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SHOP TALK

Revisiting the 1% Minimum Ownership Interest in Safe Harbors

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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How small can a partner's interest be and still be recognized for tax purposes? Recently issued Rev. Proc. 2020-12, 2020-11 IRB 511, dealing with allocations of the tax credit for carbon capture projects under Section 45Q, 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%. Will field agents and tax advisors 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?

Let's first provide our readers with historical background on the IRS/Treasury's tax treatment of teensy partnership interests. Your Shop Talk editors have long been interested (and written for the past 25 years in this column) on the question of how small is too small (or not too small) to be a partner. 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 check-the-box regulations' broad language 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 a historical summary of the so-called 1% standard that pre-dated the check-the-box regs, see, e.g., Rev. Proc. 74-17, 1974-1 CB 438, section 3.01; 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. Under that revenue procedure, one precondition 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. The IRS backed down in Rev. Proc. 89-12, stating that a favorable partnership tax status letter ruling could be granted under the *Kintner* regulations (301.7701-1 through -3 (1996)) 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 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).

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.

So, 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 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 over 23 years now, and there is no authority yet as to how miniscule the members' interests may be (while still being treated as partners for tax purposes). Some guidance has come about in a series of IRS revenue procedures dealing with certain tax credits available to partnerships and their partners.

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

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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.

Oh, sure, there are cases where fractions of 1% have gone uncriticized, uncommented upon, or unnoticed, and implicitly approved, and some others 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, 694 F.3d 425 , 110 AFTR 2d 2012-5710 (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,* 863 F. Supp. 270 , 74 AFTR 2d 94-6275 (DC N.C., 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. Also see *Brumbaugh,* TCM 2015-65, 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).

Indeed, guidance has come in the form of three revenue procedures dealing with income tax credits that are allocable to partners. The oldest, Rev. Proc. 2007-65, 2007-45 IRB 967, provides a safe harbor applicable to partners in partnerships with Section 45 production tax credits from wind. See Shop Talk, "How Small Can a Partner's Interest Be? IRS Whispers in the Wind," 107 JTAX 380 (December 2007). As described in that column, Rev. Proc. 2007-65 may or may not be interpreted by practitioners and field agents as providing an indication that the IRS National Office was/is not comfortable with partners' interests being in the range of 0.5% or less. That revenue procedure has the rare admonition that the Service generally will "closely scrutinize" a project company as a partnership or investors as partners if a project company's partnership agreement "does not satisfy each requirement of this revenue procedure." In section 5 of the procedure, the IRS distinguishes between the allocation of the LLC's gross income or loss and Section 45 tax credits to investors having interests of 99% (in Example 1) and 99.5% (in Example 2). As a result, in Example 2 the developer would have only a 0.5% (rather than the 1% minimum guideline) interest in gross income or loss and credits. In that situation, the wind energy LLC's classification as a valid partnership "would be closely scrutinized by the Service."

We further observed in our December 2007 Shop Talk article that Rev. Proc. 2007-65 did not delineate who is a partner and who is not for substantive purposes-it merely provides requirements for safe harbors in the wind energy partnership area. Nonetheless, we raised our concern that field agents and tax advisors might come away with the sense that *any* partner holding less than a 1% interest in a partnership should be "closely scrutinized," and if so, *query* what would be the result of that "close scrutiny." Although the IRS has not answered that question substantively, the Service did throw taxpayers a bone and revised Rev. Proc. 2007-65 (as memorialized in Ann. 2007-112, 2007-50 IRB 1175), to add the following in section 3 thereof: "The requirements set forth in this revenue procedure that must be satisfied in order to qualify for the Safe Harbor, however, are *not* intended to provide substantive rules and are *not* to be used as audit guidelines." (Emphasis added.) See Shop Talk, "How Small Can a Partner's Interest Be? The Answer is Blowin' in the Wind," 108 JTAX 57 (January 2008).

In Rev. Proc. 2014-42, 2014-3 IRB 415, section 4.02(1), "Partners' partnership interests-principal's minimum partnership interests," the IRS reasserted the 1% "gold standard" minimum requirement for purposes of partnerships and partners meeting a safe harbor for rehabilitation tax credit partnerships under Section 47. Like Rev. Proc. 2007-65, Rev. Proc. 2014-12 gives no explanation as to 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.

