

ASPEN CASEBOOK SERIES

*YIN  
BURKE*

**PARTNERSHIP  
TAXATION**

*Third  
Edition*



Wolters Kluwer

ASPEN CASEBOOK SERIES

# Partnership Taxation

---

**Third Edition**

**George K. Yin**

Edwin S. Cohen Distinguished Professor of Law and Taxation  
University of Virginia School of Law

**Karen C. Burke**

Professor and Richard B. Stephens Eminent Scholar in Taxation  
University of Florida Levin College of Law



**Wolters Kluwer**

Copyright © 2016 CCH Incorporated. All Rights Reserved.

Published by Wolters Kluwer in New York.

Wolters Kluwer Legal & Regulatory US serves customers worldwide with CCH, Aspen Publishers, and Kluwer Law International products. ([www.WKLegaledu.com](http://www.WKLegaledu.com))

No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or utilized by any information storage or retrieval system, without written permission from the publisher. For information about permissions or to request permissions online, visit us at [www.WKLegaledu.com](http://www.WKLegaledu.com), or a written request may be faxed to our permissions department at 212-771-0803.

To contact Customer Service, e-mail [customer.service@wolterskluwer.com](mailto:customer.service@wolterskluwer.com), call 1-800-234-1660, fax 1-800-901-9075, or mail correspondence to:

Wolters Kluwer  
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 978-1-4548-7767-7

### **Library of Congress Cataloging-in-Publication Data**

Names: Yin, George K., author. | Burke, Karen C., 1951- author.

Title: Partnership taxation / George K. Yin, Edwin S. Cohen Distinguished Professor of Law and Taxation, University of Virginia School of Law, Karen C. Burke, Professor and Richard B. Stephens Eminent Scholar in Taxation, University of Florida Levin College of Law.

Description: 3rd ed. | New York: Wolters Kluwer, [2016] | Series: Aspen casebook series

Identifiers: LCCN 2016012475 | ISBN 9781454877677

Subjects: LCSH: Partnership — Taxation — Law and legislation — United States. | LCGFT: Casebooks

Classification: LCC KF6452 .Y56 2016 | DDC 343.7305/2662-dc23

LC record available at <http://lcn.loc.gov/2016012475>

# Partnership Taxation

## EDITORIAL ADVISORS

### **Rachel E. Barkow**

Segal Family Professor of Regulatory Law and Policy  
Faculty Director, Center on the Administration of Criminal Law  
New York University School of Law

### **Erwin Chemerinsky**

Dean and Distinguished Professor of Law  
Raymond Pryke Professor of First Amendment Law  
University of California, Irvine School of Law

### **Richard A. Epstein**

Laurence A. Tisch Professor of Law  
New York University School of Law  
Peter and Kirsten Bedford Senior Fellow  
The Hoover Institution  
Senior Lecturer in Law  
The University of Chicago

### **Ronald J. Gilson**

Charles J. Meyers Professor of Law and Business  
Stanford University  
Marc and Eva Stern Professor of Law and Business  
Columbia Law School

### **James E. Krier**

Earl Warren DeLano Professor of Law  
The University of Michigan Law School

### **Tracey L. Meares**

Walton Hale Hamilton Professor of Law  
Director, The Justice Collaboratory  
Yale Law School

### **Richard K. Neumann, Jr.**

Professor of Law  
Maurice A. Deane School of Law at Hofstra University

### **Robert H. Sitkoff**

John L. Gray Professor of Law  
Harvard Law School

### **David Alan Sklansky**

Stanley Morrison Professor of Law  
Stanford Law School  
Faculty Co-Director  
Stanford Criminal Justice Center

## Preface to the Third Edition

This book introduces students to the federal income taxation of partners and partnerships. In general, partnership tax law disregards the partnership as a business entity and treats the partnership's income as if it were earned by the partners. In this sense, partnership tax is a natural extension of principles learned in the introductory income tax course and this book builds upon that common foundation. The universe of businesses subject to partnership tax has been steadily increasing, and includes not only traditional partnerships and limited liability companies but also more exotic arrangements such as domestic and international joint ventures.

