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The Existence of State and Tax Partnerships: A Primer

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THE EXISTENCE OF STATE AND TAX PARTNERSHIPS:
A PRIMER†

DONALD J. WEIDNER*

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STATE AND TAX PARTNERSHIPS

I. INTRODUCTION

The question when does a partnership exist has been described as "the most tormented and heavily litigated area of partnership law." Partnerships can exist as a matter of law contrary to the express intent of the people deemed to be partners. This is true both for state law purposes and for federal income tax purposes. For state law purposes, one basic consequence of being deemed a partner is the imposition of unlimited personal liability to the contract and tort creditors of a business. Another is that the Uniform Partnership Act (U.P.A.) will be presumed to reflect the agreement of the partners in the absence of a provable agreement to the contrary. For federal income tax purposes, a wide range of consequences can flow from the finding that a partnership exists. Most basically, the partnership provisions of the Internal Revenue Code (Code), contained in Subchapter K, will be applied to the group considered partners. The unanticipated application of these provisions can have consequences that are extremely harsh. Properly anticipated, the provisions of Subchapter K can offer a wealth of tax savings. The purpose of this article is to explain when a partnership will be found to exist, both for state law purposes and for federal income tax purposes. In particular, an attempt will be made to explain some of the basic consequences that can flow from a finding that a tax partnership exists. A discussion of limited partnerships follows a discussion of general partnerships.

II. STATE LAW OF GENERAL PARTNERSHIP

A. Definition of Partnership: State Law

The U.P.A. broadly provides that a "partnership is an association of two or more persons to carry on as co-owners a business for profit." The word "association" connotes that two or more persons have come together voluntarily. The term "person" includes "individuals, partnerships, corporations, and other associations."

5. CRANE & BROMBERG, supra note 1, at 38 n.37, points out that "association" is used different ways in different contexts. The U.P.A. sense seems to be no more particularized than a coming together. The word has a very different meaning in federal income tax law.
Thus, a partnership can itself be a member of another partnership. The requirement that the persons intend to carry on "as co-owners" does not mean that there must be an identifiable asset. Rather, it indicates that there must be something more than a principal-agent relationship: "To state that partners are co-owners of a business is to state that they each have the power of ultimate control." On the other hand, partnership has been found even though one person has exclusive management rights. Similarly, a partnership can exist even though one person has agreed to bear all the losses.

Each partner is deemed to be an agent of the partnership for the purpose of partnership business,

and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership... binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

The purpose of this section is to "avoid any possible doubt as to whether a partner has the authority, in the ordinary course of busi-

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7. U.P.A. § 6, Official Comment, 6 U.L.A. at 23: The words "to carry on as co-owners a business" remove any doubt in the following case: A and B sign partnership articles and make their agreed contributions to the common fund. A refuses to carry on business as agreed. Is there a partnership to be wound up in accordance with the provisions of Part VI "Dissolution and Winding-up"? The words quoted require an affirmative answer to this question. If the words "carrying on business" had been used, in the case given, no partnership would exist, and Part VI would not apply.

On the other hand, at least one court refused to find partnership in the case of an isolated transaction. Walker, Mosby & Covert, Inc. v. Burgess, 151 S.E. 165 (Va. 1930).


9. For example, in Greenhouse v. Zempsky, 218 A.2d 533, 535 (Conn. 1966), against a strong dissent, the court found that a two-person partnership existed even though one person was the sole "boss." The non-boss was "not a general partner and therefore not a partner in the usual sense," but was a partner nonetheless.

10. See, e.g., Stafford v. First Nat. Bank, 13 S.W.2d 21, 22 (Ark. 1929), which states: In submitting the issue of whether funds on deposit were partnership money, the court instructed the jury as follows... "A partnership is a collection of two or more individuals who enter into a mutual agreement to conduct a joint venture or enterprise and share in the profit and losses arising therefrom as may be agreed upon." This instruction was an erroneous declaration of law, because it is not essential to every partnership that each man share in the losses. By agreement it may be otherwise.

ness, to enter into formal contracts for his partnership, or to convey partnership property when the conveyance is the result of a sale in the ordinary course of partnership business." On the other hand, an act of a partner in contravention of a restriction on his authority will not bind the partnership to anyone having knowledge of the restriction. Nor will the partnership be bound by an act "which is not apparently for the carrying on of the business of the partnership in the usual way," unless the act was authorized by the other partners. Nor may certain extraordinary steps be taken unilaterally by an individual partner:

Unless authorized by the other partners or unless they have abandoned the business, one or more but less than all the partners have no authority to:

(a) Assign the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership,
(b) Dispose of the good-will of the business,
(c) Do any other act which would make it impossible to carry on the ordinary business of a partnership,
(d) Confess a judgment,
(e) Submit a partnership claim or liability to arbitration or reference.

In short, the relationship of partnership under state law has long been considered an intimate one of potentially great consequence. Perhaps the most sobering consequence that should be considered by someone contemplating a partnership is the exposure to unlimited personal liability for the day-to-day business activities and frailties of each of his partners. Also to be considered is the fact that the U.P.A. will be deemed to govern the partnership relation unless a contrary partnership agreement can be proven. That the U.P.A. defines the relationship as one of great consequence, intimacy and fiduciary duty is clear. For example, every partner must account to the partnership as a fiduciary for any profits derived without the consent of the other partners from any transaction connected with the partnership business or from any use of part-

Thus it makes sense both that no one can be made a partner without the consent of all the other partners, and that any partner can dissolve the partnership at will at any time, notwithstanding any provision in the partnership agreement to the contrary.

B. Partners By Estoppel and the Role of Intent

The basic U.P.A. definition of partnership as "an association of two or more persons to carry on as co-owners a business for profit" is obviously susceptible to extremely broad interpretation. That definition, however, cannot be read in isolation. It must be read in conjunction with U.P.A. section 7, which states more specific rules for determining whether a partnership exists. On the one hand, section 6 provides a very broad definition of what constitutes a partnership. On the other hand, section 7 tells the courts that not every relationship that falls within the literal definition of section 6 should be considered one of partnership. Section 7 says that courts should not always find partnership from the basic fact of financial interdependence in a profit-making venture. Although profit-sharing always suggests the question of partnership when there is unincorporated business activity, it can be explained by relationships other than partnership.

Section 16 of the U.P.A. concerns partners by estoppel. It rejects the rule that a person is liable if he has been held out as a partner and knows that he is being held out, unless he prevents such holding out, even if to do so he must take legal action. It adopts instead the rule that to be liable as a partner, the person held out must consent to the holding-out and that consent is a matter of fact. When someone has been represented to be a partner in an existing partnership,

he is an agent of the persons consenting to such representation to bind them to the same extent and in the same manner as though he were a partner in fact, with respect to persons who rely upon the representation. Where all the members of the existing part-

17. U.P.A. § 21(1), 6 U.L.A. at 258. See Meinhard v. Salmon, 249 N.Y. 458, 468 (1928), for Cardozo's famous statement that, for the managing co-adventurer and those like him, "the rule of undivided loyalty is relentless and supreme."
nership consent to the representation, a partnership act or obligation results, but in all other cases it is the joint act or obligation of the person acting and the persons consenting to the representation.\textsuperscript{23}

Section 7(1) of the U.P.A. provides that "[e]xcept as provided by section 16 (dealing with partners by estoppel) persons who are not partners as to each other are not partners as to third persons."\textsuperscript{24} It might be thought that this means that, unless they are partners by estoppel, people are not partners unless they intend to be. In one sense, this is true. A partnership is an "association," which connotes two or more persons intentionally coming together. It has frequently been said that intent is necessary to become a partner, and that no one will become a partner merely by the act of someone else.\textsuperscript{25} In another sense, it is not true that people are not partners unless they intend to be. It is not necessary that the parties intend to be classified as partners. The question is whether they intended to enter a relationship which is in essence a partnership, however the relationship is described. Stated differently, whether a partnership exists is a question of law. If the essence of a partnership relationship is found, a partnership will be deemed to exist. Martin v. Peyton\textsuperscript{26} contains what is perhaps the classic statement that entrepreneurs cannot avoid a finding of partnership merely by stating that none exists:

Assuming some written contract between the parties, the question may arise whether it creates a partnership. If it be complete, if it expresses in good faith the full understanding and obligation of the parties, then it is for the court to say whether a partnership exists. It may, however, be a mere sham intended to hide the real relationship. Then other results follow. In passing upon it, effect is to be given to each provision. Mere words will not blind us to realities. \textit{Statements that no partnership is intended are

\textsuperscript{23} U.P.A. § 16(2), 6 U.L.A. at 195-96.
\textsuperscript{24} U.P.A. § 7(1), 6 U.L.A. at 38. \textit{See CRANE & BROMBERG, supra note 1, at 37:}

Many jurisdictions formerly recognized the doctrine of "partnership as to third persons" for imposing liability on persons associated with a business, e.g., where the courts were convinced that persons sharing profits ought to share losses even though not co-proprietors. The U.P.A. abolishes the doctrine, save in cases of estoppel from holding out, by providing that "persons who are not partners as to each other are not partners as to third persons." This is an attempt to apply a uniform test, whether the dispute is among the alleged partners or with an outsider (footnotes omitted).

\textsuperscript{25} CRANE & BROMBERG, supra note 1, § at 39.
\textsuperscript{26} 168 N.E. 77 (N.Y. 1927).
not conclusive. If as a whole a contract contemplates an association of two or more persons to carry on as co-owners a business for profit, a partnership there is. Section [6(1)]. On the other hand, if it be less than this, no partnership exists. Passing on the contract as a whole, an arrangement for sharing profits is to be considered. It is to be given its due weight. But it is to be weighed in connection with all the rest. It is not decisive. It may be merely the method adopted to pay a debt or wages, as interest on a loan or for other reasons.27

Conversely, statements that a partnership does exist, although persuasive, are not necessarily conclusive.28 The question that remains is how courts determine when a partnership exists as opposed to some other legal relationship. Courts are guided in this task by section 7 of the U.P.A., which among other things provides that not all profit-sharers are prima facie partners.

C. The Co-Ownership Element

Partners are people who "carry on as co-owners a business for profit."29 It is co-ownership of a business that is essential rather than co-ownership of a particular asset. Thus, an asset that is necessary to the partnership business may simply be loaned to the partnership by one of the partners and never become partnership property.30 On the other hand, there is no automatic finding of partnership from the mere fact that there is a financial asset that is co-owned.31 The U.P.A. provides: "Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property."32 Co-ownership will not rise to the level of partnership unless it involves a sufficient degree of activity to con-
stitute a business. How much more there must be beyond "mere co-ownership" before co-tenants will be deemed partners is a question of continuing uncertainty and importance, both for state law purposes and for federal income tax purposes.

If the requisite level of business activity is present, the question is whether it is being carried on by the parties "as co-owners." Co-ownership, also referred to as "community of interest," has been said to be the most important element of partnership and consists of several components: capital or property sharing; loss sharing; profit sharing and control sharing. Of these, profit sharing and control sharing are the most important. It has been noted that capital or property sharing is not necessary to partnership and it is clear that partners may agree among themselves whether and how to share losses. Profit sharing is at the essence of partnership and is prima facie evidence of partnership unless one of several special relationships is present. Profit sharing is also a relatively easily identifiable factor, much more so than control sharing.

The U.P.A. Official Comment is very brief with respect to the co-ownership element and its important control component:

The definition asserts that the associates are "co-owners" of the business. This distinguishes a partnership from an agency — an association of principal and agent. A business is a series of acts directed toward an end. Ownership involves the power of ultimate control. To state that partners are co-owners of a business is to state that they each have the power of ultimate control.

Once someone is established as a partner, he has the power to bind the partnership to third persons unless they know of a restriction on his authority. The question is when is a person's authority so restricted or delegated that he should not be considered a partner?

33. Compare section V of this article concerning the opportunity for certain relatively passive unincorporated organizations to elect to be excluded from some or all of the rules of Subchapter K.
34. See CRANE & BROMBERG, supra note 1, at 59-63.
35. See infra section III C.
37. "[S]ubject to any agreement between them . . . [e]ach partner . . . must contribute to the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits." U.P.A. § 18(a), 6 U.L.A. at 213.
38. See infra section I D.
40. U.P.A. § 9(4), 6 U.L.A. at 133. See generally infra section II A.
The question is a difficult one because partnership agreements often entail significant restrictions on the authority of one or more of the partners. It is often unrealistic to assume that "each [has] the power of ultimate control" if that term refers to the agreement or practice of the partners. The U.P.A. itself anticipates that partners may agree that management will not be shared equally. In large law firms, for example, important policy decisions are often concentrated in a relatively small group, often called an executive committee.

