Persistent Partnership Problems Parsed

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The Practising Law Institute (PLI) has gathered some of the brightest minds in public and private practice for a highly informative conference entitled *Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances*. The name of this program may not trip nicely off the tongue, but these issues are of increasing importance. As with other PLI conferences, the various panelists provided a thorough review of the current and perennial issues in the passthrough entity area.

Although it was held in San Francisco, the conference was broadcasted nationwide and should soon be available shortly as a CD-ROM. For the partnership beginner to the Subchapter K expert, this conference had enough appetizing meat to leave even the most inveterate San Francisco vegetarian demanding some. As most M&A Tax Report readers are aware, gone are the days when Subchapter C acumen was enough to handle the gauntlet of M&A transactions. Like it or not, passthroughs are essential.

Teflon TEFRA

Julia M. Kazaks and Robert R. Martinelli provided a review of examination, processing and judicial procedures that affect the way that the IRS works with partnerships and LLCs that file as partnerships. Entitled "Hot Audit/Controversy Issues, Dispute and Litigation Strategies - Partnership Tax Cases," this seminar provided a nonstick guide to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), found in Internal Revenue Code Sections ("Code Secs.") 6221 through 6233. TEFRA procedures require that everything be handled in one partnership-level proceeding and not at the partner level.

Identifying TEFRA Partnership Returns

First, it must be determined whether the partnership return is subject to TEFRA. All partnership returns come within the TEFRA skillet unless they meet the Small Partnership Exception. This exception excludes from the fiery TEFRA regime partnerships that have 10 or fewer partners, provided the partners include only C corporations, individuals or estates of deceased partners.

TEFRA Examinations

The panelists outlined the procedural requirements and chronology of a TEFRA examination. The procedural steps are numerous.

Under TEFRA, a "Tax Matters Partner" (TMP) acts as the main contact point among the IRS, the partnership and its partners during a TEFRA examination. The TMP is usually the general partner designated by the partnership. If no designation has been made, the TMP is the general partner who has the largest profits interest in the partnership.

If TEFRA applies, the IRS issues a Notice of Beginning of Administrative Procedures (NBAP) to the TMP, which initiates the partnership proceeding/examination. The IRS also issues copies of the NBAP to all Notice Partners and 5% Notice Groups.

After the examination, the IRS issues a summary report to the TMP containing a detailed explanation of each proposed adjustment. At least 30 days later, the TMP, Notice Partners and Notice Groups that choose to participate attend a closing conference where the IRS attempts to solicit agreements or waivers from partners in connection with the proposed adjustments. If all of the partners execute the agreements/waivers, the case is submitted to the local TEFRA Coordinator and closed.

If the case is unagreed, a 60-day letter is issued. The partners may either agree within 60 days to the adjustments or may file a protest to go to IRS Appeals in an effort to settle the proposed adjustments. If no protest is made or no settlement is reached in Appeals, those partners who have not agreed to the proposed adjustments are issued a Notice of Final Partnership Administrative Adjustments (FPAA).

The FPAA issuance begins the 150-day period during which the TMP or Notice Partners/Notice Groups may petition to go to either the Tax Court, the Court of Federal Claims or to District Court. If no petitions to the FPAA are timely filed, the opportunity to contest the partnership item adjustments in the FPAA is lost, the FPAA "defaults," and the tax is computed and assessed as to each partner who had not previously agreed to the adjustments.

Practical Tips from In-House Counsel

No matter how elegantly an agreement might be drafted or how accurately it may reflect the partners' business deal, if those who manage the day-to-day affairs of the partnership don't understand it, the actual economic results from the partnership might differ significantly from the partners' expectations. This can pose particular problems for in-house counsel. Often, these practitioners are on the front lines of ensuring that the provisions of a partnership agreement are respected.

Luckily for PLI attendees, a panel of in-house counsel presented several tips to deal with these and other practical challenges. Panelists were Wendy Aitken, Tax Director of Pass-thru Entities at the Fremont Group; Linda A. Klang, Senior Vice President at Lehman Brothers Holdings Inc.; and Scott Naatjes, Vice President and General Tax Counsel of Cargill, Incorporated.

