
CASES AND MATERIALS

FUNDAMENTALS OF PARTNERSHIP TAXATION

FIFTH EDITION

by

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To our friend, Billy Hutton

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PREFACE

The fundamental principles of partnership and S corporation taxation have remained intact since this text was first published in 1984, but the federal tax system continues to be unstable or dynamic, depending on one's perspective. During the five-year shelf life of the Fourth Edition, the emergence of the limited liability company, the Treasury's issuance of more permissive tax classification regulations, and the greater availability of Subchapter S all have contributed to the growth of the pass-through entity as a preferred vehicle for conducting many closely-held businesses. The Tax Relief Act of 1997, with its capital gains rate reductions and technical fine tuning, also has influenced the business enterprise tax environment. These developments, along with the usual flow of new regulations and rulings, more than justified this new edition and offered another opportunity to cure some minor viruses that may have infected our earlier efforts.

The relentless barrage of tax legislation and regulations presents a continuing challenge to instructors who seek to provide manageable coverage of an increasingly intricate subject matter. Although somewhat more detail has become unavoidable in a partnership tax course, we once again reaffirm our allegiance to teaching the "fundamentals." As we said in the Preface to the First Edition:

The pedagogical philosophy of this book is grounded in the problem oriented "fundamentals" approach to tax teaching that was pioneered by James J. Freeland, Stephen A. Lind and Richard B. Stephens in *Fundamentals of Federal Income Taxation*. For the uninitiated, the fundamentals approach involves selectivity of subject matter, an emphasis on basic concepts, avoidance of esoteric detail and realistic depth of coverage. It recognizes that the primary sources for any tax course are the Code and Regulations. Proceeding from these premises, this lean volume is a product of considerable self restraint by the authors. Cases have been selected and edited with care. Legislative history has been included but only when it is informative. Lengthy notes and voluminous citations to every case on a particular point have been scrupulously avoided. This is designed as a teaching text, not a treatise.

The book also contains a healthy dose of explanatory text and problems to accompany every topic. Partnership tax is a difficult course for law students. Although there are several fine treatises in the area, they are written primarily for practitioners. From our

experience, even an abridged student edition of a professional treatise is simply too overwhelming and sophisticated to serve as an effective teaching tool. This volume attempts to fill the void by providing just enough explanation to provide a framework for the study of Subchapter K without getting bogged down in the details.

We also believe—almost as an article of faith—that the most productive method of teaching tax fundamentals is through a manageable set of problems that require the student to apply the Code and Regulations to discrete factual situations. Some of the problems in this book are intended to guide the student through the statutory maze; as such, they may even have specific answers. Others do not have definite solutions, reflecting the fact that much of Subchapter K remains unexplored territory. We have modestly attempted to confront students with some of the realities of practice by including a few problems with a planning orientation.

Turning to organization and coverage, the Fifth Edition retains the time-tested “cradle to grave” organization of its predecessors, and includes updated policy excerpts selectively throughout the text. A substantially revised Chapter 1 introduces students to Subchapter K, examines the new “check-the-box” tax classification regime (without dwelling at great length on outdated concepts and cases), and provides a fresh perspective on choice of entity issues. Chapter 2 covers partnership formations and includes an introduction to partnership accounting and the concepts of “outside” and “inside” basis, and previews the impact of partnership liabilities on a partner’s outside basis.

Chapters 3 through 5 address operational issues, moving systematically from the basic pass-through taxation scheme through partnership allocations, including allocations with respect to contributed property and partnership liabilities, and transactions between partners and partnerships. Our efforts at self restraint have been tested here by the intricacy and length of the regulations. Instructors who are pressed for time or are concerned about a student meltdown should consider confining the assignments on allocations attributable to nonrecourse debt and partnership liabilities to the introductory material on each of those topics.

Chapters 6 through 8, covering sales and exchanges of partnership interests, operating and liquidating distributions, and partnership terminations, have been revised to reflect several important technical amendments to Subchapter K made by the Tax Relief Act of 1997. We also took this opportunity to make some minor organizational changes to Chapter 9, which covers the special problems faced on the death of a partner. In all these chapters, the tax stakes have been raised with the reemergence of a significant capital gains rate preference. But we decided not to burden students with fine distinctions between the numerous new “long-term” rates on the theory that they have suffered enough with this clutter in the basic income tax course. On a more positive note, the lower capital gains rates contribute a renewed sense of urgency to a body of material that became less meaningful, and at times painful to teach, for the post-1986 interlude when capital gains and ordinary income were taxed at the same rate.

Chapter 10, which is new, includes a brief discussion of the partnership anti-abuse regulations. We decided not to integrate this material into earlier chapters because students would not have sufficient background to appreciate their meaning and scope. For those with the time and inclination, Chapter 10 presents an opportunity to review a few concepts studied in earlier chapters and to remind students that some tax planning maneuvers may be too good to be true.

Chapter 11 covers S corporations, incorporating the many long-promised reforms enacted as part of the Small Business and Job Protection Act of 1996. Similar chapters are included in our companion volume, *Fundamentals of Corporate Taxation*, and in *Fundamentals of Business Enterprise Taxation*, a new alternative text for a combined course on corporate and partnership tax. We remain neutral on whether S corporations are best covered in corporate tax, a course on taxation of pass-through entities, or a combined business enterprise taxation offering. Our books accommodate any of these approaches.

Turning to matters of style, we assume that the text will be assigned with the most recent edition of the Code and Regulations. Suggested assignments to these sources are provided for each topic. Instructors should review these assignments carefully, editing when necessary to ensure that they are consistent with the desired depth of coverage. Deletions from cases and other authorities have been made freely, with asterisks used to denote substantive omissions, but citations and internal cross references in excerpted materials have been deleted without so indicating. Editorial additions are in brackets. Footnotes to the original text are numbered consecutively within each section, and many footnotes have been deleted from cases without renumbering those that remain.

We are particularly grateful to the late Richard B. Stephens of the University of Florida College of Law for his advice on the First Edition of this book. For their work as research assistants on prior editions, we thank former students Bob Appert, Steve Gee, Matt Richardson, Jim Berard, Thea Chester, Bill Goddard, and Jami Changaris Voge from Hastings College of the Law; Jay Katz, Dennis McGlothlin and Chris Hanna from the University of Florida; and Francine Augustyn, Royda Krames and Piero Sallusolia from the University of San Francisco.

The Fifth Edition is current through March, 1998. As always, timely publication would not have been possible without the assistance of Jim Coates and the staff at Foundation Press.

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