Despite the difficulty, several generalizations may be ventured. If the parties intend to be partners and call themselves partners, it probably matters little that management has been concentrated in the hands of one or a few. On the other hand, other profit-sharers, such as lenders, can be vested with a great deal of control without being rendered partners if they carefully document their relationship as something other than partnership. The control, however, must be consistent with the alternative relation asserted. For example, it is not uncommon for a creditor to assert consultation rights or even veto power concerning certain types of transactions. It is more suggestive of partnership, however, if affirmative control is exercised. Examples of affirmative control include selecting investments and directing pricing policies. It is sufficient that there is a right to control; an actual exercise of that right is not necessary.

At some point, the lack of control raises the question whether the interest acquired, particularly if it is acquired for cash rather than services, is a "security." The basic definition of a security, both for federal and state securities law purposes, is an investment of money in a common enterprise with the expectation of profit solely or primarily through the efforts of a promoter or a third party. Because limited partners are passive investors who are not to take part in the control of the business, limited partnership

41. U.P.A. § 18, 6 U.L.A. at 213 provides that, "subject to any agreement between them ... [a]ll partners have equal rights in the management and conduct of the partnership business."
42. See, e.g., Bernstein, Bernstein, Wile & Gordon v. Ross, 177 N.W.2d 193, 195 (Mich. Ct. App. 1970), which held that a person was a partner, and not merely an employee, even though he "agreed to relinquish all management to the senior partners."
43. See, e.g., Martin, 158 N.E. 77.
46. See infra section VI.
interests are most commonly treated as securities, both for federal and state securities law purposes. On the other hand, some have assumed incorrectly that interests in general partnerships cannot constitute securities. There is no reason to suppose that an interest in a general partnership can never fall within the rather sweeping definition of security. Perhaps the most pointed example of this is the Empire State Building, which was the subject of a publicly syndicated offering of units of participation in general partnership interests. The prospectus in that syndication described the investors as "joint venturers" and reflected an opinion of counsel that they would qualify as partners for federal income tax purposes. It does seem clear that at some point, the absence of control of a joint venturer or partner can at least raise a serious question whether he has purchased a security.

D. Share of Gross versus Profits; Nonpartner Profit Shares

Section 7 of the U.P.A. makes clear that the sharing of gross receipts is a lesser indication of partnership than the sharing of net receipts. The sharing of gross receipts "does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived." One who shares in the gross receipts of a business is less dependent on the overall success of the business.

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.
50. The distinction between a share of gross receipts and a share in profits can be important for several tax purposes. Not only can it influence whether a partnership will be found to exist for federal income tax purposes, but also may influence whether a particular amount qualifies as a "guaranteed payment." See I.R.C. §§ 707(c), 736(a) (1982). But see Pratt v. Commissioner, 64 T.C. 203 (1975), aff'd in part, rev'd in part, 550 F.2d 1023 (5th Cir. 1977).
than one who shares only if there are profits. One who shares in the gross receipts can profit even though everyone else is breaking even or losing money because total expenditures equal or exceed total gross receipts. Because sharing of profits is at the heart of partnership, it is easy to understand the notion that someone who only profits if his associates profit is more like a partner than someone who profits as his associates are losing money. Accordingly, the general rule under the U.P.A. is that profit sharing, but not the sharing of gross receipts, is prima facie evidence of partnership.  

The general rule that profit sharing is prima facie evidence of partnership is qualified by a short list of situations in which profit sharing is not prima facie evidence of partnership. Two situations that must be distinguished are those in which the profits are received in payment “[a]s a debt by installments or otherwise,” and those in which profits are received “as interest on a loan, though the amount of payment vary with the profits of the business.” In the first of these two situations, there is profit sharing in payment of principal on a debt (or in payment of both principal and interest), whereas in the second situation there is profit sharing only insofar as the payment of interest is concerned. The first of these two exceptions appears to be a codification of a common law rule developed to protect holders of previously created debt who tried to salvage what they could from a failing debtor by taking some or all of his profits. Ordinarily, of course, a creditor is entitled to be paid regardless of profits, but enforcement of this right may sink a weakened business and produce a total loss. Creditors are therefore sometimes willing to keep a business afloat, usually under their guidance, in a sort of informal receivership or reorganization. The salvage effort is often unsuccessful, further liabilities accumulate, and the question is whether the creditors are themselves liable as partners to those who extended credit while they were sharing profits.  

Whatever its origins, this first exception is not limited to pre-existing debt or salvage cases. It includes financings, refinancings, or

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55. CRANE & BROMBERG, supra note 1, at 80-81. The authors cite Cox v. Hickman, 11 Eng. Rep. 431 (1860) as the leading case.
sales on credit in which payment to the creditor is from the outset keyed to profits. However, if the terms of the alleged extension of credit are functionally indistinguishable from a capital contribution, partnership status can result. The second type of situation, in which there is a fixed obligation to repay principal coupled with a promise to pay a portion of profits in lieu of or in addition to a fixed rate of interest, is perhaps typified by the lender who seeks to fall within an “interest contingency” exception to a usury law and at the same time avoid partnership status. In general, the investor who is promised a return of his investment and is to receive a share of profits in lieu of or in addition to interest will not be deemed a partner unless he takes part in the control of the business.

The U.P.A. lists several additional situations in which the receipt of a share of profits is not prima facie evidence of partnership. One is when profits are received as “wages of an employee.” “Employee” in this context presumably is broader in scope than its common law meaning, and apparently includes independent contractors and others who provide services for profit. Because the money partner and the service partner are a classic combination, the absence of a capital contribution by the service partner may be of little or no significance. Intent to become partners and the degree to which control is shared are both important factors, although it is possible to find someone a partner even though he has little or no control over the business. However, an agreement to share losses seems so alien to the normal employment relation that

57. See, e.g., Davis v. Gilmore, 244 S.W.2d 671 (Tex. Civ. App. 1951). A “loan” to a partnership can also be recharacterized as a contribution to capital for federal income tax purposes. See, e.g., Hambuechen v. Commissioner, 43 T.C. 90 (1964) and Rev. Rul. 72-135, 1972-1 C.B. 200. It is possible for federal income tax purposes to be both a partner and a creditor. See I.R.C. § 707(a), (c) (1982).
58. In general, if the loan terms are such that the lender could wind up with a return significantly less than the maximum that would be permitted under a fixed rate of interest, for example, in the event the borrower makes no profit, it will not be usurious if the lender's actual return turns out to be much greater than the fixed rate maximum. See, e.g., Thomasen v. Carr, 58 Cal. Rptr. 297, 300-02 (1967).
59. Such an investor is similar to a limited partner who has been promised a return of his contribution. Martin is a classic case in which a lender for profits in lieu of interest had a great deal of control over the business yet withstood a challenge that he was a partner. 158 N.E. at 77.
61. See generally Annot., 137 A.L.R. 6 (1942) (partnership as distinguished from employment). For federal income tax purposes, a person may act both as a member of a partnership and as its employee. See I.R.C. § 707(a), (c) (1982).
its presence would presumably be a strong indication of partnership. Similarly, profit sharing is not prima facie evidence of partnership if the profits are received as "rent to a landlord." Once again, intent of the parties and control of the business are important. As in the case of the lender, the landlord may exercise some considerable control, particularly inspection or veto power, without becoming a partner. As in the case of wages, an agreement to share losses seems so peculiar to the usual landlord-tenant relationship that it strongly suggests partnership. And, as is generally true, rent based on gross receipts is a lesser indication of partnership than rent based on profits.

Only two additional statutory exceptions to profit-sharing as prima facie evidence of partnership remain to be considered. The first is when the profits are received as "an annuity to a widow or representative of a deceased partner." The partner who is selfish enough to live, retire and receive the payments himself is probably governed by the final and much broader exception, the situation in which the profits are received as "the consideration for the sale of a good-will of a business or other property by installments or otherwise." As was the case with the other protected categories, the caveat must again be raised that the seller receiving profits as his sales proceeds can be deemed a partner if that was the intent or if he takes part in control.

E. Consequence of Partnership: The Tenancy in Partnership

Both for state law purposes and for federal income tax purposes,

62. See generally Annot., 131 A.L.R. 508 (1941) (lease or tenancy agreement as creating partnership relationship between lessor and lessee). For federal income tax purposes, a person may act both as a member of a partnership and as its landlord. See I.R.C. § 707(a) (1982).


64. CRANE & BROMBERG, supra note 1, at 90:

The principle holds in farming cases where the landowner receives a share of the crop. However, if he bears any of the expenses of planting, cultivating and harvesting, he is actually sharing not the gross but something approximating the net profits of the operation. This makes him a bit more susceptible to partnership liability, but he is normally not vulnerable unless he participates in control, say, by designating crops or markets. In the latter situation, he may be able to show that the farmer was his employee or servant, thus avoiding partnership but incurring vicarious liability for the farmer's actions in the scope of employment.


66. U.P.A. § 7(4)(e), 6 U.L.A. at 39. For federal income tax purposes, there is great flexibility to characterize the payments made to a withdrawing partner or his successor. See I.R.C. §§ 741, 736 (1982).
it is important to ask whether a particular question will be answered in accordance with an "entity" theory of partnership or in accordance with an "aggregate" theory of partnership. A certain amount of tax law confusion in this area is understandable, because it has been preceded by well over a century of state law confusion.\textsuperscript{67} Is there a separate entity, a partnership, that is interposed between partner and partnership affairs, which separate entity, like a corporation, has its own relationships with its assets, its members, and the outside world, the results of which are simply divided by the partners as residual owners, like shareholders? Or is a partnership simply a collection of individuals, some of whom play a very distinct part in certain dealings with assets, fellow members, and the outside world, and who should be treated accordingly? The answer today, both for state law purposes and federal income tax purposes, is the same as it always has been and probably always will be: whether an entity approach or an aggregate or conduit approach will be applied depends upon the situation. This is as it should be. Only those with a perverse sense of and passion for consistency could hope otherwise. Courts in England never could decide.\textsuperscript{68} The English mercantile courts said that of course partnerships are entities, that is how they are treated throughout the world of commerce. The English common law courts, on the other hand, saw only aggregations of individuals, and felt powerless to create a new business entity with a separate legal personality.\textsuperscript{69} Building upon this tradition of disagreement, the U.P.A. was finalized as a compromise among people who were divided in their support for these two different theories. Although the U.P.A. does not expressly adopt the separate entity theory or reject the aggregate theory, entity notions predominate.\textsuperscript{70}

Both for state law purposes and federal income tax purposes, the application of the entity theory can have staggering consequences that may be not only unanticipated, but also counterintuitive. Perhaps one of the most overlooked fundamentals of partnership law is that the U.P.A. provides that partnership property is held by the partners in a special form of co-ownership designated tenancy in partnership: "A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership."\textsuperscript{71} As the

\textsuperscript{67} CRANE & BROMBERG, supra note 1, at 16-30.
\textsuperscript{68} Id. at 18-20.
\textsuperscript{70} See CRANE & BROMBERG, supra note 1, at 16-29.
\textsuperscript{71} U.P.A. § 25(1), 6 U.L.A. at 326.
incidents of the tenancy in partnership are unfolded, it becomes clear that the partnership is treated as an independent, almost tangible entity, that stands firmly between its assets and the partners. In a very real sense, the effect of the tenancy in partnership is to cut off the individual partner from partnership assets:

(2) The incidents of this tenancy are such that:
   (a) A partner, subject to the provisions of this act and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.
   (b) A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property.
   (c) A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. When partnership property is attached for a partnership debt the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the homestead or exemption laws.
   (d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.
   (e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin.

Indeed, the interest of the partners is not in the partnership assets, but in the partnership entity: "A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property." Just as the property interest of shareholders is viewed as being in their shares, which are their contracts of residual ownership, a partnership interest is seen as a separate asset and one that is personal property.

