section 707(a)) the better response to the concern? Application of Section 707(a)(2) brings the same result sought by the Commissioner-the individual is not a partner for tax purposes. Well, if the service provider is not a partner and there is no other general partner for tax purposes, doesn't it follow that there is no partnership for tax purposes? And if there is no tax partnership, then isn't the result the same that taxpayers' representatives were concerned about in 1974, when they sought advance rulings to avoid just that result under Rev. Proc. 74-17?

3. Does "a real interest in the partnership" require an interest in profits and losses "at all times"?

The stated test in section 3.01 of Rev. Proc. 74-17 is that the purported general partner have no less than a 1% interest in all material items of income, gain, loss, deduction, or credit "*at all times during the life of the partnership.*" Why is that critical? If the general partner only has a 0.9% interest in all those items during the majority of the life of the partnership but a 50% (or 25% or 20% or 10%) carried interest in the sales proceeds when the partnership assets are disposed of, is the purported partner not motivated to generate profits "during the life of the partnership"? To the extent that operating profitability is reflected in the sales price of the assets in liquidation of the partnership, is the general partner not motivated "during the life of the partnership" for it to have a significant operating profit and cash flow? Recollect that back in the 1960s partnership profits interests were being received by general partners for services rendered or to be rendered and their tax treatment (potentially being ordinary income upon receipt) was being litigated. *See, e.g., Sol Diamond*, 56 TC 530 (1971), aff'd 492 F.2d 286 (CA-7, 1974).

Perhaps the "1% at all times" requirement was intentionally designed to preclude favorable rulings where general partners had a carried interest and (virtually) nothing else. Was the IRS's brain trust thinking, "If tax shelter limited partnerships feature carried interests, let's stop giving rulings on all limited partnerships that feature general partners having (virtually) nothing but carried interests"?

Or perhaps the simple explanation as to the "1% at all times" standard relates to administrability. Back in the 1970s, the IRS was being crushed with ruling requests under the Kintner Regulations as to the tax status of state law limited partnerships. The ruling specialists in the IRS National Office almost certainly had virtually no time to determine whether general partners having layered or tiered profits interests or carried interests would meet an "overall standard" (be it 1% or something else). In the early 1970s, a PC was a professional corporation, not a personal computer, so fancy computations for present value analysis of the economics of a general partner's subordinated profits interest were difficult and time consuming.

In any event, those tax shelter (and other) limited partnerships seeking a tax status ruling after the issuance of Rev. Proc. 74-17 restructured their partnerships to comply with the "1% interest at all times" minimum requirement, and those that didn't restructure didn't get a ruling. But as Mr. Bigelman stated with respect to his private (i.e., post-government) practice, he has been a "1% general partnership interest guy" all his professional life for tax planning purposes, even though the standard only is supposed to apply for advance ruling purposes. And that result was recognized by commentators who contemporaneously observed that Rev. Proc. 74-17 would have an unavoidable impact on the classification process itself in that it injects considerations over and beyond those of the Kintner Regulations which must be considered by tax practitioners in their evaluation of the issue. Sexton and Osteen, *supra,* at 742. And as Mr. Bigelman's response ("I've been a '1% general partner interest' guy all my life") illustrates, at least some tax advisors continue to apply that standard under the check-the-box regs as well.

Interestingly, in Rev. Proc. 89-12, issued 15 years after Rev. Proc. 74-17, the Service eased up slightly on the accelerator with respect to the "at all times" requirement. The revenue procedure reiterates the 1% minimum standard of Rev. Proc. 74-17 but then provides that, should there be "temporary nonconformance" with the 1% standard, relief will be given if "it is demonstrated that the general partners' interest over the life of the partnership is material." That might give some comfort for audit purposes that the general partners don't need to have at least 1% "at all times" if they have meaningful profits interests in years that profits are generated, but it doesn't signal that the Service will accept on audit general partnership interests that are less than 1% at all times.

So can a taxpayer get a letter ruling today on any aspect of the minimum 1% requirement? It's not likely. See Rev. Proc. 2020-3, 2020-1 IRB 131, the latest version of the annual advance ruling (and non-ruling) revenue procedures, which states at section 3.01(95): "Section 761. - Terms Defined. - matters relating to the validity of a partnership or whether a person is a partner in a partnership" are areas in which rulings or determination letters will not be issued.

4. Revenue procedures are like sausages; better not to see them being made. You really want to know how Rev. Procs. are made? Mr. Bigelman's story of how Rev. Proc. 74-17 came to be approved is illuminating. And a comparison to the making of sausages is apt. Start with an order from your customer (here, the Commissioner of Internal Revenue). Mix in one percent of every item in a partnership interest you can think of: income, gains, losses, deductions, credits-you name it! Have your boss taste it. He tells you it's too bland-our customer will never buy it. So you throw in a handful of section 3.02 and

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a pinch of section 3.03. Mix them all in. Serve it up to your boss (the Group Chief), and then your boss's boss (the Division Director), and then your boss's boss's boss (the Assistant Commish-Technical). Everybody like it? Good! Now you can serve it to your customer, The Boss of Bosses (The Commish). He jiggy with it? Great! You got one Rev. Proc. to go (out the door)!