Shades of 1974! Is the 1% standard 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).

Well, six years later, a third tax credit safe harbor revenue procedure has gone to the magic 1% standard. Rev. Proc. 2020-12 provides a safe harbor whereunder an investor will be respected for tax purposes as a partner-owner in (and not a lender to) a partnership that owns carbon capture equipment and thus will be entitled to an allocation of the available credits under Section 45Q. Rev. Proc. 2020-12, section 4.02(1), states, "The Developer must have a minimum one percent Partnership Interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the existence of the Project."

So, what's the reason the developer must maintain a 1% interest in each item of partnership income, gain, loss, deduction, and credit at all times? It is not explained in any of the three revenue procedures. However, section 2, "Background," in Rev. Proc. 2020-12, states at 2.05, "A partnership exists when two or more 'parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.' *Commissioner v. Culbertson*, 337 U.S. 733 , 742 (1949)." And a well-respected writer states that, by having at least a 1% interest, the developer cannot sell 100% of the carbon capture credits. "Why not? Because the deal would not otherwise meet the requirements to be a partnership under the case law that the drafters of the revenue procedure relied on." Sheppard, "Capturing Carbon

Credits," Tax Notes Federal, 03/02/2020, p. 1389.

But there is nothing in *Culbertson* that sets a 1% minimum standard. Moreover, this view of Rev. Proc. 2020-12 does not appear to be grounded in reality. In the "real world," it is common for a person respected as a partner to have less than a 1% interest in the partnership without raising questions of whether that person is a partner. And *Culbertson* requires a sharing of profits, but it does not set forth a minimum amount of profits that must be shared. Furthermore, any reference to a percentage may miss the point if the partner has a significant financial investment in the partnership-if the partnership has a billion dollars of assets, one would have to think that if a person contributed "only" $5 million to the partnership, that investment was sufficient to make that person a partner (even though it was only 0.5%).

Moreover, turn the problem on its head. Assume that A contributed $5,000 in exchange for a 0.5% interest in a partnership in which B contributed $995,000, and A is entitled to receive 0.5% of the income, gain, profits, losses, deductions, and credits from partnership AB. Would any practitioner be willing to give A an opinion (at any level of confidence) that A was not a partner for tax purposes? If A did not want to report as a partner in the partnership, would any accountant be willing to sign a return that disregarded A? And if A was a foreign person and AB is engaged in a trade or business in the U.S., would anyone suggest that the withholding rules under Section 1446 did not apply to A? Your authors believe that the answer to all of these questions is an emphatic "no."

It has been suggested that safe harbor guidance is designed to "encourage" taxpayers to structure their transactions to more closely resemble commercial (e.g., real estate) investments that do not involve tax credits. Roberts, "Navigating the Safe Harbor When the Cargo Includes Federal and State Historic Tax Credits," 125 JTAX 5 (July 2016). But it is commercially reasonable (and not infrequently encountered) for general partners and managing members to have less than a 1% share of all items of partnership income, gain, deductions, and losses in such investments that do not involve tax credits.

How does the newest (2020) revenue procedure differ from its 2007 and 2014 cousins? The 2020 revenue procedure has only one example-a partnership that qualifies for the safe harbor, and that example states the developer is allocated 1% of the gross income or loss and the Section 45Q Credit. Unlike the 2007 revenue procedure, no example of a lower percentage interest is provided. One could easily infer that had the developer owned only a 0.9999% interest, they would not qualify under the safe harbor.

One might also infer that the 1% level is meant to be an audit standard, at least for this credit. Unlike Announcement 2007-112 (described above), there is nothing in Rev. Proc. 2020-12 that states that revenue procedure is not intended to provide substantive rules and is not to be used as audit guidelines.

So, when three separate tax credit safe harbor revenue procedures issued over a 13-year period all turn on their respective developers/managers maintaining a 1% minimum interest in the partnership at all times to qualify for their respective safe harbors, one can look at the glass as being half empty or half full. That the IRS is applying a safe harbor requirement consistently is a good thing. That it has not taken with it (at least not so far in 2020) a strong disclaimer to field agents and revenue officers not to apply the 1% requirement as an audit tool is a bad thing.

As always, we welcome our readers' comments.