73. U.P.A. § 26, 6 U.L.A. at 349.
74. Similarly, for federal income tax purposes, a partner's interest in his partnership is
Consider one possible consequence of the unanticipated application of the rule that the partnership is a separate entity that cuts off partners from partnership assets. Consider, for example, a three-person partnership that owns investment real estate. One of its members might draft a will that devises all his real property to his family and all his personal property to his alma mater. He might assume that he and his partners directly owned undivided interests in real property. He might regard it as a sad comment on the law that the partnership of which he is so proud is seen as a separate entity that actually cuts him off from the interest in the real property he thought he had, leaving him with only an interest in personal property, a slice of an invisible intangible.\footnote{generally treated as a separate, capital asset. I.R.C. § 741 (1982).}

The drafters of the U.P.A. had several important objectives to be served by this definition of the tenancy in partnership. The first was a general goal to simplify the law, which also is frequently the goal when an entity model is adopted for federal income tax purposes.\footnote{The federal income tax consequences of an inadvertent tax partnership can be equally counterintuitive. See infra. section IV A-E.} The second was to incorporate selected features of the law of joint tenancy into the law of partnership. For example, when a joint tenant dies, his interest in the property passes to the other joint tenants. This is known as the “right of survivorship” of the other joint tenants. The drafters of the U.P.A. felt that “[t]he incident of survivorship fits in with the necessities of partnership. On the death of a partner, the other partners and not the executors of the deceased partner should have a right to wind up partnership affairs.”\footnote{Compare I.R.C. § 707(a), (c) (1982).} The third goal was to lay the foundation for a simplified procedure in those cases in which the separate creditor of one partner wishes to secure satisfaction out of his debtor’s interest in the partnership. The basic policy judgment was that particular pieces of partnership property, and, hence, potentially, the very business of the partnership, should not be jeopardized by every claim of separate creditors. No partner has any interest in specific partnership assets for his own personal purposes, he can convey no such interest for personal purposes, nor can his personal creditors force such a conveyance. Rather, his interest in the partnership is his share of the profits and surplus, and it is against that interest that his separate creditors may seek a charging order.\footnote{U.P.A. § 25, Official Comment, 6 U.L.A. at 327.}
III. PARTNERSHIPS FOR TAX PURPOSES

A. Definition of Partnership: Tax Law

For a variety of state law purposes, individuals may be deemed to be partners independent of and contrary to their intent concerning partnership classification, often with unanticipated consequences. So, too, for federal income tax purposes, people may be deemed partners against their will and to their great displeasure. As under state law, intent to be classified as partners is evidence of partnership, but the ultimate "intent" question is not the parties' thoughts concerning how they are classified; the ultimate question is whether they intended to enter a relationship, however denominated, the essence of which is tax partnership. It should be emphasized that people can be deemed to be partners for tax purposes even though their relationship is not one of partnership under state law. Tax classification is determined under the Code and is ultimately independent of state law classification.

The inadvertent tax partnership continues as a trap for the unwary because the tax definition of partnership is extremely broad. The term "partnership" is defined to include any "syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this

(2d Cir.), cert denied, 334 U.S. 819 (1948):

The practical effect of these interpolations into the common law was to impound firm assets and deprive the individual partners of any control over them except in so far as they were dealing with them on behalf of the firm as a unit. The individual partner's beneficial interests as a legal joint owner were trimmed down so that he had nothing left save that the firm assets should be devoted to the firm business, that he should share in any profits they produced and in the surplus upon winding up, whether voluntary or by legal process.

79. On the matter of intent, in Commissioner v. Culbertson, 337 U.S. 733 (1949), the Supreme Court said all facts must be considered:

The question is . . . whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Id. at 742 (footnote omitted). For a much more recent case in which the parties were held to be tax partners even though neither they nor their government regulators considered them partners, see Madison Gas and Electric Co. v. Commissioner, 633 F.2d 512 (7th Cir. 1980), aff'g, 72 T.C. 521 (1979).

Thus, the Code defines partnership in the negative, and that is why the category of partnership is potentially enormous. Partnership is a residual category. If any unincorporated business group is nothing else for tax purposes (a corporation or trust or estate), it is a partnership. And a "partner" is defined to include any member of the group. The "term 'partnership' is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships." Perhaps the most extreme example of this breadth of scope of the category of partnership for federal income tax purposes is presented by certain limited partnerships that fall outside the present regulatory definition of a corporation. Despite repeated statements in the Official Comment to the Uniform Limited Partnership Act (U.L.P.A.) that a limited partner is "not in any sense a partner," limited partners are routinely held to be partners for tax purposes, even if their sole general partner is a corporation.

B. Assignee of a Capital Interest

The Latin term delectus personae, meaning choice of the person, has long been used to refer to the state law rule that each of the parties involved must intend to enter into a partnership relationship. This notion is embodied in the U.P.A.'s rule that one cannot "become a member of a partnership without the consent of all the partners."

Delectus personae operates mainly to keep out of an existing partnership someone who receives an interest in a partnership by assignment or inheritance. However, the necessary consent of the

81. I.R.C. § 761(a) (1982), which is applicable for income tax purposes only. See also I.R.C. § 7701(a)(2) (1982), which is a virtually identical definition. The § 7701(a)(2) definition applies to all of Title 26, which includes subtitles relating to income tax, estate and gift tax, employment tax, procedure and administration.
82. I.R.C. § 761(b) (1982): "(b) Partner.—For purposes of this subtitle, the term 'partner' means a member of a partnership." See also Treas. Reg. § 1.761-1(b) (1972); I.R.C. § 7701(a)(2) (1982).
84. See infra section VII.
87. For the requisite nature of this intent, see infra section II B.
88. U.P.A. § 18(g), 6 U.L.A. at 213.
other persons may be given or waived by conduct. Or they may give it in advance by their agreement, say by providing for freely transferable interests. Or they may delegate to some of their number (say a managing partner) the authority to consent for all.  

Even though an assignee does not become a partner without the consent of the other partners, a partner's interest in a firm is assignable. The assignment of a partner's interest does not of itself cause a dissolution of the firm or entitle the assignee to participate in management, but it does entitle him "to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled."  

An assignee of a partnership interest can become a partner for tax purposes even though he does not become a partner under state law. The so-called "family partnership" rules contain a supplemental definition of "partner" in section 704(e)(1), which has been held to be generally applicable outside the area of family partnerships: "A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." For purposes of this provision, a capital interest is "an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership." The mere right to participate in the earnings and profits does not constitute a capital interest. Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the use of capital; for example, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.  

In Evans v. Commissioner, the Seventh Circuit stated that section 704(e)(1) is a general definition applicable to all partnerships.

89. Crane & Bromberg, supra note 1, at 44.
91. Id.
94. Id.
96. 447 F.2d 547 (7th Cir. 1971), aff'g 54 T.C. 40 (1970).
Mr. Evans assigned his 50-percent interest in a two-man partnership to his wholly-owned corporation solely in exchange for the stock of that corporation. His partner did not know about the existence of the corporation or about the assignment, and partnership tax returns continued to be filed listing Evans as a partner. Checks from the partnership representing distributions were made payable to Evans, but were deposited directly in his corporation's bank account. Evans did not inform third persons dealing with the partnership of the assignment, nor did he represent to them that he was no longer a partner. He continued to perform services for the partnership as he had prior to the assignment, but was paid a salary by his corporation. Eventually, the assignment was discovered, and Evans' partner purchased the interest Evans had assigned to the corporation. The sale proceeds were deposited directly into the corporation's bank account.

The Service argued that, because Evans did not obtain the consent of his partner to the assignment or notify third parties, he remained a partner after the assignment, having assigned no more than his right to future partnership income. Under this analysis, Evans remained responsible for 50 percent of all partnership income even after the assignment, and for gain on the sale of the partnership interest.

The Seventh Circuit affirmed the Tax Court's conclusion that the assignment had effectively transferred to the corporation all of Evans' interest in the partnership, and not merely the right to future income. This was true even though the assignment did not terminate the original partnership under state law. Tax termination, which is independent of the termination or continuation of a partnership under state law, had automatically occurred on the transfer to the corporation because it involved the sale or exchange of 50 percent of the total interest in partnership capital and profits.

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97. Evans' goal was to fall within the nonrecognition provisions of section 351 of the Code.
98. The court stated:
   Under Wisconsin law a partner's interest in the partnership is his share of the profits and surplus. This interest is personal property and is assignable. An assignment of a partnership interest entitles the assignee to receive the profits to which the assigning partner would otherwise be entitled and, in the case of a dissolution of the partnership, entitles the assignee to receive the assignor's interest. And it appears that there is no requirement that consent to the assignment be obtained from the other partners.

54 T.C. at 49.
within a 12 month period.99 Because the corporation acquired a capital interest in a business in which capital was a material income producing factor, it became a tax partner in a new partnership by virtue of Section 704(e)(1).

C. Tenants in Common as Tax Partners

People who are tenants in common for state law purposes are often deemed partners for federal income tax purposes, and it is not always clear when this will happen. Part of the reason it does happen is the Code’s broad definition of partnership which includes any “unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not . . . a corporation or a trust or estate.”100 The regulations, however, leave room for certain profit-seeking co-owners to fall outside the definition of partnership. 101 They provide that a joint undertaking “merely to share expenses” does not constitute a partnership.102 The regulations provide, for example, that no partnership exists if two or more persons jointly construct a ditch merely to drain surface waters from their property, and further indicate that an asset that is independently income producing may be co-owned without the creation of a tax partnership. “Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership.”103 The scope of this last sentence is unclear, and the possibility of a narrow construction is suggested by the illustrative example that follows it: “For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a partnership thereby.”104 The case of the individual owner suggests the state law rule that profit sharing is not prima facie evidence of partnership if it is paid as “rent to a landlord.”105 The case of rented co-owned land suggests not only the rule that the co-owners will not become partners with someone who is more properly deemed their tenant, but

100. I.R.C. §§ 761(a), 7701(a)(2) (1982).
101. See also discussion of opportunity to “elect out” of the provisions of Subchapter K infra at section V A-I.
103. Id.
104. Id.
also the further rule that the co-owners of the rented land will not themselves be deemed partners. Further language also suggests that income-producing property may be co-owned without the presence of partnership, but only if the investment is a fairly passive one:

Tenants in common . . . may be partners if they actively carry on a trade, business, financial operation, or venture and divide the profits thereof. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.106

The language “and in addition provide services” suggests that for federal income tax purposes, as well as for state law purposes, it is the presence of business activity by the co-owners that can trigger a finding of partnership.

Although consistency in result is probably too much to expect, Revenue Ruling 75-374107 suggests the maximum level of business activity that may be present before co-owners will be deemed tax partners: A life insurance company and a real estate investment trust each owned an undivided one-half interest in an apartment project that was operated and maintained by an unrelated management corporation. The management company performed services “customarily associated with maintenance and repair,” including heat, air conditioning, hot and cold water, unattended parking, normal repairs, trash removal, and cleaning of public areas. Customary services were furnished to tenants at no additional charge above their basic rental. All costs incurred by the management company in rendering the customary services were absorbed by the co-owners, each of whom paid the management company “a percentage of one half of the gross rental receipts derived from the operation of the project” as compensation for the customary services. The management company also performed certain “additional services,” including attendant parking, cabanas, and gas, electricity and other utilities. The additional services were fur-

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   Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association.

nished to the tenants for a separate charge. The management company bore all the costs incurred in providing the additional services and retained for its own use all the charges paid for them, which were stated to be adequate compensation.

The Ruling stated that the furnishing of customary services in connection with the maintenance and repair of an apartment project does not render a co-ownership a partnership. “However, the furnishing of additional services will render a coownership a partnership if the additional services are furnished directly by the coowners or through their agent.” It was ruled that, by reason of the contractual arrangement with the management company, the co-owners were not furnishing the additional services either directly or through an agent. The Ruling emphasized that the management company was solely responsible for determining the time and manner of furnishing the services, bore all the expenses of providing them, and retained for its own use all the income they produced. None of the profits arising from the additional services were divided with the life insurance company or the real estate investment trust. Therefore, they were “treated as coowners and not as partners.”

D. Partnership versus Other Relationships

When it is clear that business activity is present, the question is whether people are participating in that activity as partners or whether their association should be classified as something other than partnership. As under state law, the dividing line between partnership and other unincorporated relationships is not always clear. Although state law classification of a relationship is not controlling for tax purposes, tax disputes frequently involve an inquiry into the “business” or “economic” reality of a transaction. This, in turn, typically involves an inquiry into the legal consequences of the transaction under state law. Accordingly, tax opinions usually involve a discussion of the same kinds of factors that are discussed in state law classification cases, and the results are often the same. Thus, for example, disputes have involved whether profit sharers should be deemed tax partners despite the fact that management and control is concentrated in someone else, or whether they

108. Id. The Ruling did not state precisely what issue was involved. It appears to have concerned the passive investment requirements of real estate investment trusts.