Their recommendations include the following:

- Summarize the business deal in a term sheet. Ms. Aitken reminded attendees that accounting and tax compliance staff greatly appreciate term sheets written in plain English. Numerical examples, either attached to the partnership agreement or in a separate document, can also be very helpful. Not only do term sheets help compliance and administration, but they are also helpful in drafting the agreement itself.
- Take into account the likelihood that overwhelmed tax compliance personnel will probably not have time to read, let alone understand, a complex partnership agreement. If you can't summarize the deal on a one-page term sheet, Mr. Naatjes says simply, "Forget it!"
- Avoid later confusion by involving tax compliance professionals in advance as the agreement is being drafted. A compliance perspective can help spot vague or ambiguous sections.
- Always plan for losses, Mr. Naatjes advised. The sad truth is that most joint ventures fail, and are often entered into by companies and other investors that don't really know what they are doing.
- Better yet, Mr. Naatjes recommended, don't do joint ventures at all, if possible. Often a license agreement, employment arrangement or derivative instrument can accomplish all you want with more control, simpler tax consequences and less risk.
- Joint ventures generally don't have tax departments, but outsourcing tax return preparation to an accounting firm is no panacea. Mr. Naatjes said he reviews draft tax returns carefully, often finding major errors on every page.
- If you are a partner in a joint venture, don't count on getting tax return data in a timely fashion. Mr. Naatjes estimated that, of the many joint ventures in which Cargill is a member, he obtains only 10 percent of the partnership tax return data by April 15, and many are received *after* the corporate return is filed. The good news is that, at least in his experience, the IRS has been generous in allowing corrections to be made after the return is filed.
- Take into account state and local tax consequences. Ms. Klang reminded us that many states impose entity-level fees and taxes on pass-through entities. A partnership agreement should address the allocation and responsibility for these entity-level expenses. Of course, the partnership will also need a source of cash to pay these taxes.

Compensatory Interests in Partnerships

One compelling panel involved a discussion of compensatory interests in partnerships. Bob Crnkovich, Senior Counsel in the U.S. Department of Treasury's Office of Tax Policy in Washington, D.C., Julie Divola of Pillsbury Winthrop Shaw Pittman and Paul Kugler of KPMG were able to frame and coherently explain the past and current issues in this changing area of the law. One fundamental problem they raised is as follows: if a partner contributes services to a partnership in exchange for an interest in the partnership, does the receipt of the partnership interest create gross income to the partner? This is a growing issue and is of enormous practical significance.

Code Section Fisticuffs

Code Sec. 721 makes clear that no gain or loss is recognized to a partnership or the contributing partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. However, Code Sec. 83 provides that if property is transferred to any person in connection with the performance of services, the person who performed the services is required to include in income the fair market value of such property (less any amounts which were paid for such property). Which section trumps the other?

In part, the answer may depend on whether the partner's interest is a capital interest or a profits interest. The panelists pointed out that Reg. §1.721-1(b)(1) leaves little doubt that the receipt of a *capital interest* in exchange for services provided to the partnership creates taxable income to the partner. However, the treatment a *profits interest* received was far from clear until relatively recently.

Code Sec. 721 Trump Card

Messrs. Crnkovich and Kugler and Ms. Divola discussed Rev. Proc. 93-27, 1993-2 CB 343, and Rev. Proc. 2001-43, 2001-2 CB 191.

In these, the IRS conceded that it would not treat the receipt of a profits interest for the provision of services to or for the benefit of a partnership as a taxable event for the partner or the partnership. However, to qualify for this attractive holiday, the following safe harbors must be met:

- The profits interest does not relate to a substantially certain and predictable stream of income from partnership assets.
- The partner does not dispose of the profits interest within two years of receipt.
- The profits interest is not in a publicly traded partnership.

Employee or Partner?

The panelists also discussed a variety of other issues raised by compensatory interests in the partnership area. For example, they reviewed the seemingly basic question of whether a partner can be an employee of the partnership. This is hardly a new issue, but it has increasingly become an important point of contention given the rise in passthrough entities operating in contexts small and large. Mr. Kugler pointed out that the IRS's position has been that dual status (partner and employee) is not possible (Rev. Rul. 69-144, CB 1969-1).

However, what about tiered partnerships or other passthrough entities? The panelists agreed that an individual may be the employee of a LLC that is wholly owned by a partnership (which itself is owned by the LLC employee). Additionally, the panelists agreed that in the case of large public partnership, the analysis of employee/partner status might be different.

Conclusion

The panelists provided cool and reflective reviews of various other passthrough issues, despite the uncharacteristic San Francisco heat that prevailed when they spoke and recorded their sessions. If practitioners could not attend, they are well-advised to view the CD-ROM when it becomes available. Details are at *www.pli.edu.*

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