We have written this book to help students overcome the many challenges of learning partnership tax. For example, in considering the tax treatment of transactions involving partnerships, we have employed a building-block approach, progressing from an analysis of basic to more complex transactions. This approach enables students to see that the same transaction may be structured in different ways to achieve different tax goals, and that the taxation of complex transactions to some extent flows naturally from how simpler ones are taxed. By avoiding unnecessary detail yet not oversimplifying, the book facilitates mastery of the material and prepares students to think rigorously and creatively about the kinds of problems they will encounter as practitioners of tax and business law.

Partnership tax is characterized by policy choices that lend structure and coherence to the law, and we emphasize these choices and structural features throughout the book. This structure makes the law so much more than a mere collection of rules. Understanding the law's conceptual underpinning provides immeasurable assistance for students, both in helping them to learn and comprehend specific details and in anticipating the need for, and understanding the meaning of, subsequent changes in the law. This knowledge also provides collateral benefits, as the policy structure of partnership tax is replicated to some extent in the tax rules relating to certain other business arrangements.

We have organized the book around major themes that expose the underlying structure of the law. The first six chapters explain how the income of a partnership is taxed, and how the law achieves its objective of disregarding the business entity and taxing the partners directly. Chapters one through three focus on classification of business entities, the passthrough of a partnership's tax items to the partners of the partnership, and the concept of partnership capital accounts. Chapters four through six examine the difficult question of how the partnership's tax items must be shared or "allocated" among the partners.

Building on this foundation, the balance of the book describes the tax treatment of transactions involving partnerships, including transactions between partners and partnerships. Chapters seven through nine consider transfers of partnership interests, contributions to and distributions from partnerships, and potential recharacterization of these transactions. Chapter ten addresses the tax consequences of compensating partners for services and use of capital, and chapter eleven discusses partnership terminations. Finally, chapter twelve explores special anti-abuse rules that limit opportunities for manipulating the flexible provisions of the law. One of the important themes initially introduced in the first half of the book and more fully developed in the latter half is how the tax law reconciles its disregard of the business entity with the respect given the entity for other legal purposes.

Throughout the book, we emphasize the core source material of the law—the statute and regulations—as amplified in interpretive administrative materials and judicial decisions. We have deliberately tried to make background explanations and illustrative examples concise without being cryptic, based on our firm belief that actively engaging students with the material enhances the learning process. We have interspersed many explanations, problems, and questions to help lead the students through the material. Although partnership tax has earned a reputation as an especially daunting field, we are confident that students will emerge from the course equipped to analyze and evaluate the critical issues they will encounter in practice.

In preparing the first edition, we enjoyed the luxury of starting with a clean slate, without being constrained by past editorial, organizational, or pedagogical choices. This revised third edition builds on the approach of the prior editions, and is updated to reflect developments through March 2016. Tax law is dynamic, and we have brought our combined experience in teaching, private practice, and government to bear in taking a fresh look at the subject matter. We have tried to identify the most important issues and themes that will confront future lawyers in this area.

As a matter of editorial prerogative, we have freely edited judicial decisions and other materials to focus attention on essential analysis and holdings. Footnotes are numbered consecutively within each chapter, and many footnotes in the original sources have been deleted or renumbered. Internal citations and cross-references in cases and other authorities have been omitted without so indicating, while substantive omissions are indicated by an ellipsis (“...”).

*George K. Yin*  
*Charlottesville, VA*

*Karen C. Burke*  
*Gainesville, FL*

May 2016

# Acknowledgments

We gratefully acknowledge the permission extended by the American Law Institute to reprint an excerpt from the material listed below:

Federal Income Tax Project, Taxation of Private Business Enterprises: Reporters' Study copyright © 1999 by The American Law Institute. All rights reserved. Reprinted with permission.

Federal Income Tax Project, Taxation of Pass-Through Entities, Memorandum No. 1 copyright © 1995 by The American Law Institute. All rights reserved. Reprinted with permission.