109. See, e.g., Podell v. Commissioner, 55 T.C. 429, 432 (1970), in which an attorney who passively furnished a portion of the money to acquire and renovate buildings was held a tax
should be more properly characterized as employees rather than partners,\textsuperscript{110} as landlords or tenants rather than partners,\textsuperscript{111} as lend-

partner:

The fact that petitioner did not exercise as much managerial control over the day-to-day activities relating to the purchase, renovation and sale of the real estate as Young is not sufficient reason for this Court to find against the existence of a joint venture. While petitioner gave Young discretion with respect to all aspects of the purchase, renovation, and sale of the real estate in question, petitioner retained the power to approve of the steps undertaken by Young to execute their agreement through his control over his continued contribution of funds to the venture.

\begin{itemize}
  \item In Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964), the Tax Court stated that the following factors, none of which is conclusive, bear on the issue whether a contract to share profits is one of employment or partnership:
    \begin{itemize}
      \item The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to [the Service] or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.
    \end{itemize}
  \end{itemize}

Even if the profitsharing "employee" shares to a limited extent in losses, he will not be deemed a tax partner if his profit share is received "as compensation for services and not through a vested and continued interest in a joint venture or partnership." Rosenberg v. Commissioner, 15 T.C. 1, 9 (1950). The Rosenberg court felt that the absence of a proprietary interest was indicated by a variety of factors: the taxpayer's contract was stated to be simply one of employment; he did not share personal liability for debts of the business; his responsibilities and duties under the contract and even his rights to his "Bonus Account" were carefully circumscribed and subject to change at the pleasure of the employer; and he was not consulted about certain important business decisions. \textit{Id.} at 8-9.

\begin{itemize}
  \item Factors that determine whether a purported landlord-tenant relationship constitutes a tax partnership appear to be similar to those that determine whether a purported employment relationship constitutes a tax partnership. The court in University Hill Found. v. Commissioner, 51 T.C. 548 (1969), \textit{rev'd on other grounds}, 446 F.2d 701 (9th Cir. 1971), \textit{cert. denied}, 405 U.S. 965 (1972), refused to hold that a "lessor" was a tax partner of its "lessee." Neither of the "critical elements" of "the existence of controls over the venture and a risk of loss in the taxpayer" were present. \textit{Id.} at 568. The taxpayer did not participate in the day-to-day management of the leased premises; its inspection rights and veto powers "were not inconsistent with the simple objective of an owner of property in making certain that the value of his ownership and his right to receive the payments due him not be dissipated by a third party in possession." \textit{Id.} The taxpayer

\begin{itemize}
  \item did share in expenses to a degree, since such expenses were charged against income in arriving at net profits and the "rent" paid to petitioner was a percentage participation of profits. This element is often one indication of a joint venture but standing alone it is not enough. This is particularly true where, as is the case herein, petitioner was not required to contribute to losses. If losses occurred, petitioner simply did not collect any rent for the particular period.
\end{itemize}
ors\textsuperscript{112} or guarantors rather than partners, and so forth.\textsuperscript{113}

IV. CONSEQUENCES OF TAX PARTNERSHIP

A. The Partnership as Tax-Computing Entity

If a partnership is deemed to exist for federal income tax purposes, it will be subject to the rules of Subchapter K contained in sections 701-761.\textsuperscript{114} Some of these rules can be advantageous to taxpayers, while others can be unanticipated and extremely disadvantageous. Most basically, the income or loss of the business must be computed and reported at the partnership level.

Just as for state law purposes the partnership is seen as a separate entity that owns its own assets and conducts its own business,

\textit{Id.} at 568-69. A lessor and lessee who had attempted to draft away partnership status were nevertheless held to be tax partners in Haley v. Commissioner, 203 F.2d 815 (5th Cir. 1953), rev'g 16 T.C. 1509 (1951), acq. 1952-1 C.B. 2. The "lease" agreement was coupled with a "purchase" agreement, the combined provisions of which took the participants beyond the normal realm of the landlord-tenant relationship.

112. Purported "loans" to partnerships can be recharacterized as contributions to capital. Rules that distinguish debt from equity, although developed primarily in the corporate context, also apply in the partnership area:

Numerous factors . . . are pertinent to the question whether a debtor-creditor relationship has been established for tax purposes. Such factors as adequacy of the capitalization of the debtor, issuance of any notes, provision for and payment of interest, presence or absence of a maturity date, intention to repay, whether the alleged debt is subordinated to claims of outside creditors, whether outside creditors would have made similar advances under the circumstances, presence or absence of security for the alleged loan, reasonableness of expectation of payment, use to which the funds were put, and whether payment can only be paid out of future profits, are a few of those most frequently mentioned. . . . Although no one factor by itself is determinative of the question, a significant factor is "whether the funds were advanced with reasonable expectations of repayment regardless of the success of the venture, or were placed at the risk of the business."

Hambuechen v. Commissioner, 43 T.C. 90, 99-100 (1964) (citations omitted). See also Hartman v. Commissioner 17 T.C.M. (CCH) 1020, 1023 (1958): "[W]here the party receiving the money assumes no obligation for its return and it is subject to the hazard of the business, the parties have been generally held to be joint venturers notwithstanding the money is to be repaid with interest before the net profits are to be divided."

113. Against a strong dissent, the court in O'Hare v. Commissioner, 641 F.2d 83 (2d Cir. 1981), aff'd 39 T.C.M. (CCH) 1006 (1980), denied the taxpayer's claim that his exposure as title holder and mortgagor was so great that he should be deemed a tax partner, rather than merely a guarantor for a contingent fee. For detailed discussion of partnerships versus other economic relationships for tax purposes, see SPADA & RUGE, PARTNERSHIPS—STATUTORY OUTLINE AND DEFINITION, Tax Management Portfolio 161-2d (1975), W. McKee, W. Nelson & R. Whitmore, \textit{FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS} § 3.03 (1977), and 1 A. Willis, J. Pennell & P. Postlewaite, \textit{PARTNERSHIP TAXATION}, §§ 3.01-.08 (3d ed. 1982).

114. There is an opportunity for certain types of partnerships to be excluded from the operation of some or all of Subchapter K. See the discussion of I.R.C. § 761(a) (1982), \textit{infra}, at section V A.
it is also treated as a separate entity for many federal income tax purposes. Even though the partnership is not a tax paying entity, as is a corporation, it is a tax computing entity, and one that wrests certain decisions from the hands of its members. The partnership has its own taxable year and it, rather than the individual partners, makes the basic decisions with respect to the computation of partnership income.116 The partnership computes taxable income or loss in much the same manner as an individual,116 and files a partnership return.117 Because there is no tax due at the partnership level, the purpose of the partnership return is to indicate how the tax results of partnership operation are "passed through" to the partners and allocated among them by their partnership agreement.118 The character of a partner's distributive share of partnership income or loss, however, is determined at the partnership level.119 Indeed, in computing partnership taxable income or loss, the partnership itself makes numerous significant elections that bind all partners not only to the character of income or loss, but also to its amount and timing.120 It determines, for example, the method of computing depreciation of partnership property,121 whether to use a cash or accrual method of accounting,122 whether to report income from an installment sale on an installment method,123 and whether certain optional adjustments will be made with respect to the basis of partnership property.124 Certain elections can only be made at the partnership level.125 For example, if a partnership fails to elect to reinvest a condemnation award in property of like kind, an individual partner may not elect to do so with his share of the award.126 The importance of the partnership as an entity that binds all its members was increased dramatically by The Tax Equity and Fiscal Responsibility Act of 1982

115. I.R.C. § 703(b) (1982).
118. I.R.C. § 704(a) (1982).
119. I.R.C. §§ 702(b), 6221 (1982). See, e.g., Podell v. Commissioner, 55 T.C. 429, 433 (1970): "[I]t is the intent of the partnership and not that of any specific partner which is determinative in characterizing the income for purposes of taxation."
120. I.R.C. § 703(b) (1982).
122. I.R.C. §§ 446(c), 703(b) (1982); Treas. Reg. § 1.703-1(b) (1974).
125. I.R.C. § 703(b) (1982).
(TEFRA), which introduced rules for binding audits at the partnership level.\footnote{127}

\textbf{B. The Separate Partnership Interest}

We have seen that for state law purposes an entity theory is reflected in the tenancy in partnership and that each partner's interest is in his share of the profits and surplus, and not a direct share in underlying partnership assets. The same basic approach is taken for federal income tax purposes. Each partner is seen to have a separate interest in his partnership. Just as for state law purposes that separate interest is generally seen as an interest in personal property, for tax purposes that interest is generally seen as a capital asset. Thus, the gain or loss that must be reported by a partner when he sells or exchanges his partnership interest is generally reported as capital gain or loss.\footnote{128}

There are, however, exceptions to the general rule of capital gain or loss treatment. In certain situations, the Code requires that the sale or exchange of a partnership interest be fragmented into its ordinary and capital components. If there are certain ordinary income assets, known as "section 751 assets," that lie behind a partnership interest, the partner selling his interest will be treated as if he were trading in the underlying assets.\footnote{129} Similarly, certain distributions to a partner will result in ordinary income if they are made because he has, in effect, sold his share of certain ordinary income assets. The purpose of these so-called "collapsible partnership" rules is to prevent the entity theory of partnerships from being relied on to convert ordinary income into capital gain.

The general rule of "no peeking" behind the partnership interest is perhaps best demonstrated by \textit{M.H.S. Company, Inc. v. Commissioner},\footnote{130} in which a corporation had some of its real property condemned. It reinvested the real property condemnation award by purchasing shopping center property with another company as equal tenants in common. The court held that the tenants in common were, as a matter of law, partners, and that, therefore, what the corporation had acquired was not real property, but an interest in a partnership, which is personal property. Accordingly, the proceeds of the real property condemnation award were not reinvested

\begin{footnotes}
\item[129] I.R.C. § 751(a) (1982).
\item[130] 35 T.C.M. (CCH) 733 (1976), aff'd per curiam, 575 F.2d 1177 (6th Cir. 1978).
\end{footnotes}
in property of "like kind," and the corporation was required to recognize gain on the condemnation award.

C. Partner's Basis in Separate Partnership Interest

It is difficult to give a short statement of the rules that govern a partner's basis in his partnership interest. This section is offered to identify the basic variables that determine each partner's basis account in his partnership interest. Some of the consequences of inadvertent tax partnerships cannot be understood without some appreciation of the basis rules.

The rules that govern the determination of a partner's basis in his partnership interest sometime require a bit of getting used to by newcomers to partnership tax whose notion of basis was developed in the context of an individual's ownership of a depreciable asset, such as a building. Essentially, an individual's basis in a building is its cost less any depreciation deductions he is subsequently allowed. Nothing could be more simple than that initial cost minus depreciation deductions equals adjusted basis, which might most easily be thought of as a measure of unrecovered cost for tax purposes. Throw that building into a partnership and things get complicated, in part because a separate entity, the partnership, is deemed to be created. The partnership will now have its own basis\textsuperscript{131} in the building, which will be adjusted in the same manner as an individual owner's basis in a building.\textsuperscript{132} The partnership entity's basis in its assets is referred to by many as "inside basis," that is, the basis the asset has inside the partnership. It is the partner's separate basis in his partnership interest, referred to as "outside basis," that gives newcomers pause. Although it is true that a partnership's basis in its assets is often equal to the sum of the partners' bases in their partnership interests, a partner's basis in his partnership interest increases and decreases for a greater number of reasons than does an individual's or a partnership's basis in a depreciable asset.

If a person becomes a partner by purchasing part or all of the interest of an existing partner, his initial basis in his partnership interest is his cost.\textsuperscript{133} On the other hand, a person who is admitted

\textsuperscript{131} If a partnership purchases a building, its initial basis in the building is the building's cost. If the building is contributed to the partnership by one of its members, the partnership's initial basis in the building is the adjusted basis the partner had in the building. I.R.C. § 723 (1982).

\textsuperscript{132} But see the result of certain distributions, Treas. Reg. § 1.734-2(b)(1) (1956).

