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Current Pass-Through Tax Issues

By Steven E. Hollingworth and Richard I. Tay • Wood & Porter • San Francisco

PLI's Tax Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2010 was held in San Francisco, and though the world's eyes were not on this stage (but on the pitch in South Africa), it was an ideal place for tax professionals. The conference offered a wealth of information about the tax treatment of partnerships and other pass-through entities. We walked away enriched by the discussions over difficult and cutting-edge issues in partnership taxation.

Update on the Codified Economic Substance Doctrine

The codification of the economic substance doctrine in Internal Revenue Code Section ("Code Sec.") 7701(o) has been described as a "sea change." The speakers at the session devoted to this topic were Armando Gomez (Skadden, Arps, Slate, Meagher & Flom LLP), Richard M. Lipton (Baker & McKenzie LLP), Mark J. Silverman (Steptoe & Johnson LLP) and Robert J. Crnkovich (Senior Counsel (Tax Policy), Department of the Treasury).

The courts originally formulated the economic substance doctrine in an effort to recharacterize or disregard the tax treatment of a transaction in which the taxpayer was motivated by no business purpose other than obtaining tax benefits, or when the transaction had no reasonable possibility of a pre-tax economic profit. Before the enactment of Code Sec. 7701(o), the exact formulation of the doctrine varied among the courts. Code Sec. 7701(o) now provides that economic substance for income tax purposes requires both a meaningful change in the taxpayer's economic position (apart from tax benefits) *and* a substantial nonfederal income tax purpose for the transaction. For prior coverage, *see* Robert W. Wood, *Health Care Reform and Economic Substance*, M&A TAX REP., May 2010, and Steven E. Hollingworth, *The "Codified" Economic Substance Doctrine*, M&A TAX REP., May 2010.

ALSO IN THIS ISSUE

Significantly, the new statute applies only if the economic substance doctrine would be considered "relevant," determined as if the statute had not been enacted. Once the statute applies, a taxpayer will be subject to a 40-percent *strict liability* penalty (20-percent if the transaction was adequately disclosed on the return) unless the transaction meets the two-pronged test.

The panelists pressed Mr. Crnkovich for guidance on how the statute will apply to particular transactions and when the government might impose the penalty. Unfortunately, there is not likely to be any "angel list" of approved transactions. Mr. Crnkovich cautioned that although Joint Committee reports contain several taxpayer-friendly examples, these reports are technically not legislative history. Mr. Crnkovich stressed that codification of the economic substance doctrine wasn't intended to make major changes to the law, other than making the doctrine's two prongs conjunctive, rather than disjunctive.

Accordingly, a practitioner should continue to feel comfortable about transactions with which he was comfortable under prior law. That clearly didn't satisfy the other panelists. With a 40-percent strict liability penalty at stake, they pointed out the risks are much higher if their judgment turns out to be wrong. In addition, the balance of power has shifted in defending an audit, since the examiner now has the threat of a 40-percent penalty.

All of the panelists, including Mr. Crnkovich, agreed that the government needs to provide guidance on the procedures the IRS will follow in asserting the strict liability penalty. The scope of this penalty is uncertain, applying not only to the economic substance doctrine, but "any similar rule of law." Mr. Lipton forcefully argued that the substance-over-form, sham-transaction and step-transaction doctrines are not similar to economic substance. He pointed out the case of *AWG Leasing Trust*, DC-OH, 2008-1 USTC ¶50,370, 592 FSupp2d 953 (2008), as a good example of the distinction between these doctrines.

However, Treasury's Mr. Crnkovich did not agree that the statute makes such a distinction. While he expressed openness to the idea of listing certain judicial principles that would be considered substantially similar to the economic substance doctrine, we should not expect a comprehensive list.

All the panelists noted that there are multiple terms in the statute crying out for clarification. For example, a taxpayer's "reasonably expected" pre-tax profit must be "substantial" in relation to the present value of the expected net tax benefits. How, exactly, is this calculation to be done? Moreover, what constitutes "adequate" disclosure that will reduce the penalty from 40 percent to 20 percent? Mr. Crnkovich seemed to believe that the standard should be similar to the disclosure rules under Code Sec. 6662, and that disclosure under the proposed Schedule UTP would probably be satisfactory for this purpose.

