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# PARTNERSHIP TAXATION

*Third Edition*

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Aspen Casebook Series

# Partnership Taxation

**Third Edition**


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# Partnership Taxation

# 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 (". . .").

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# 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?