\textsuperscript{133} I.R.C. §§ 742, 752(a) (1982).
to membership upon contribution to the partnership has an initial basis in his partnership interest that includes the amount of money he contributes, plus the adjusted basis of any property he contributes.\textsuperscript{134} Ordinarily, no gain or loss is recognized to the partnership or to any of its partners when property is contributed to the partnership in exchange for an interest in the partnership.\textsuperscript{135} In general, there is no recognition of any gain or loss that may have been realized; the partner's basis in the property he contributes becomes the partnership's basis in that property and also becomes his initial basis in his partnership interest. To the extent, however, that a partner receives his interest as compensation for services, he will have to include the value in income, and will thereby get an additional “tax cost basis” in his partnership interest.\textsuperscript{136}

There is an additional way a partner may realize gain when he contributes property to a partnership. When a partner contributes encumbered property, he is deemed to receive a distribution of cash from the partnership to the extent that his fellow partners undertake a share in the liabilities that encumber that property.\textsuperscript{137} Consider, for example, Contributor A who acquires a 20% interest in a partnership by contributing property that has a fair market value of $10,000, an adjusted basis of $4,000, and that is subject to a mortgage of $6,000. Contributor A's basis in his partnership interest is zero, computed as follows:

\textsuperscript{134} I.R.C. § 722 (1982).

\textsuperscript{135} I.R.C. § 721(a) (1982). Alternatively, a partner could sell property to his partnership or simply permit the partnership to use it. See Treas. Reg. § 1.721-1(a) (1956). I.R.C. § 721(b) (1982) provides that the general nonrecognition rule “shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.”

\textsuperscript{136} Treas. Reg. § 1.722-1 (1956): “If the acquisition of an interest in partnership capital results in taxable income to a partner, such income shall constitute an addition to the basis of the partner’s interest. See paragraph (b) of § 1.721-1.” The same rule should apply when the receipt of an interest in partnership profits constitutes taxable income.

\textsuperscript{137} I.R.C. § 752(b) (1982) provides in part: “[A]ny decrease in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.” The same rule applies even though the partnership simply takes “subject to” those liabilities.
Adjusted basis to A of property contributed $4,000
Less portion of mortgage undertaken by other partners which must be treated as a distribution (80% of $6,000)
4,800
$ (800)

Because A's basis cannot be less than zero, the $800 by which the "deemed distribution" of cash exceeds his basis is treated as gain from the sale or exchange of a partnership interest.

Conversely, a partner's initial basis in his partnership interest is increased by the extent to which he undertakes a share of partnership liabilities. Consider, for example, money partner A who acquires a 20% interest in a partnership by contributing $10,000 cash at a time when the partnership has property encumbered by a $40,000 mortgage. A will be deemed to share in the mortgage for basis purposes to the extent of $8,000 (20% of $40,000). Stated differently, A will be deemed to have made a contribution of cash in the amount of $8,000. Hence, A's basis in his partnership interest is $18,000 (his $10,000 actual cash contribution plus his $8,000 deemed cash contribution). If $1,000 of mortgage principal is subsequently repaid, A's 20% share of the mortgage will be decreased by $200, and he will be deemed to receive a distribution of cash in that amount.

A partner's initial basis in his partnership interest, adjusted to reflect deemed contributions and distributions caused by taking on and passing on shares of liabilities, is increased by his share of partnership income. Conversely, his basis in his partnership interest is decreased by his distributive share of partnership loss. It is also decreased by the amount of any cash he receives in either an actual or a deemed distribution, and by the adjusted basis of any property distributed to him.

140. I.R.C. § 752(a) (1982): "Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership." A partner's share of partnership liabilities is determined in accordance with Treas. Reg. § 1.752-1(e) (1956).
Part of the reason for the continuing succession of upward and downward adjustments is to reflect that a partner must report his share of the income computed and reported at the partnership level, whether any cash behind that income is distributed to him or not. Consider, for example, an equal two-person partnership, AB, that computes a taxable income of $100. Each equal partner must report $50 of taxable income even if the $50 cash that lies behind the taxable income is not distributed to him. Each will have his basis in his partnership interest increased by $50, so that when the $50 cash is subsequently distributed, it will not be taxed. The actual distribution of cash will simply eliminate the increase in basis he previously received when and because he reported his distributive share of taxable income. Suppose, for further example, that when the $100 cash is eventually distributed, it is not divided equally but is distributed entirely to B. B’s basis in his partnership interest, which was increased by his $50 share of the partnership’s taxable income, will be decreased by the $100 cash distribution, but not below zero. To the extent the distribution exceeds B’s basis in his partnership interest, he must recognize gain.

In short, distributions themselves are not taxed unless the amount of money distributed exceeds the distributee partner’s adjusted basis in his partnership interest immediately prior to the distribution. This is true whether the distribution is a current (nonliquidating) distribution or a distribution in liquidation of a partner’s interest. Loss, on the other hand, can only be recognized on a distribution if the distribution is in liquidation of a partner’s interest. In the event of a liquidating distribution, loss is allowed

146. I.R.C. § 731(b) (1982).
147. I.R.C. § 731(a)(1) (1982). But see the discussion of the “collapsible partnership” rules in I.R.C. § 751(b) (1982). The basic idea is that a distribution may be taxed even if it is not in excess of basis if it is in effect a payment to a partner for some or all of his share of certain ordinary income assets.
(a) Partners—In the case of a distribution by a partnership to a partner —

(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner’s interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner’s interest in the partnership over the sum of —

(A) any money distributed, and

(B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)(2)).
if only money and certain section 751 assets are distributed and the distributee partner's adjusted basis in his partnership interest exceeds the amount of money and the adjusted basis, to him, of section 751 assets.\textsuperscript{149} Suffice it to say for the moment that section 751 assets are assets that would produce ordinary income if sold by the partnership. The terribly complex rules of section 751 are basically designed to require the recognition of ordinary income on the sale of an interest in a partnership that holds section 751 assets and on certain distributions from such a partnership.\textsuperscript{150}

In general, if property is distributed to a partner other than in liquidation of his interest, the partnership’s adjusted basis in the property becomes the distributee partner’s basis in that property, which he now holds in his individual capacity.\textsuperscript{151} There is, however, a ceiling on the amount of partnership basis that can be passed to the distributee. The partner who receives property in a current (nonliquidating) distribution may not receive a basis in the distributed property that exceeds his adjusted basis in his partnership interest reduced by any money distributed in the same transaction.\textsuperscript{152} Distributions that liquidate a partner's interest in the partnership are treated differently than current distributions. The partner who receives a liquidating distribution that includes property will have his adjusted basis in his partnership interest, reduced by any money distributed in the same transaction, substituted as his new basis in the property.\textsuperscript{153}

\section*{D. Consequences of Inadvertent Partnership}

In Helmer v. Commissioner,\textsuperscript{154} a holding that property held in the names of two individuals was owned by a partnership resulted in the recognition of gain in a situation in which there would be no gain under co-ownership classification. The Tax Court found that a cattle-raising partnership whose members were two brothers, rather than the brothers as co-owners, owned land that was optioned to a development corporation.\textsuperscript{155} The option called for an

\begin{itemize}
\item \textsuperscript{149} Id.
\item \textsuperscript{150} See I.R.C. § 751(a)-(b) (1982).
\item \textsuperscript{151} I.R.C. § 732(a)(1) (1982).
\item \textsuperscript{152} I.R.C. § 732(a)(2) (1982).
\item \textsuperscript{153} I.R.C. § 732(b) (1982). For the rules to allocate basis among distributed properties, see I.R.C. § 732(c) (1982).
\item \textsuperscript{154} 34 T.C.M. (CCH) 727 (1975).
\item \textsuperscript{155} The holding that the land was owned by the partnership is not surprising. Although the brothers never entered into any formal or written partnership agreement, partnership returns in the name of "Helmer Brothers" were filed for each of the years in question. Al-
initial payment of $150,000 and annual payments of $75,000. Upon exercise of the option, the purchase price was to be reduced by the amount of option payments made, but there was no provision for refund of the payments should the agreement terminate. Payments were made to an escrow agent, which distributed them to the Helmer brothers after subtracting taxes, interest, and principal due on the property. During the three years in question, the optionee made the required payments and neither forfeited nor exercised the option. The escrow agent paid the Helmers by checks which they endorsed and deposited into their personal bank accounts rather than into their partnership bank account.

It was held that the checks deposited into the brothers' personal accounts constituted distributions of cash from the partnership. The service had: “conceded that the income from the option payments was deferrable by the partnership until characterized as ordinary income (because of a default by the optionee) or capital gains (because of an exercise of the option by the optionee).” Nevertheless, the court held that the distribution to the two brothers from their own partnership was a taxable event. They were required to pay tax to the extent the distributions exceeded their bases in their partnership interests. The court confessed that its holding “may run counter to the general concept of subchapter K that the partnership is a conduit as to income and loss items.”

though the evidence was “cursory at the best” as to whether the land in question was owned by the brothers individually or by their partnership,

the partnership books and tax returns for 1966 through 1969 listed the land subject to the option as an asset of the partnership. The balance sheets of the partnership returns . . . also listed the allocable part of the option deposit payments to George and T.L. Helmer as partnership liabilities. The amounts received directly by petitioners were reflected as distributions to them on pertinent tax returns and on the partnership books. . . . Having represented to the Internal Revenue Service that this property was owned by the partnership, the partners are bound by such representation.

Id. at 729-30.

156. Id. at 731.

157. The brothers alternatively argued that no gain arose because the distributions of cash were not in excess of their bases in their partnership interests. Their theory was that the receipt of the option payments created a partnership liability in which they shared for basis purposes. See I.R.C. § 752(a) (1982) and Treas. Reg. § 1.752-1(a)(1) (1960). The Tax Court held that no partnership liability was created. There was no provision for repayment of the amounts paid should the agreement terminate, and there was no restriction on the amounts paid other than that on any exercise of the option the amounts paid would be applied against the purchase price.

158. The Tax Court obviously felt uncomfortable with its decision and suggested the case might have been litigated differently:

We believe that the problem created in this case is analogous to the receipt of tax-
The result was an application of strict entity theory of partnerships. The partnership was seen as an entity which cut the partners off from the underlying transaction; they were not permitted to look behind the partnership entity to see that the cash they received was traceable to income that could be deferred until its character as ordinary income or capital gain was established.

As pointed out above, if a partnership is deemed to exist, it as an entity, rather than its individual members, is entitled to make a wide range of important elections to defer recognition of gain. If the partnership as an entity does not so elect, the election is forfeited and cannot be made pro rata by individual partners. A good illustration of this preemption is *McManus v. Commissioner,*\(^\text{160}\) in which the taxpayer was found to have been a partner of the two individuals with whom he had purchased property, a portion of which was condemned. He reinvested his share of the condemnation proceeds and attempted to elect to defer the gain realized on the condemnation sale under the provisions of Code section 1033.\(^\text{160}\) The court held that he could not avail himself of the 1033 election because of the presence of the partnership. The partnership, rather than the partners individually, is entitled to make the election, even though the Code specifies that nonrecognition is available “at the election of the taxpayer.”\(^\text{161}\) To emphasize, even though the partnership is not a tax paying entity, it was seen as the only “taxpayer” for the purpose of making the election.

One of the most striking recent applications of the entity theory to an inadvertent tax partnership occurred in *Madison Gas and Electric Co. v. Commissioner.*\(^\text{162}\) Madison Gas and Electric Company (MGE) was a public utility that had been involved since 1896 in the production and distribution of electricity. In 1967, MGE signed a “Joint Power Supply Agreement” with two other utilities

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exempt income under section 705(a)(1)(B) which permits a partner's basis to be increased by the amount of such income so that upon distribution there will be no recognition of gain in excess of basis. . . . Neither party, however, raised the issue of whether, under other provisions of subchapter K, there would not be recognition of income to the petitioners in this case. We therefore express no opinion with regard to issues other than those raised by the parties as noted on page 2 of this opinion.

34 T.C.M. (CCH), at 731 n.4.

159. 65 T.C. 197 (1975), *aff'd,* 583 F.2d 443 (9th Cir. 1978).

160. I.R.C. § 1033 (1982) provides an opportunity to defer recognition of gain on the involuntary conversion of property by reinvesting the proceeds in property of like kind.