# Table of Contents

<i>Preface</i>	<i>xix</i>
<i>Acknowledgments</i>	<i>xxi</i>

## Chapter 1: Introduction to Partnership Tax 1

A. Introduction	1
B. Classification	3
1. Qualifying as an Entity Separate from Its Owners	3
Rev. Rul. 75-374	4
<i>Wheeler v. Commissioner</i>	7
Problem 1-1	12
2. Not Taxable as a Corporation	12
C. Tax Choices Available to Private Unincorporated Firms	17
American Law Institute Reporters' Study	17

## Chapter 2: The Passthrough System 29

A. Introduction	29
<i>Schneer v. Commissioner</i>	29
B. Determination and Passthrough of Partnership Tax Items	37
1. In General	37
2. Partnership Taxable Year	38
Problem 2-1	39
Problem 2-2	39
3. Partnership Elections	41
<i>Demirjian v. Commissioner</i>	41
4. Characterization Issues	44
<i>Podell v. Commissioner</i>	45
<i>United States v. Basye</i>	48
C. Basis Adjustments and Limitation on the Passthrough of Losses	51
1. Basis Adjustments	51
Problem 2-3	52
Problem 2-4	53
Rev. Rul. 96-11	53

2. Limitation on the Passthrough of Losses	55
Problem 2-5	56
Rev. Rul. 66-94	56
Problem 2-6	58
Problem 2-7	58
<b>Chapter 3: Introduction to Partnership Accounting</b>	<b>61</b>
A. Introduction	61
B. Starting the Partnership	63
C. Contributions of Appreciated Property and the Concept of "Tax Capital"	66
Problem 3-1	70
D. Sales of Partnership Interests and Potential Imbalances	70
E. Partnership Income, Loss, and Distributions	72
Problem 3-2	74
F. Entry of New Partners and the Need for Revaluations	76
Problem 3-3	77
<b>Chapter 4: Partnership Allocations: General Rules</b>	<b>79</b>
A. Introduction	79
<i>Orrisch v. Commissioner</i>	81
B. The Section 704(b) Regulations: General Rules	87
1. Overview	87
2. Economic Effect	88
a. Basic Test for Economic Effect	88
b. Alternate Test for Economic Effect	89
Problem 4-1	90
Rev. Rul. 97-38	91
c. Economic Effect Equivalence	95
3. Substantiality	95
a. Introduction	95
b. "Shifting," "Transitory," and "Overall-Tax-Effect"	
Tests for Substantiality	97
Problem 4-2	99
c. The "Value-Equals-Basis" and Five-Year Rules	100
Rev. Rul. 99-43	101
d. Testing Allocations for Substantiality	105
4. Reallocation in Accordance with the Partners' Interests in the Partnership ("PIP")	108
Problem 4-3	109
5. Special Rules for Tax Items That Cannot Satisfy the Economic-Effect Requirement	110

6. Target Allocations	110
Problem 4-4	111
C. Outside Basis and the Allocation of Partnership Recourse Liabilities	112
1. What Is a Partnership Liability?	112
Rev. Rul. 88-77	113
Notice 2000-44	115
Problem 4-5	118
2. Allocating Partnership Recourse Liabilities	118
a. Introduction	118
<i>Raphan v. United States</i>	119
b. The Economic Risk of Loss Concept	122
c. Determining the Payment Obligation	125
Problem 4-6	128
 <b>Chapter 5: Partnership Allocations: Nonrecourse Deductions</b>	 <b>131</b>
A. Introduction	131
<i>Commissioner v. Tufts</i>	132
B. Allocation of Nonrecourse Deductions	136
1. What Are Nonrecourse Deductions?	137
2. The Nonrecourse-Deduction Safe Harbor	137
3. Partnership Minimum Gain	140
a. Net Increases in PMG	141
b. Net Decreases in PMG	141
4. Nonrecourse Distributions	147
Problem 5-1	149
Problem 5-2	149
C. Outside Basis and the Allocation of Nonrecourse Liabilities	150
1. Introduction	150
2. Tier 1: Partner's Share of PMG	150
3. Tier 2: Partner's Share of Minimum Section 704(c) Gain	152
4. Tier 3: Partner's Share of Partnership Profits	153
Problem 5-3	155
Problem 5-4	156
Problem 5-5	156
D. At Risk and Passive Loss Limitations	157
1. Introduction	157
2. "At Risk" Limitation	158
3. Passive Loss Limitation	159
4. Relationship of Sections 704 and 752 to the At Risk and Passive Loss Rules	161