Clearly, the panel was dissatisfied with the status quo. At the end of the session, Mr. Gomez suggested, half seriously, half in jest, that the government should issue a notice that it will not assert any penalty until all these issues have been addressed. Mr. Crnkovich

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promptly responded, "Consider it done!" If only he hadn't been joking …

Upcoming Regulations and Other Guidance

Current and former IRS and Treasury officials gave a sneak peek of forthcoming partnership-related guidance. Although most of these items are identified in the Treasury's 2009–2010 Priority Guidance Plan (sometimes rather cryptically), a more detailed preview emerged from the panel's discussion. The panelists were Curtis G. Wilson (Associate Chief Counsel (Passthroughs & Special Industries), IRS), Robert J. Crnkovich (Senior Counsel (Tax Policy), Department of the Treasury) and William P. O'Shea (Deloitte Tax LLP, former Associate Chief Counsel (Passthroughs & Special Industries)).

Passive Activities

Mr. Wilson began with some background on the passive loss rules, material participation, and the seven ways one can qualify as a material participant under the current regulations. However, limited partners are subject to more restrictive rules.

The current temporary regulations talk about "limited partners" and "general partners" but do not expressly address how members of a limited liability company should be treated. Taxpayers have argued that members of an LLC are not the same as limited partners, since under state law they are allowed to participate in management. Therefore, members of an LLC should not be subject to the more restrictive material participation test that applies to limited partners. The Tax Court and Court of Federal Claims have agreed, and the IRS recently acquiesced.

The regulations now seem hopelessly outdated. According to Mr. Wilson, the IRS recognizes that the current Code Sec. 469 regulations do not reflect current business practices. We can expect new regulations, but what they will contain is unclear. Notably, Mr. Wilson declined to commit to carrying over the same seven tests found in the current temporary regulations. He stressed, however, that this regulation project was limited to the passive loss rules. It will not cover self-employment taxes, another contested issue for LLCs.

Deficit Restoration Obligations

In addition to the passive activity loss regulations, the government intends to issue regulations dealing with the at-risk rules of Code Sec. 465. Under the at-risk rules, an individual investor generally cannot deduct a loss greater than his investment and borrowings for which he is personally liable.

The impetus for this regulation project is the controversial case of *Hubert Enterprises*, 95 TCM 1194, Dec. 57,351(M), TC Memo. 2008-46, which addressed the effect of a deficit restoration obligation, or DRO. A DRO requires a partner or LLC member to make a contribution to the company if the member has a negative capital account upon the company's liquidation. In *Hubert*, the Tax Court held that a DRO does not increase an LLC member's at-risk amount under Code Sec. 465 when the member does not assume personal liability for the liabilities of the LLC.

The court agreed with the IRS that, since the member's obligation to contribute to the LLC was triggered only upon liquidation, the member was not at risk for the amount of the DRO at the time the losses were incurred. Critics have argued that the court should have determined the risk of loss by applying the regulations under Code Sec. 752. Under these regulations, a partner is on the hook for a partnership liability if he would be required to make a contribution to the partnership in the event the partnership sold its assets for nothing and liquidated. Unlike the Tax Court's holding in *Hubert,* the partner doesn't have to wait for the partnership to actually liquidate before he is deemed to bear the economic risk of loss.

The panelists expressed uncertainty as to whether Code Secs. 465 and 752 should be coordinated, since they arguably serve different purposes. However, the IRS and the Treasury recognize the existence of conflicting authorities on this issue and intend to issue regulations that will prospectively address the problem.

Noncompensatory Partnership Options

Mr. Crnkovich reminded attendees about the proposed regulations on noncompensatory partnership options issued back in January 2003. Final regulations are expected no later than June 2011.