162. 633 F.2d 512 (7th Cir. 1980).
to construct, own and operate a nuclear plant to generate electricity. Under state law, the utilities owned and operated the plant as tenants in common. It was the intention of the utilities to create only a co-tenancy with an expense-sharing arrangement and not a partnership. MGE deducted certain expenditures incurred to train employees for the new plant and to establish procedures for the safe operation of the new plant, claiming that they were section 162(a) ordinary and necessary expenses for carrying on the business that they had been in for almost three-quarters of a century.\textsuperscript{163} The Commissioner conceded that if no partnership existed between MGE and the other utilities, MGE could deduct the expenses under section 162.\textsuperscript{164} The government’s position, which prevailed, was that a partnership had been created among the three utilities for federal income tax purposes, and that MGE’s outlays were nondeductible pre-operating expenditures toward the new partnership business. The Seventh Circuit stressed that Congress had intended to include in the definition of tax partnerships a number of arrangements that are not partnerships under local law. It rejected MGE’s argument that there was no partnership because there was no division of profit, each utility simply took its share of the electricity generated and marketed it independently. It agreed with the Tax Court’s conclusion that “the Code definition of partnership does not require joint venturers to share in a single cash profit and that to the extent that a profit motive is required by the Code it is met here by the distribution of profits in kind.”\textsuperscript{165}

MGE argued in the alternative that, even if a tax partnership did exist, it should be recognized that MGE was a member solely to expand its existing business such that expenditures toward the partnership venture should not be seen as “pre-operating” capital outlays. The Seventh Circuit rejected this argument, saying it was tantamount to a request that the partnership be ignored for tax purposes. Analogous to the tenancy in partnership under state law,\textsuperscript{166} the entity is seen as “cutting off” the partners from the partnership assets and business. \textit{It} has its own assets, \textit{it} has its own business, \textit{it} is new, and \textit{its} business is new. Hence, \textit{its} initial training and planning expenditures were “pre-operating” and capi-

\textsuperscript{163} I.R.C. § 162(a) (1982).
\textsuperscript{164} The concession was perhaps an unnecessary one that placed pressure on the court to resolve the matter in favor of the government according to the stipulation: that deductibility would stand or fall on whether a tax partnership had been inadvertently created.
\textsuperscript{165} 633 F.2d at 515.
\textsuperscript{166} See infra section IIE.
Tal in nature.

Taken at face value, Madison Gas poses a troublesome policy issue. If MGE had been large enough or wealthy enough to start its very own nuclear plant, its outlays would have been deductible. However, because its lack of wealth or other economies forced MGE to participate with others, it was denied the deduction. It is hard to see how the substance of the transaction varies enough to require different tax results, at least when the partnership is inadvertent.

E. Partnership Permits Flexibility

Thus far, much of the discussion in this article has emphasized negative consequences of the unanticipated imposition of the rules of Subchapter K. It is equally clear, however, that it can be extremely advantageous to taxpayers to fall within the rules of Subchapter K. As indicated earlier, Congress intended that partners are to have a great deal of flexibility to allocate among themselves the tax consequences of partnership operations. A full discussion of the use of partnership doctrine to time income, to change the character of income, and even to vary the amount of income that may be recognized, is outside the scope of this article. For our purposes, the basic rules on partnership allocations suffice to illustrate that there can be much good news in the imposition of Subchapter K, particularly with proper planning. In general, partners are free to determine in their “partnership agreement” how the tax consequences of partnership operations will be allocated among themselves.167 A “partnership agreement” is generously defined to include any modifications made up until the time required for the filing of the partnership return.168 Although agreed-upon allocations will be disregarded if they lack “substantial economic effect,”169 there remains great, congressionally intended flexibility to allocate separately various tax benefits and burdens to the partners who most need or can best bear them.170 Co-owners who are inadvertent tax partners often fail to exercise the opportunity to allocate in a way that reduces the overall tax burden of the partners.

Assume that a tax partnership will be formed at some point in a

business relationship. The timing and manner of the formation and capitalization of the partnership can be critical to the tax consequences to be achieved. In some situations, for example, it will be advantageous for new partners to rely on the general rule that no gain or loss shall be recognized on the contribution of property to a partnership. In other situations, it may be advantageous for one or more partners to trigger the realization of gain on partnership formation. *McDougal v. Commissioner* involved such a situation, and the taxpayer used old-fashioned “horse sense” to triple the amount of depreciation deductions that could be taken by his partnership.

*McDougal* was a rancher who purchased a horse on January 1, 1968, for $10,000 and promised the trainer who recommended the purchase that if he would train the horse to race he would receive the standard trainer’s fee plus a half interest in the horse upon the rancher’s recovery of acquisition costs. The horse began to race with success and within a matter of months attracted offers to purchase as high as $60,000. By October 4, 1968, the rancher had recovered his costs and on that date transferred a 50% interest in the horse to the trainer. The following day a “Bill of Sale” was executed that described the transfer as a gift. The trainer continued to receive the standard training fee after the transfer. The court found that on November 1, 1968, the rancher and trainer had concluded a partnership agreement by parol to effectuate their design of racing the horse for as long as that proved feasible and of offering him out as a stud thereafter. Profits were to be shared equally by the [rancher] and the [trainer], while losses were to be allocated to the [rancher] alone.

The oral agreement was not reduced to writing until April of 1970. By amended returns, the rancher claimed he transferred the half interest in the horse as compensation for services and was entitled to a business expense deduction of $30,000, the value of the half interest based on the last offer to purchase prior to the transfer. He also reported the $30,000 as an amount realized and

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173. *Id.* at 722.
174. The parties initially assumed reporting postures different than those reflected in the amended returns. The rancher initially claimed no deduction by reason of the transfer of the half interest to the trainer. The trainer initially reported additional gross income in the amount of $5,000 that he identified as a gift interest in a racehorse.
claimed long term capital gain on the amount by which the $30,000 exceeded his basis in the half interest. The rancher's amended reporting posture, the trainer's amended returns reported the value of the half interest as ordinary income and further claimed that this inclusion in income gave him a $30,000 “tax cost basis” in his half interest. Finally, “purporting to have transferred the horse to a partnership in concert on November 1, 1968,” they together claimed that the partnership's basis in the horse was the sum of the rancher's adjusted basis in the half interest he contributed plus the trainer's $30,000 tax cost basis in the half interest he contributed. The inclusion of the trainer's tax cost basis led the partnership to claim triple the amount of depreciation deductions it had originally claimed. For 1969, the partnership claimed a depreciation deduction of $5,602 and reported a loss of $8,911. Pursuant to the partnership agreement, the entire loss was allocated to the rancher.

The court held for the taxpayers on all points, except that it found that the tax partnership was created by the October 4 transfer rather than by the November 1 oral agreement. It rejected the Commissioner's argument that the partnership's depreciable basis in the horse was limited to the rancher's basis at the time of his contribution.

When on the formation of a joint venture a party contributing appreciated assets satisfies an obligation by granting his obligee a capital interest in the venture, he is deemed first to have transferred to the obligee an undivided interest in the assets contributed, equal in value to the amount of the obligation so satisfied. He and the obligee are deemed thereafter and in concert to have contributed those assets to the joint venture.

The logic of this two-step analysis resulted in the holding that the partnership's basis in the horse included the trainer's $30,000 “tax

175. The rancher reported a $25,000 gain on the transfer by charging all depreciation deductions for the period prior to the transfer against his $5,000 basis in the half interest he retained. The court said that the depreciation for those months would have to be allocated between the half interest retained and the half interest transferred to the trainer.

176. The partnership's basis in contributed property is the contributing partner's adjusted basis in the property at the time of contribution. I.R.C. § 723 (1982).

177. The Commissioner had also argued that the transaction was a gift. The court rejected the gift analysis and was “undeterred in so doing by the fact that petitioners originally characterized the transfer as a gift” because the relationship of the parties “was essentially of a business nature.” 62 T.C. at 724-25.

178. Id. at 725.
cost basis” in the half interest he contributed.

The court’s explanation of its decision that the rancher was entitled to a $30,000 business expense deduction is both curious and significant. It began by stating:

When an interest in a joint venture is transferred as compensation for services rendered, any deduction which may be authorized under section 162(a)(1) by reason of that transfer is properly claimed by the party to whose benefit the services accrued, be that party the venture itself or one or more venturers. . . .

It reasoned that until the trainer received his interest, the rancher was the “sole” owner of the horse and recipient of its earnings and no joint venture existed. The court’s conclusion that the rancher “alone could have benefitted from the services rendered” prior to the transfer is less than obvious. Every dollar of winnings from the trainer’s efforts brought him closer to the transfer of the half interest in the horse that had rapidly and substantially appreciated in value. The court’s reasoning is significant because it could be applied in the case of a person who receives an interest in partnership profits as compensation for services. It has been suggested that the partnership gets a deduction for the value of the profits interest which may be specially allocated to the recipient of the profits interest so he will not be required to pay tax on a receipt that has not yet resulted in cash in hand. *McDougal* appears to suggest that such an approach is inappropriate because it allocates the deduction away from those who bear the burden and reap the benefit.

179. *Id.* at 728.

180. The court apparently did not question the appropriateness of the allocation of the entire 1969 partnership loss to the rancher. However, it did object to the extent to which the rancher had claimed depreciation. It held that the partnership had been formed on October 4, not on November 1, and that the rancher “[was] entitled to claim depreciation” on the horse “only until the transfer of October 4, 1968. Thereafter depreciation . . . ought to have been deducted by the joint venture in the computation of its taxable income.” 62 T.C. at 726. The holding that the rancher was not entitled to claim depreciation after the formation of the partnership is tantamount to a holding that it would be inappropriate, absent further facts, for the partnership to specially allocate all depreciation to him. The fact that the rancher reported all depreciation during the initial stage of the partnership’s life could have been treated as simply an informal special allocation of the depreciation deduction. *McDougal*, therefore, is at least some authority for the proposition that a partner who agrees to bear all economic losses may be allocated the entire amount of the partnership’s overall tax loss, but may not be allocated all depreciation deductions independent of other items of income or loss.
V. ELECTION OUT OF SUBCHAPTER K

We have seen that there are a variety of reasons why a particular co-owner who is deemed a tax partner might wish to avoid the application of some or all of the rules of Subchapter K. Most basically, he may want to independently compute the taxable income or loss flowing from his pro rata share of the business. For example, he may not wish to relinquish his choice of method of computing depreciation. Such a co-owner may find relief under the provisions of section 761(a), which authorize regulations to permit certain unincorporated organizations to elect to be excluded from the application of all or a part of Subchapter K. The “election-out” is one that can only be made with the consent of all of the members of the organization, and only if their income may be adequately determined without the computation of partnership taxable income.\(^\text{181}\) The election is only available to organizations that are availed of (1) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted;\(^\text{182}\) (2) for investment purposes only, and not for the active conduct of a business;\(^\text{183}\) or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.\(^\text{184}\) The Tax Court has said that the filing of a partnership return and an election-out under section 761(a) are not admissions of partnership status.\(^\text{185}\)

A. Operating Agreements

When the election-out provisions were first enacted in 1954, it was clear that Congress had oil and gas operating agreements foremost in mind.\(^\text{186}\) The regulations are more specific than the Code about the operating agreements that are eligible to elect to be excluded from all or a portion of Subchapter K, and they include more than oil and gas arrangements. They describe participants in the joint production, extraction, or use of property who

\[
\text{(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and}
\]

\(^{181}\) I.R.C. § 761(a) (1982).
\(^{185}\) Madison Gas, 72 T.C. at 558.
\(^{186}\) See Taubman, Oil and Gas Partnerships and Section 761(a), 12 Tax L. Rev. 49 (1956).
(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and
(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year. . . . 187

No election-out is available if one of the principal purposes of the organization is cycling, manufacturing, or processing for persons who are not members of the organization. 188

In Madison Gas, 189 the taxpayer argued that, in providing the election-out, Congress had in mind only oil, gas and mineral ventures acting under operating agreements and that the election-out provisions should not be broadly interpreted to include an operating agreement for the production of electricity. In rejecting this argument, the Seventh Circuit quoted commentary that Congress intended to establish an election not only for oil and gas, but for all types of operating agreements. 190

B. Investment Partnerships

Section 761(a)(1), which lists investment partnerships as a separate category of organization eligible for election-out, was part of the original election-out provision enacted in 1954. Basically, investments were included as a separate category, but subject to the same kinds of tests as operating agreements. Congressional intent behind the investment partnership category was not made clear in the legislative history, but one leading commentator of the day summarized the statutory scheme very nicely:

Investment as a method of passive business has generally been sufficient to take a trust out of the association category and therefore not taxable as a corporation, since investment purpose is not active business purpose. Investment not in the form of an association or a trust might be in a form classifiable under the partnership definition. As with oil and gas operating agreements, there is a twilight zone between partnership classification and tenancy in common. Government and the oil and gas industry have been in

188. Id.
189. 633 F.2d 512.
disagreement for almost a quarter of a century about this. Congress thus attempted to establish a workable formula which would be valid not only for oil and gas, but all types of operating agreements, as well as the related and equally difficult field of investment.191

The regulations define investment partnerships eligible for the exclusion to include participants in the joint purchase, retention, sale, or exchange of investment property who

(i) Own the property as coowners,
(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and
(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property . . . but not for a period of more than a year.192

C. Certain Dealers in Securities

The Revenue Act of 1978 imposed a penalty on partnerships that fail to file a partnership return.193 Historically, partnership returns had not been filed in the case of syndicates of dealers in securities formed for the purpose of underwriting, selling, or distributing a securities issue.194 Congress felt that “those syndicates which historically have not been treated as partnerships should be given the opportunity to avail themselves of the election under the Code not to be treated as a partnership for income tax purposes.”195 Accordingly, the Technical Corrections Act of 1979 amended section 761(a) to add a third category of organizations that may elect out of Subchapter K: those availed of “by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.”196

195. Id. Note that the legislative history incorrectly states the substantive result of the section 761(a) election out. The election out is not “for income tax purposes” in general, it is simply an election out of some or all of Subchapter K. See infra section V D. On the other hand, that same legislative history is support for the position that Congress does not intend such syndicates to be classified as partnerships for any purposes.
D. Limited Effect of Electing Out

An important word of caution about the election out: it is not a complete election out of partnership doctrine. Even if there is an effective election out of all of Subchapter K, a partnership can exist for the purposes of tax rules that lie outside of Subchapter K. Thus, in Madison Gas even though the three utilities filed a partnership return and elected out of Subchapter K, a partnership was held to exist, a new entity was deemed to have been inadvertently created, with its own new business and with outlays that were denied deductibility because they were pre-operating expenditures of that new partnership.

