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TAXATION AND BUSINESS PLANNING FOR PARTNERSHIPS AND LLCS

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Published by Wolters Kluwer in New York.

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Attn: Order Department
PO Box 990
Frederick, MD 21705

Printed in the United States of America.

1 2 3 4 5 6 7 8 9 0

ISBN 978-1-4548-7025-8

Library of Congress Cataloging-in-Publication Data

Names: Borden, Bradley T., author.
Title: Taxation and business planning for partnerships and LLCs / Bradley T. Borden, Professor of Law Brooklyn Law School.
Description: New York : Wolters Kluwer, [2017] | Series: Aspen casebook series | Includes bibliographical references and index.
Identifiers: LCCN 2016056652 | ISBN 9781454870258
Subjects: LCSH: Partnership—Taxation—Law and legislation—United States. | Income tax—Law and legislation—United States. | Tax planning—United States. | Private companies—Taxation—Law and legislation—United States. | Limited partnership—United States. | LCGFT: Casebooks.
Classification: LCC KF6452 .B69 2017 | DDC 343.7306/62–dc23 LC record available at https://lccn.loc.gov/2016056652

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To Sam, Claire, and Poppy

Preface

Over the past few decades, limited liability companies (LLCs), limited partnerships (LPs), and limited liability partnerships (LLPs), i.e., limited liability entities, have become the preferred choice of legal entity to own property and conduct business. LLCs in particular have become popular among business and property owners. The growth and prevalence of these entities is driven by the favorable tax treatment they can receive, the limited liability they afford their members, and the management flexibility they provide. Limited liability entities qualify for partnership taxation. Consequently, partnership taxation is extremely important to businesses and property owners, and its importance will continue to increase as the use of limited liability entities continues to increase. This casebook covers the taxation of the limited liability companies and partnerships from a transactional perspective.

Partnership taxation consists of perhaps the most complicated regulatory rules in tax law, and it presents some of tax law's most challenging conceptual problems. In addition to understanding tax rules, however, a partnership tax practitioner must understand general business, accounting, and legal concepts. For example, to understand tax rules governing the allocation of partnership liabilities, a person must understand state law governing limited liability in entities, subrogation, indemnification, and contractual tools used to shift liability. The complicated allocation rules, which are the heart of partnership taxation, also require a general understanding of basic accounting concepts. As needed, the materials in this book provide general background information about each of those topics. By learning those concepts out of class, students should be able to incorporate them into the class discussion of the relevant tax concepts.

The commentary cites to statutes, cases, regulations, rulings, secondary authorities, and other materials. Generally, chapters include, in whole or in part, all of the cited cases, rulings, and other relevant primary source materials, other than the Internal Revenue Code and Income Tax Regulations, which often are the most critical part of partnership taxation. Students therefore must find the cited statutes and regulations in other sources, such as published versions of selected tax statutes and income tax regulations. They can refer to cited secondary sources to obtain deeper understanding of concepts.

This book adopts a transactional-tax-practice focus. It provides treatise-like descriptions of concepts with extensive footnotes to primary source materials.

Using treatises is a fundamental part of legal practice.[1] Treatises explain concepts, but more importantly, they lead to primary source materials. Students should use the commentary in the chapters to gain some background and general understanding of concepts, but they should use the cited materials to analyze problems. Along those lines, the book provides relevant background and contextual explanations of business, accounting, and legal concepts that are essential to understanding and practicing partnership taxation. By gaining an understanding of those non-tax concepts, students can prepare to handle the challenges of applying tax law to real-life situations. The book can be used in conjunction with the partnership tax client file that accompanies the book. The client file presents a typical fact pattern of a business operating as a tax partnership. The client file includes the tax partnership's governing documents and financial information. It also includes several memoranda that correspond with the chapters in the book. The memoranda present questions addressed to a hypothetical law-firm associate from a hypothetical senior tax partner, which reflect the type of questions that practitioners often face when advising clients. The questions require students to understand the fact pattern, become familiar with the entity documents, work with the financial information, and learn and apply the law. Thus, the book and accompanying client file provide the opportunity to adopt the client-file method of studying partnership taxation.[2] Because this book presents materials in a practice-focused manner, it will help bridge the gap between law school and practice for students, and it will help them become familiar with products they will use in practice. Consequently, some adopters of this book will choose to teach from it alone and will not adopt the accompanying client file.

Business taxation casebooks and courses often follow the life cycle of a business from formation to dissolution. This book deviates from that practice for a number of reasons. First, many of the issues that arise on formation of a tax partnership often require knowing other concepts, such as how to allocate tax-partnership liabilities and navigate the disguised-sale rules. Thus, starting with formation is often impractical. Second, clients often contact tax advisors after a business has been formed and has operated for some time. The advisor is thrust into the ongoing business and must become familiar with that business and provide tax advice in that context. By focusing on operations to start with, the book thus lays the groundwork for studying other more complex topics and provides some semblance of real-world orientation.

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1. *See* MARK HERRMANN, THE CURMUDGEON'S GUIDE TO PRACTICING LAW (ABA Section of Litigation 2006) ("If you are looking for a particular legal authority, you should not begin by looking through the entire universe of cases and hope that you may find what you need. First, you should read a secondary source (such as a chapter of a good treatise) to learn general contours of the relevant law. Next, you should look through the descriptions of cases found in the digests. By skimming scores (or hundreds) of case digests, you will develop a sense for this area of the law. Then, read in their entirety the cases that appear to be most relevant. Only then, after you know the location, size, and shape of the haystack, are you able to search intelligently for the needle.").