Mandatory Basis Adjustments

Another upcoming project relates to adjustments to the basis of partnership property. Under Code Sec. 743(a), the basis of partnership property generally isn't adjusted up or down if a partner dies or sells his interest. An exception applies if the partnership makes an election under Code Sec. 754 or if the partnership has over $250,000 of built-in losses immediately after the transfer occurs. In the case of a substantial built-in loss, the basis of partnership assets must be reduced by the excess of the transferee partner's share of the basis of the partnership assets over the basis of his interest in the partnership.

Regulations will address whether a transfer of an interest in an upper-tier partnership may trigger a basis adjustment in a lower-tier partnership. Mr. Crnkovich believed it made sense to analyze each partnership in the tiered structure to see if there is a substantial built-in loss. The panelists agreed this must be the correct answer, since it would otherwise be easy to avoid the mandatory basis adjustment.

"Stuffing" Allocations

Mr. Crnkovich spoke approvingly of "stuffing" or "fill-up" allocations, commonly used in hedge funds to avoid having to make a Code Sec. 754 election. He stated that commentators had made a "convincing argument" that this technique actually works. But what exactly is a stuffing allocation?

Assume a hedge fund recognizes $10 in gain. In the same year, it redeems a 10-percent partner (who has a basis in his interest of $90) for $100. The partner would recognize $10 in gain, $1 from his 10-percent share of partnership gain, and $9 from receiving cash upon redemption in excess of his basis. The remaining partners may not be happy with this result, since they are taxed on gain currently, while the redeemed partner gets cash.

Unless the partnership makes a Code Sec. 754 election, the inside basis of the partnership assets is not adjusted to take the partner's $9 gain into account. What does the partnership do if a Code Sec. 754 election is administratively impractical? The answer is a "stuffing allocation"—a special allocation of the partnership's gain to the redeemed partner ($10 in this case, up to the excess of his cash over his outside basis). The redeemed partner is usually indifferent, since he would recognize the same amount of gain ($10) whether or not the stuffing allocation occurred. Of course, this also benefits the existing partners, since their gains are deferred.

The Treasury is considering issuing updated rules for hedge funds in Reg. §1.704-3(e)(3). Mr. Crnkovich noted that these regulations are over 20 years old and too restrictive in light of current practices.

Publicly Traded Partnerships and COD Income

Other guidance we can expect in the near future relates to the income tests for publicly traded partnerships. Publicly traded partnerships are generally treated as corporations for income tax purposes. An exception applies if at least 90 percent of the partnership's annual gross income comes from passive sources, such as interest, dividends, rents and gains from real property. As a result of current economic conditions, the question is, in which category cancellation of debt income belongs.

The panelists concurred that COD income should not be disqualifying. Possibilities for future guidance include treating COD income as "good income," or perhaps excluding the income from both the numerator and denominator of the fraction, as is permitted with REITs. Mr. Wilson said the more difficult question the IRS is looking into is how closely the COD income should be traced back to the debt giving rise to the income.

Conversion of Debt to Partnership Equity

Mr. Wilson reminded the audience about proposed regulations under which a lender to a partnership generally does not recognize gain upon converting a loan into a partnership interest. Yet some commentators have objected to a provision in the proposed regulations that would prohibit claiming a bad debt deduction on conversion. Final regulations are being prepared that will take this objection into consideration.

Regulations Under Code Secs. 706(d) and 108(i)

Mr. Wilson noted that all comments are in on the proposed regulations under Code Sec. 706(d), relating to the determination of distributive shares when a partner's interest changes. The IRS is currently working on the final regulations. The government also plans to issue more guidance on the election under Code Sec. 108(i) to defer discharge of indebtedness income over a five-year period.

Partnership Tax Cases: Dispute and Litigation Strategies

On the tax controversy menu, Ms. Julia Kazaks (Skadden, Arps, Slate Meagher & Flom LLP) and Loretta Richard (Ropes & Gray) covered updated litigation and dispute resolution strategies. Both Ms. Kazaks and Ms. Richard brought to the stage their rich experience from the front lines of partnership taxation, and their presentation showed their expertise in these matters.