The section 761(a) election out is expressly limited to the provisions of Subchapter K. Another statutory basis for finding that a tax partnership can exist notwithstanding an election out of Subchapter K is the definition of partnership outside of Subchapter K. Section 7701(a)(2) defines partnership in essentially the same way as section 761(a), except it, together with 7701(a)(1), defines and declares a partnership to be a "person" for all purposes of the entire Code, "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof."

E. Time for Making Election for Exclusion

An eligible organization that wishes to be excluded from all of Subchapter K must make the election not later than the time required for filing the partnership return for the first taxable year for which exclusion from Subchapter K is desired. Nevertheless, even if the election is not timely made, it may be treated as if it had been timely made if it can be shown that it was the intention of the members of the organization at the time of formation to secure exclusion from all of Subchapter K beginning with the first taxable year of the organization. The regulations provide that the following are among the facts that may indicate the requisite intent:

(a) at the time of the formation of the organization there is an

197. See infra section IV D.
198. I.R.C. § 7701(a)(1), (2) (1982). See also Bryant v. Commissioner, 399 F.2d 800 (5th Cir. 1968), aff'd 46 T.C. 848 (1966), in which taxpayers found to be partners were told that they could not avoid the section 48(c)(2)(D) investment credit limitation on partnerships by an election out of Subchapter K.
agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or

(b) the members of the organization owning substantially all of the capital interest report their respective shares of the items of income, deductions and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization. ²⁰¹

F. Method of Making the Election

The election is to be made "in a statement attached to, or incorporated in, a properly executed partnership return, Form 1065." ²⁰² Even though a partnership return must be filed to make the election, the filing of the return and election will not be treated as an admission of partnership status. ²⁰³ The return shall be filed with the internal revenue officer with whom a partnership return would be filed if the organization were a partnership and no election were made. The principal office or place of business of the person filing the return shall be considered the principal office or place of business of the organization. ²⁰⁴ The partnership return shall contain, in lieu of the information required by Form 1065, only the name and address of the organization and, either on the return or an attached statement: the names, addresses, and identification numbers of all the members of the organization; a statement that it qualifies under the 761(a) regulations; ²⁰⁵ a statement that all of the members of the organization elect that it be excluded from all of Subchapter K; and a statement indicating where a copy of the agreement under which the organization operates is available (or if the agreement is oral, from whom the provisions of the agreement may be obtained). ²⁰⁶

The election will be effective unless within 90 days after the formation of the organization any member notifies the Commissioner both that he wants Subchapter K to apply and that he has so notified the other members of the organization by registered or certi-

²⁰¹ Id.
²⁰³ Madison Gas 72 T.C. at 558.
²⁰⁵ There are not yet regulations that specifically refer to section 761(a)(3).
The election is irrevocable as long as the organization remains qualified under the regulations, unless approval of revocation is obtained from the Commissioner.

An organization that wishes to be excluded from part, but not all, of Subchapter K, must submit a request for partial exclusion not later than 90 days after the beginning of the first taxable year for which partial exclusion is desired. The request should state the sections of Subchapter K from which exclusion is sought, that the organization qualifies under the regulations, and that the members of the organization elect to be excluded to the extent indicated. A request for a partial exclusion is only effective upon approval by the Commissioner, and is subject to any conditions he might impose.

VI. LIMITED PARTNERSHIPS UNDER STATE LAW

A. Historical Perspective

Perhaps the most interesting historical point to be made about the limited partnership in the United States is that it began as a corporate substitute. Today, it is the most ministerial of matters for entrepreneurs to set up a corporation and thereby avoid the unlimited personal liability imposed upon partners. Each state now has a "general incorporation act," so-called because it is a single statute that makes corporations generally available to anyone who follows a purely mechanical procedure. Creating a corporation is similar to what the process to obtain a driver's license would be if competency testing were stripped away. The result of one or two secretarial acts is the creation of what is, in the eyes of the law, a separate legal person, of potentially infinite life, that can engage in any lawful business activity. The general incorporation act provides for the relationships among the shareholders themselves, and the fundamental rule that the corporate entity insulates shareholders from liability to the outside world for claims arising from corporate business. General incorporation acts were hotly resisted...
throughout a large portion of our nation's history. In the beginning of the nineteenth century, the idea of the large corporation was viewed as vaguely un-American. It sounded too much like advocacy for a return to a royal family, self-perpetuating, aggrandizing and above-the-law, to urge the creation of legal persons, of potentially infinite life, behind whom the wealthy classes could hide, to engage in any activity and accumulate unlimited wealth. Initially, state legislatures would create corporations no faster than one at a time; it took a special statute to create each corporation. Shareholder freedom from personal liability was seen as an extraordinary statutory privilege; the personal liability of partners was the norm, and extraordinary justification had to be shown for deviating from that norm. Initially, the extraordinary justification was often found in the nature of the endeavor. State legislators were more willing to create corporations to insulate shareholders from personal liability for projects that were perceived to be particularly beneficial to the common weal, such as the construction of roads, bridges and barge canals.

Venture capitalists pressed their case. Here we are, they said, not only in a new land, at least new to us, but also in the middle of what years from now will be called the industrial revolution. Is it not desirable to have people place capital in these new, American enterprises? If so, it must be recognized that the venture capitalists will want a share in profits, but not at the risk of being deemed partners and held unlimitedly liable for all the claims that might arise from unprecedented undertakings. The arguments bore fruit in 1822, decades before any state was willing to pass a general incorporation act, when New York and Connecticut passed this country's first limited partnership statutes.

Based on the French Societe en Commandite, the limited partnership acts generally authorized the creation of partnerships with two classes of "partners," general and limited. This basic approach is similar to that utilized today. General partners are what we normally think of as partners, persons with full and equal power to run the business who are unlimitedly personally liable to the contract and tort creditors of the business. Limited partners, on the other hand, were passive investors who could lose their protected status as limited partners if they took part in the control of

the business. In short, if the limited partners were truly passive investors, and if they followed a statutorily prescribed procedure for publicly recording their status as passive investors, they would be insulated from personal liability to the creditors of the partnership.213

Limited partnership statutes spread, and limited partnerships became quite popular. However, by the late nineteenth century, interest in limited partnerships began to fade as the corporate form became more freely available. State legislatures had been passing, and then liberalizing, general incorporation acts. Initially, for example, it was common for state statutes to limit how long a corporate charter could last. Like today's so-called "sunset" legislation, corporate charters were created to expire, for example, after 20 years; only in time would perpetual corporations become acceptable. There were also limits on the amount of capital any particular corporation could have because the fear of unlimited accumulations of wealth lingered. Over time various restrictions were gradually, then rapidly liberalized, as some states actually competed with each other for success in what came to be perceived as the lucrative business of selling corporate charters.214

The limited partnership had not completely disappeared from the economic scene by the beginning of the twentieth century. It still had its uses, and that of Andrew Carnegie is one of the more notable.215 It is not entirely fortuitous that when general incorporation statutes were finally enacted, the corporation, at least at one level, appeared less regal and more "American." Indeed, the corporate structure looked very much like the American government. There were the shareholders, the people, who had the right to vote to elect a board of directors,216 a Congress, to make basic policy decisions. The board of directors, in turn, appointed management to carry out its basic policy mandates. Andrew Carnegie considered this model of the corporation an unwanted extension of democracy. He was an extraordinarily successful capitalist who felt that any investor participating in the profitability of his enterprise should be grateful for his profits and not meddle in management, by voting or otherwise. Carnegie did not want to be hampered by minor-

213. See infra section VI B, 1.
214. One of the most famous statements of the evolution of state corporation law is contained in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 548 (1933) (Brandeis, J., dissenting).
215. See J. Hurst, supra n.211, at 74.
ity shareholders, so he held Carnegie Steel in a limited partnership. The state statute authorizing the creation of limited partnerships was attractive precisely because it said that limited partners are not to take part in the control of the business. Andrew Carnegie notwithstanding, the limited partnership form lay fairly dormant until the middle of the twentieth century when, for reasons of federal income tax law rather than state law, it exploded into popular usage and came to be a household word in middle and upper class America.

B. The Uniform Limited Partnership Act

It was in this period of relative dormancy of the limited partnership that the U.L.P.A. was drafted. The National Conference of Commissioners on Uniform State laws approved the Uniform Partnership Act in 1914 and the U.L.P.A. in 1916. The U.P.A. applies not only to general partnerships, but also to limited partnerships "except in so far as the statutes relating to such partnerships are inconsistent" with the U.P.A. The U.L.P.A., therefore, can be seen as a supplement to the U.P.A. and as such it might be expected to be brief. Nevertheless, the U.L.P.A. is striking both in terms of the skimpiness of its provisions and the minimal nature of its Official Comments. Most simply, because of the dramatically increased availability of the corporate form, the U.L.P.A. was drafted at a time when it was not considered a particularly important form of business organization. Decades later, the emergence of publicly-syndicated limited partnerships created a demand for a Revised Uniform Limited Partnership Act, which was approved by the National Conference of Commissioners on Uniform State Laws in 1976.

1. Basic Purpose of U.L.P.A.

What little Official Comment there is makes clear that the basic purpose of the U.L.P.A. was to enlarge the category of limited partners who are to be insulated from personal liability. The Official Comment sets out three basic classes of supplied capital: one, the loan on interest; two, the loan in which the lender, in lieu of interest, takes a share in the profits of the business; three, situations in which the person advancing the capital secures, besides a share in the profits, some measure of control over the business. The early limited partnership acts were adopted at a time when it was generally held that any interest in the profits of a business
should make the person holding that interest liable for its obligations. Accordingly, in interpreting the original acts the courts assumed two principles as fundamental:

First: That a limited (or as he is also called a special) partner is a partner in all respects like any other partner, except that to obtain the privilege of a limitation on his liability, he has conformed to the statutory requirements in respect to filing a certificate and refraining from participating in the conduct of business. Second: The limited partner, on any failure to follow the requirements in regard to the certificate or any participation in the conduct of his business, loses his privilege of limited liability and becomes, as far as those dealing with the business are concerned, in all respects a partner.

These interpretative assumptions accurately reflected the intent behind the original statutes. But the law of inadvertent partnership had changed since the original limited partnership statutes were enacted. By the time the U.L.P.A. was being drafted, a man could “lend money to a partnership and take a share in the profits in lieu of interest without running serious danger of being bound for partnership obligations,” and this development had, to a very great extent, “deprived the existing statutory provisions for limited partners of any practical usefulness. Indeed, apparently their use is largely confined to associations in which those who conduct the business have not more than one limited partner.” Accordingly, the drafters of the U.L.P.A. scrapped the underlying assumptions of earlier limited partnership acts and sought to secure protection for the only category of capital supplier that still needed protec-

217. U.L.P.A. § 1, Official Comment, 6 U.L.A. at 562-63:
   At first, in the absence of statutes the courts, both in this country and in England, assumed that one who is interested in a business is bound by its obligations, carrying the application of this principle so far, that a contract where the only evidence of interest was a share in the profits made one who supposed himself a lender, and who was probably unknown to the creditors at the time they extended their credits, unlimitedly liable as a partner for the obligations of those actually conducting the business.
218. Id. at 563.
219. Id. at 563.
220. Id. at 563.
tion: those who obtain, in addition to a share in the profits, some measure of control over the business.