2. *See* Bradley T. Borden, *Using the Client-File Method to Teach Transactional Law*, 17 CHAPMAN L. REV. 101 (2013).

Chapter 1 serves as an orientation to the practice of transactional tax law and provides an overview of basic income tax concepts. Because the book is geared toward transactional practice and advising clients with respect to various transactions, students must have some knowledge of the rules that govern tax practice. Chapter 1 provides the opportunity to review or obtain that knowledge. Students generally study partnership taxation after taking an entry-level tax course, but often they forget basic income tax concepts that are important to the study of partnership taxation. Chapter 1 provides a review of basic concepts that students can use to refresh their understanding of relevant income tax concepts.

Part I of the book focuses on operations and formation of tax partnerships. It begins with Chapter 2 on choice of entity, which provides the opportunity to study the general tax and non-tax differences among entities such as corporations, partnerships, and limited liability companies. Chapter 3 then turns to the tax treatment of tax-partnership operations. It covers the basics of partnership pass-though taxation. Because tax partnerships do not pay an entity-level tax, a special tax regime governs the computation of tax items, such as income, gain, and loss at the tax-partnership level and the allocation of those items to the members of the tax partnership. Chapter 4 introduces the general rules that govern allocations of tax items.

Part II of the book turns attention to transactions that occur between tax partnerships and their members. It begins in Chapter 5 with coverage of contributions to tax partnerships. Contributions of property to tax partnerships can raise accounting and allocation issues that require a special set of rules. Chapter 6 presents the rules that govern allocations following contributions or admissions of new members to tax partnerships. Chapter 7 covers the rules governing distributions from tax partnerships. The chapter illustrates that even though the general rules governing distributions can be straightforward, many of the distribution rules are quite complex. Many transfers to and distributions from tax partnerships occur with respect to members' interests in the tax partnership; others occur in exchange for consideration. Chapter 8 presents the general rules that govern transfers to and from tax partnerships for consideration. In the case of property transfers, these transactions are known as disguised sales. Partnership tax law can treat transactions as occurring between a tax partnership and its members even though nothing actually moves between the tax partnership and its members. For instance, partnership tax law may treat changes in a member's share of tax-partnership liabilities as contributions to or distributions from the tax partnership. Chapter 9 discusses the rules governing allocations of tax-partnership liabilities and how they can result in deemed distributions and contributions. The deemed transactions that result from changes in shares of tax-partnership liabilities can also apply when property transfers to and from tax partnerships, resulting in such transfers being treated as disguised sales. Chapter 10 explains how transfers of property and changes of shares of tax-partnership liabilities can result in disguised sales. Chapter 11 concludes Part II with a discussion of allocations that arise with respect to property securing nonrecourse liabilities. Such property can generate tax items known as nonrecourse deductions and minimum gain, which are not subject to the general allocation rules. Chapter 11 describes the allocation rules that apply to those items.

Part III covers transactions that change the ownership structure of tax partnerships through transfers of interests or business transactions. Chapter 12 discusses transfers of tax-partnership interests, and Chapter 13 discusses mergers and division of tax partnerships.

Note on Presentation of Cases, Rulings, and Administrative Material

As a general matter, the cases and rulings in the primary authority sections of chapters represent the original language of such authorities. Ellipses (. . .) or asterisks (* * *) generally appear in the place of omitted language or other material. If, however, including such markings would unnecessarily disrupt the flow of the text, the omitted language is not marked. For instance, some internal cross references, citations to court filings, or other references that are not material to a ruling are omitted and such omissions are not indicated with ellipses or asterisks. Case footnotes are numbered to reflect a consecutive pattern within chapters, so they do not necessarily track with the actual footnote numbers in the cases. The citations in commentary footnotes adopt common titles for preambles to proposed and final regulations to help clarify what is being cited. Preambles appear in the primary authority sections of chapters under the common titles cited in the footnotes. The primary authority is ordered within each chapter in accordance with Bluebook conventions.

Bradley T. Borden
January 2017

Acknowledgments

Several Brooklyn Law School students made significant contributions to this book. Lena Smith was present at the beginning of this project. We worked together to come up with the book's framework and structural design. She worked tirelessly to proofread and edit chapters as I wrote them and presented them to class for initial use. Her work extended beyond work done by a typical research assistant. She carefully read each cited source and provided very thoughtful suggestions regarding style and technical substance. After Lena graduated, Katherine Arango picked up where Lena left off and helped prepare the final chapters for publication. Their work was invaluable.

Multiple classes at Brooklyn Law School have used the materials that became this book in their pre-publication form. The students were very receptive of the materials and many provided very valuable input and ideas for making them better. In particular, Bob Nelson-Sullivan and Yosef Gindoff provided specific comments on numerous occasions that I adopted to improve the materials.

This idea for this book and the client file was originally conceived with Rick Mixter, and I thank him for his vision and encouragement that helped get the project off the ground and into production. Steve Dean joined in a similar undertaking for a book on corporate taxation, and I always look forward to talking with him about how to make these products better.

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