<b>Chapter 6: Partnership Allocations: Special Anti-Income-Shifting Rules</b>	<b>165</b>
A. Introduction	165
B. Allocations Involving Contributed or Revalued Property	166
1. Introduction	166
2. Traditional Method	169
Problem 6-1	169
Problem 6-2	170
3. Traditional Method with Curative Allocations	171
Problem 6-3	172
4. Abusive Use of the Traditional Method and Traditional Method with Curative Allocations	173
5. Remedial Allocation Method	175
Problem 6-4	175
6. Revalued Property	178
Problem 6-5	179
Problem 6-6	182
7. Collateral Impact of Section 704(c) on Other Subchapter K Issues	182
a. Allocation of Nonrecourse Liabilities	182
Rev. Rul. 95-41	183
Problem 6-7	184
b. Tax Treatment of Non-Liability Obligations	185
C. Allocations When Partners' Interests Change During the Year	187
1. The Basic Rules	187
Problem 6-8	189
2. Planning Under the Basic Rules	189
D. Family Partnerships	191
<i>TIFD III-E, Inc. v. United States</i>	194
<b>Chapter 7: Sales of Partnership Interests</b>	<b>201</b>
A. Introduction	201
B. Consequences to the Transferor	202
1. The Entity Approach	202
2. The Look-Through Exception	204
a. Definition of Unrealized Receivables and Inventory Items	205
<i>Ledoux v. Commissioner</i>	205
b. Mechanics of the Look-Through Exception	211
Problem 7-1	211
C. Consequences to the Transferee	212
1. The Entity Approach	212
2. The Look-Through Approach	214

a. Calculating the Overall SBA	215
Problem 7-2	216
b. Allocation of Inside Basis Adjustments	216
Problem 7-3	217
Problem 7-4	218
c. Using the SBA	218
3. Prevention of Loss Duplication	218
Problem 7-5	220

## **Chapter 8: Property Contributions and Distributions 223**

A. Introduction	223
B. Contributions and Nonliquidating Distributions	224
1. Contributions	224
Problem 8-1	224
2. Nonliquidating Distributions	226
Problem 8-2	226
3. Contributions and Distributions of Encumbered Property	227
a. Contributions of Encumbered Property	227
Problem 8-3	228
Problem 8-4	230
b. Distributions of Encumbered Property	230
Rev. Rul. 79-205	230
Problem 8-5	234
C. Liquidating Distributions	234
1. Introduction	234
Problem 8-6	236
2. Basis of Distributed Property	236
a. Allocation of Upward Adjustments	237
b. Allocation of Downward Adjustments	237
Problem 8-7	239
D. Partnership Basis Adjustments	241
1. Introduction	241
2. Amount of Section 734(b) Adjustment	242
3. Allocation of Section 734(b) Adjustment Among the Assets of the Partnership	243
Problem 8-8	244
4. Section 734(b) "Trap"	246
E. Distributions Affecting the Allocation of Income Character	247
1. Liquidating Distributions	250
Problem 8-9	252
2. Nonliquidating Distributions	252
Problem 8-10	253

<b>Chapter 9:   Recharacterizing Contributions,                  Distributions, and Sales</b>	<b>257</b>
A. Disguised Sales or Exchanges	257
1. Introduction	257
<i>Otey v. Commissioner</i>	258
<i>Jacobson v. Commissioner</i>	263
2. Section 707(a)(2)(B)	268
a. In General	268
b. Part-Sale, Part-Contribution	268
Problem 9-1	269
c. Liabilities	269
Problem 9-2	270
d. Debt-Financed Distributions	271
B. Other Anti-“Mixing Bowl” Provisions Linking Contributions and Distributions	274
1. Overview: Sections 704(c)(1)(B) and 737	274
2. Section 704(c)(1)(B)	275
Problem 9-3	275
3. Section 737	276
C. Distributions of Marketable Securities	278
<i>Countryside Limited Partnership v. Commissioner</i>	280
D. Recharacterizations Based on Common-Law Principles	284
<i>Southgate Master Fund, L.L.C. v. United States</i>	284
 <b>Chapter 10:   Compensating Partners for Services                  or the Use of Property</b>	 <b>289</b>
A. Introduction	289
B. Receipt of a Partnership Interest	289
1. Introduction	289
2. Receipt of a Vested Capital Interest	290
<i>McDougal v. Commissioner</i>	290
Problem 10-1	297
3. Receipt of a Vested Profits Interest	298
<i>Diamond v. Commissioner</i>	298
Rev. Proc. 93-27	305
Problem 10-2	308
4. Receipt of an Unvested Capital or Profits Interest	309
Rev. Proc. 2001-43	310
<i>Crescent Holdings, LLC v. Commissioner</i>	312
5. Tax Treatment of “Carried Interests”	318
6. Partnership Options and Debt-Equity Exchanges	321
C. Guaranteed Payments	325