TEFRA Terms—An Audit by Any Other Name

The presentation covered a wide range of topics of Tax Equity and Fiscal Responsibility Act (TEFRA) examinations, from basic to sophisticated. Since some in the audience might have been new to TEFRA examinations, the presenters first flagged certain TEFRA terms, listing the individual audit equivalents of TEFRA examination notices. For example, a Notice of Final Partnership Administrative Adjustment (FPAA) is the TEFRA equivalent of a Notice of Deficiency of an individual audit. This baseline knowledge was a springboard into topics both complicated and controversial.

A member of the audience queried another fundamental term. What is a partnership item versus a nonpartnership item for tax purposes, and what difference does it make? Ms. Richard explained that a partnership item is an item that has tax attributes determined at the partnership level. The distinction can have substantial implications. A loan, for example, can be nonrecourse at the partnership level. At the partner level, however, the loan can be recourse and used for at-risk purposes.

Partnerships and Partners—To Be, or Not to Be

Moving through their slides, the presenters explained that the TEFRA rules apply only to "small partnerships," which are partnerships with 10 or fewer partners. Partners are defined as individuals, which, according to the IRS, do not include disregarded entities such as single-member LLCs. Taxpayers, however, have argued that such disregarded entities should be individuals for TEFRA purposes.

This issue has implications beyond the basic qualifying requirements of TEFRA rules to partnerships. Ms. Richard and Ms. Kazaks identified an apparent inconsistency in the IRS's treatment of "disregarded entities." While a disregarded entity is not considered a partner, a disregarded entity can *act* as a Tax Matters Partner, or TMP (*see* Rev. Rul. 2004-88), for purposes of the TEFRA partnership rules. Still, there is a controversy whether a disregarded entity can be a Tax Matters Partner in a court proceeding. Accordingly, our presenters suggested that partnerships re-designate the Tax Matters Partner before filing a court action.

The presenters recommended taking great care in choosing a TMP. Indeed, there are material consequences to a bad choice. If a TMP initiates a court action on behalf of a partnership and the TMP is found not to qualify, the action may be dismissed for lack of subject matter jurisdiction! At that point, it may be too late to re-file the action.

Statute of Limitations

The expiration of the statute of limitations can be a red-letter day, and the expiration date for partnership items is three years after the later of (1) the date on which the partnership return was filed, or (2) the last day for filing the partnership return for the year. True, this seems like standard tax procedure.

Yet it gets complicated in application. The statute of limitations applies at both the partnership and partner level, and the fact that the statute has expired at one level does not mean it has expired at the other. An open statute at either level can have an adverse effect on other partners.

Of course, these days the hot issue is the three-year versus six-year question. The presenters discussed the onerous six-year statute, especially as it relates to a taxpayer's overstatement of basis. In *Colony, Inc.*, SCt, 58-2 USTC ¶9593, 357 U.S. 28 (1958), the Supreme Court held that an overstatement of basis was not an omission of income triggering the extended limitations period. However, the IRS has challenged the *Colony* case, thus far unsuccessfully. Its most recent attempt at dethroning *Colony* was to issue temporary regulations that are contrary to the Court's holding in *Colony*. Although novel, this attempt has met the same level of success.

The IRS's recent defeats include *Intermountain Insurance Service of Vail*, 134 TC No. 11, Dec. 58,209 (2010), in which the Tax Court ruled that the IRS could not overrule the Supreme Court's decision in *Colony* with regulations. Also, the Court of Federal Claims upheld *Colony* in *Grapevine Imports*, FedCl, 2007-2 USTC ¶50,555, 77 FedCl 505 (2007), which was decided before the IRS issued temporary regulations. The IRS has appealed to the Federal Circuit.

Despite the IRS's numerous challenges, the *Colony* case is still good law. For now, taxpayers don't need to worry about the IRS successfully applying the six-year statute because of an overstatement of basis on a partnership return. However, the law may change depending on the strength of the IRS's arguments in court, and of course the IRS can keep trying.

Conclusion

Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2010 is well worth attending. PLI and a stellar cast did not shy away from tackling difficult issues in the world of partnership taxation. More information can be found at *www.pli.edu/product/seminar_detail.asp?id=61304.*