5. PTSD Syndrome when you change sides in Tax Wars. Mr. Bigelman began his tax law experience working for the IRS in Washington, D.C. in 1973. That same year Shop Talk co-editor Shelly Banoff similarly started his tax law experience working in the Chicago office of IRS Regional Counsel's office as a summer intern. (Another co-editor, Dick Lipton, started his career as a law clerk for the Tax Court, while Shop Talk third musketeer Adam Cohen joined private practice straight out of law school.)

Mr. Bigelman writes that "I have been a "[Rev. Proc.] 74-17 - 1% General Partnership Interest Guy" *all my life.* (I don't know any better). You may not credit this-but I view violations of the 1% rule the same way I view those who use charitable organizations for mere deductions and who don't really have charity in their heart. Those same people would hoard bathroom tissue at the beginning of a world-wide pandemic, I think." (emphasis added.)

To place known violators of the 1% standard in the same category as heartless, my-fingers-are-crossed-behind-my-back charitable contributors and (worse still) selfish, self-absorbed (pun intended) toilet paper hoarders seems a bit extreme to your three Shop Talk editors, particularly since they would be self-described recidivists in violating the 1% standard. However, Mr. Banoff better understands Mr. Bigelman's mindset. When you've worked for the government or IRS during or straight out of law school, you are young and impressionable, you think your job is to protect the (Re)public from tax cheaters, and you see the world in black-and-white; there are no shades of grey. So viewed, the guys who fight the Good Tax War toe the Minimum 1% Line. As the late, great Jim Croce sang (or might have), you don't tug on Superman's cape; you don't spit in the wind; you don't pull the mask off that old lone ranger, and you don't give your general partners less than a 1% interest in a limited partnership. The villains cross the line and throw good judgment and caution to the wind. They should only burn in tax hell, as far as the protectors of the 1% standard are concerned.

Which has gotten us thinking again. Exactly how long does it take for a law-abiding (former) IRS tax professional to "unlearn" their taking the IRS's position ... on everything? This is an educational, psychological, and personal bias question with no one-size-fits-all answer. In Banoff's case (having worked for a small Chicago CPA firm doing tax and audit accounting work during all three years of law school), he had a pro-taxpayer bias and background before spending the Summer of '73 with Regional Counsel's office (Chicago), where the office was clearly pro-government. (If you saw some of the civil and criminal taxpayer abuses that worked their way up to Regional Counsel, you'd probably turn pro-government, too, as did Banoff.) He remembers that for about three months thereafter-the same amount of time he spent at the IRS-he went through the tax practitioner's version of post-traumatic stress disorder: he would answer every technical question at his firm with something like, "The IRS would look at it this way, so you'll be denied the tax benefit you're trying to achieve." To which his supervisor would inevitably say something like, "I don't care *what* the IRS would say! What does *the law* say? What do *the regulations* and *legislative history* say? What do *the cases* say?"

It can be hard to accept that your customer no longer is The Commish.

In contrast to Bigelman and Banoff, co-editors Lipton and Cohen were never handicapped by a conscience forged at the IRS. Indeed, Lipton was attracted to tax planning because of his philosophical view that every dollar legally denied to the government is the best dollar; he is happiest when he can come up with a way to legally minimize (or better yet, completely eliminate) the tax payable on any transaction. And in his world, the Commish is the sith leader of the Dark Side; he and his fellow tax practitioners are the embattled rebel alliance that tries to use The Force to succeed in tax planning. As for the 1% standard, he always viewed it as a line drawn out of thin air that applies only when a taxpayer is seeking a ruling (that the taxpayer likely does not need).

Cohen does not view tax law as a battle of good and evil or a zealous advocacy of the fisc, but rather as a game with changeable rules and players with a variety of motivations. When you play as the taxpayer, you win by minimizing your tax within the rules in play at the time. When you play as the game maker (e.g., Congress), you win by collecting enough taxes to pay for government and by having vertical and horizontal fairness. When you play as rule writer (e.g., the Service and Treasury), you win by making the rules administrable and keeping to the map laid out by the game maker and minimizing rule breaking (real or imagined). The 1% standard, viewed from this perspective, was a sort-of rule (with the shades of grey described in this article) and probably continues to be a go-by (if you want to be conservative) but, by no means, a hard-and-fast rule.

We thank Mr. Bigelman for his insight on how the 1% standard of Rev. Proc. 74-17 came to be and how it has shaped his professional tax life-and to varying degrees, ours. As always, we welcome our readers' comments.