<i>Miller v. Commissioner</i>	326
<i>Gaines v. Commissioner</i>	332
Problem 10-3	336
Problem 10-4	337
D. Compensation Recharacterized as Nonpartner Payments	337
Joint Committee on Taxation Excerpt	338
Problem 10-5	340

## Chapter 11: **Termination of Partnership Interests and Partnerships** **341**

A. Introduction	341
B. Termination of Partnership Interests	342
1. The Statutory Pattern of Section 736	342
2. The Significance of Section 736	344
<i>Commissioner v. Jackson Investment Co.</i>	346
3. Installment Payments	349
4. Partnership Liabilities	351
5. Liquidating Distributions vs. Sales	351
<i>Foxman v. Commissioner</i>	352
6. Special Considerations upon the Death of a Partner	355
a. Taxable Year and Outside Basis	355
b. IRD Attributable to Partnership Interests	355
<i>George Edward Quick Trust v. Commissioner</i>	356
<i>Woodhall v. Commissioner</i>	360
c. Special Basis Adjustments	363
Problem 11-1	363
C. Partnership Terminations	364
1. Events Causing a Partnership Termination	364
Rev. Rul. 84-52	365
2. Tax Consequences of a Partnership Termination	367
Rev. Rul. 99-6	368
3. Mergers and Divisions of Partnerships	370
4. Incorporation of a Partnership	374
Rev. Rul. 84-111	374

## Chapter 12: **Preventing Abuse of the Partnership Tax Rules** **381**

A. Introduction	381
<i>ACM Partnership v. Commissioner</i>	383
Problem 12-1	390

B. The Partnership Anti-Abuse Regulation	390
1. Transactions Inconsistent with the Intent of Subchapter K	390
<i>Cemco Investors, LLC v. United States</i>	392
2. The Abuse of Entity Rule	397
<i>Brown Group, Inc. v. Commissioner</i>	398
3. Evaluation of the Partnership Anti-Abuse Regulation	402
C. Codification of Economic Substance Doctrine	403
Joint Committee on Taxation Technical Explanation	403
D. Partnership Audit Rules	409
1. TEFRA Audit Rules	409
2. Post-TEFRA Audit Rules	411
Appendix: Form 1065 and Schedule K-1	415
<i>Table of Authorities</i>	423
<i>Index</i>	427



## Chapter 1

---

# Introduction to Partnership Tax

### A. Introduction

From prior study, you are already familiar with the basic concepts of income taxation, including what income is, when it arises, and what its character is. No doubt you have also been exposed to the legal concept of a “partnership” and some of the rules and policies pertaining to it. This course explores what happens when income is earned by a business that is organized as a partnership or treated as one for tax purposes.

Let us begin with an example. Assume that your daughter, Laura, decides to invest \$10 of her savings to operate a lemonade stand. She uses the \$10 to purchase the items necessary to get the business started — the stand, cups, lemons, and so forth. She then proceeds to hawk her drinks out by the curb in front of your house. The day is hot, the drinks are cool, your daughter is cute and efficient, and your neighbors are kind, and she therefore successfully sells a number of drinks by day’s end.

If necessary, we might calculate her income for the day using familiar principles. First, she should have income from services, that is, her compensation for sitting out all day in the hot sun peddling her drinks. Further, as the owner of the enterprise, she may have business income equal to her total receipts less properly allowable expenses (including the compensation her business pays to her). The business income might be thought of as the return she obtains from investing her \$10 for one day in the manner described. Our principal concern in this course will be with the taxation of the business income, the income from her \$10 capital investment.

Should the tax treatment of the business income vary, depending upon the *form of organization* of the business? For example, the foregoing describes how the business profits might be taxed if the lemonade stand is operated as a *sole proprietorship*. But suppose your daughter only has \$5 in her piggy bank and therefore seeks out her older sister, Elizabeth, for the remaining capital needed to start up the business. Elizabeth provides the additional \$5 but only on condition that the two sisters form a partnership and share equally in any profits from the business. How should the profits of the *L&E partnership* be taxed?