The U.L.P.A. replaced the assumptions of prior law with two boldly different ones:

First: No public policy requires a person who contributes to the capital of a business, acquires an interest in the profits, and some degree of control over the conduct of the business, to become bound for the obligations of the business; provided creditors have no reason to believe at the times their credits were extended that such person was so bound.

Second: That persons in business should be able, while remaining themselves liable without limit for the obligations contracted in its conduct, to associate with themselves others who contribute to the capital and acquire rights of ownership, provided that such contributors do not compete with creditors for the assets of the partnership.\(^2\)21

The U.L.P.A. Official Comment, which is so brief it doesn't say much, does make one fundamental point repeatedly: henceforth, a limited partner, "though in accordance with custom called a limited partner, is not in any sense a partner. He is, however, a member of the association."\(^2\)22

2. Formation of Limited Partnership

The U.L.P.A. defines a limited partnership as "a partnership formed by two or more persons under the provisions of Section 2, having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the obligations of the partnership."\(^2\)23 Section 2 provides for the execution and recordation of a certificate that states, *inter alia*, the names and places of residence of the general and limited partners, the agreed-upon contributions of the limited partners, the time when limited partner contributions are to be returned, the share of profits or other compensation by way of income which each limited partner shall receive, and the right, if any, of the partners to admit additional limited partners.\(^2\)24 In short, the certificate requires dis-

\(^{221}\) Id. at 564.
\(^{222}\) Id. at 564 (emphasis added). See Bassan v. Investment Exchange Corp., 524 P.2d 233 (Wash. 1974), in which a general partner was held to a strict standard of fiduciary duty to limited partners.
\(^{223}\) U.L.P.A. § 1, 6 U.L.A. at 562.
\(^{224}\) See U.L.P.A. § 2(1)(a), 6 U.L.A. at 568, for the list of items required to be included
closure of who the general and limited partners are and might be, what the limited partners invest, and what the limited partners are promised in return.

A limited partnership "is formed if there has been substantial compliance in good faith" with the requirement to record the described certificate.225 The drafters clearly intended that a limited partner, who, in their eyes, "is not in any sense a partner,"226 should not be automatically converted into a general partner because of a failure to strictly comply with the certificate filing requirements:

As limited partners are not partners securing limited liability by filing a certificate, the association is formed when substantial compliance, in good faith, is had with the requirements for a certificate (Sec. 2(2)). This provision eliminates the difficulties which arise from the recognition of de facto associations, made necessary by the assumption that the association is not formed unless a strict compliance with the requirements of the act is had.227

Perhaps because the drafters clearly intended that limited partners not be liable as general partners simply for failure to file a certificate, some courts have followed the basic purpose of the statute and held that a limited partnership has been formed notwithstanding a failure to file.228 Indeed, even a failure to file that results in non-formation of the limited partnership does not automatically make the would-be limited partner liable as a general partner.229

3. Failure to Record Certificate

At first blush, it might seem difficult to conclude that a limited partnership has been formed if no certificate has been filed. Stated differently, how can there be "substantial compliance in good faith" with the filing requirements of the U.L.P.A. if nothing is filed? There are two basic issues that are interrelated but must be

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in the certificate of limited partnership.
226. See infra section VI B, 1.
228. See, e.g., Garrett v. Koepke, 569 S.W.2d 568 (Tex. Civ. App. 1978). This approach has also been adopted for tax purposes. In Laney v. Commissioner, 674 F.2d 342 (5th Cir. 1982), the court held that a limited partnership was formed even though no certificate was filed. But see Heritage Hills v. Zion's First Nat'l. Bank, 601 F.2d 1023 (9th Cir. 1979).
229. See infra section VI B, 3.
distinguished. One, has a limited partnership been formed notwithstanding the failure to file? Two, if a limited partnership has not been formed, are the limited partners liable as general partners?230

With respect to the first issue, the courts appear to be divided. Some apparently assume that no limited partnership can exist until a certificate is filed.231 Others have emphasized that the U.L.P.A. does not state precisely when a certificate must be filed or when in relation to its filing the limited partnership begins,232 or have emphasized the lack of creditor reliance. One refreshing opinion said that the purpose of filing is simply to provide notice, and if creditors have notice that they are dealing with a limited partnership, they cannot rely on the fortuity of a failure to file to achieve a windfall.233

With respect to the second issue, some courts seem to assume that if no limited partnership has been formed, the would-be limited partners automatically become general partners.234 This is clearly an incorrect assumption. The drafters of the U.L.P.A. stated very directly: "The limited partner not being in any sense a principal in the business, failure to comply with the requirements of the act in respect to the certificate, while it may result in the nonformation of the association, does not make him a partner or liable as such."235 Thus, the would-be limited partner whose certificate has not been filed must fall within the usual definition of "partner" before he can be burdened with personal liability.236 Moreover, U.L.P.A. section 11 addresses the situation in which the failure to file results in nonformation of a limited partnership:

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230. Another basic question that could be raised is whether the "substantial compliance" test is to be applied at the partnership level or at the level of each individual partner. What, for example, if counsel for a limited partner was incorrectly told by counsel for a promoter-general partner that a certificate had been filed? Cf. Franklin v. Rigg, 237 S.E.2d 526, 528 (Ga. App. 1977), which emphasized that "the general tenor of the [U.L.P.A.] is remedial and drawn with the purpose of protecting investors where there is a substantial compliance on their part."


232. In Franklin, 237 S.E.2d at 527, the court said the U.L.P.A. "is admittedly vague as to the time when the existence of the partnership commences."

233. Garrett v. Koepke, 569 S.W.2d 568, 570-71 (Tex. Civ. App. 1978): "We hold, therefore, that where a party has knowledge that the entity with which he is dealing is a limited partnership, that status is not changed by failing to file."

234. See, e.g., Dwinell's Central Neon, 587 P.2d 191.


236. See infra section II D.
A person who has contributed to the capital of a business conducted by a person or partnership erroneously believing that he has become a limited partner in a limited partnership, is not, by reason of his exercise of the rights of a limited partner, a general partner with the person or in the partnership carrying on the business, or bound by the obligations of such person or partnership; provided that on ascertaining the mistake he promptly renounces his interest in the profits of the business, or other compensation by way of income.\textsuperscript{237}

The Supreme Court has said that this section is "broad and highly remedial" and that the existence of a partnership — limited or general — is not essential in order that it apply.\textsuperscript{238} At least one case has held that a return of profits previously received is not required; it is sufficient to renounce the right to receive profits in the future.\textsuperscript{239}

4. The "Control" Limitation

U.L.P.A. section 7 provides: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."\textsuperscript{240} There are two basic questions presented by this section. First, what constitutes "control" within the meaning of this section? It should be emphasized that it was anticipated by the drafters that limited partners take "some degree of control over the conduct of the business."\textsuperscript{241} Second, what are the consequences if a prohibited amount of control is exercised by a limited partner? It should be noted that many have stated that limited partners are automatically liable as general partners if they take part in the control of the business. That is not what the statute says; that would have been an easy thing for the drafters to say, and that is not what they said. They said that a limited partner "shall not become liable as a general partner unless . . . he takes part in the control of the business." That is, the exercise of control is a minimum requirement before a limited partner will be deemed a general partner; the statute does not expressly state that the

\textsuperscript{238.} Giles v. Vette, 263 U.S. 553, 561-63 (1924).
\textsuperscript{240.} U.L.P.A. § 7, 6 U.L.A. at 582. The lack of control in limited partners has led to detailed regulation of limited partnership interests as securities.
\textsuperscript{241.} See infra section VI B, 1.
mere exercise of control is sufficient. In short, at least in some jurisdictions, there appears to have emerged a reliance requirement that must be proved before third parties can assert the personal liability of limited partners who have exercised too much control.\textsuperscript{242}

*Delaney v. Fidelity Lease, Ltd.,\textsuperscript{243}* is a landmark case imposing personal liability on limited partners on the ground that they exercised control. The plaintiffs leased land to a limited partnership that had a corporation as its only general partner and twenty-two individuals as its limited partners. Three of the individual limited partners were directors, officers and shareholders of the corporate general partner. The lease was executed by “Fidelity Lease, Ltd., a limited partnership acting by and through Interlease Corporation, General Partner,”\textsuperscript{244} thus leaving no suggestion that any of the limited partners was to be personally liable. Indeed, it is hard to interpret the lease as anything other than a clear statement that the limited partners were not to be personally liable. The lease required the plaintiffs to build a restaurant, which they did, and required the limited partnership to take possession and pay rent, which it failed to do.

Liability was clear as to the limited partnership itself and, consequently, as to the corporate general partner. However, it was also clear that the liability of the partnership and its corporate general partner were worthless. Initially, the plaintiffs sued all the limited partners, apparently on the theory that no limited partnership had been formed because a corporation cannot be the only general partner in a limited partnership. The U.L.P.A. requires “one or more general partners and one or more limited partners,”\textsuperscript{245} and the plaintiffs’ position was that a corporation cannot be a “legal general partner.” The action was dropped against the limited partners who were not involved in the general partner and, amazingly, the court specifically declined to decide whether a corporation can ever become a “legal general partner.”\textsuperscript{246} The action proceeded, and was successful, against the three limited partners who were the

\textsuperscript{242} See Feld, The “Control” Test for Limited Partnerships, 82 Harv. L. Rev. 1471 (1969). The imposition of general liability on a limited partner who exercises control may be prospective from exercise point and not retrospective. That is, he will not necessarily be held liable as a general partner ab initio. See Garrett, 569 S.W.2d at 568.

\textsuperscript{243} 526 S.W.2d 543 (Tex. 1975).

\textsuperscript{244} Id. at 545.

\textsuperscript{245} U.L.P.A. § 1, 6 U.L.A. at 562.

\textsuperscript{246} 526 S.W.2d at 546.
directors, officers and shareholders of the corporate general partner. The court seemed to focus on them in their capacity as officers, and concluded both that they had exercised an impermissible level of control, and that they were accordingly personally liable.

The case represents an unfortunate windfall for the plaintiffs, who had not bargained for the personal liability of the limited partners.247 Indeed, it appears that the freedom of the limited partners from personal liability was at the essence of the bargain struck. The court repudiated the argument that reliance should be part of the plaintiffs' case or that lack of reliance should be an affirmative defense: "The statute makes no mention of any requirement of reliance on the part of the party attempting to hold the limited partner personally liable."248

Unhampered by any reliance requirement that other courts had found, the court concluded that the three limited partners were liable because they had exercised control of the partnership within the meaning of U.L.P.A. section 7. They had argued that it was their corporation, not they, who exercised the control, and that the corporate existence should not be ignored. The court ignored the existence of the corporation, stating that "courts will disregard the corporate fiction . . . where it is used to circumvent a statute." In the case of limited partnerships, "[s]trict compliance with the statute is required if a limited partner is to avoid liability as a general partner."249 The statute requires that there be at least one general partner.250 If the sole corporate general partner were not ignored, "the statutory requirement of at least one general partner with general liability in a limited partnership can be circumvented or vitiated by limited partners operating the partnership through a

247. Compare the better-reasoned opinion of the court below:

The logical reason to hold a limited partner to general liability under the control prohibition . . . is to prevent third parties from mistakenly assuming that the limited partner is a general partner and to rely on his general liability. However, it is hard to believe that a creditor would be deceived where he knowingly deals with a general partner which is a corporation. That in itself is a creature specifically devised to limit liability. The fact that certain limited partners are shareholders, directors or officers of the corporation is beside the point where the creditor is not deceived.


248. 526 S.W.2d at 545.

249. 526 S.W.2d at 546. Compare U.L.P.A. § 28(1), 6 U.L.A. at 617: "The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this act."

corporation with minimum capitalization and therefore minimum liability."

A different result was reached under a remarkably similar set of facts in *Frigidaire Sales Corp. v. Union Properties, Inc.* The plaintiff in *Frigidaire* sued two limited partners who were also directors, officers and shareholders of the corporation that was the only general partner of a limited partnership that had breached its contract with plaintiff. It was accepted as a matter of fact that the two limited partners "controlled [the corporate general partner] and through their control of [the corporate general partner] they exercised the day-to-day control and management of [the limited partnership]." Nevertheless, the Supreme Court of Washington held that the two limited partners were not personally liable.

The court first made clear that it is permissible in Washington to have a limited partnership with a corporation as the sole general partner. The U.P.A., which applies to limited partnerships absent express provision to the contrary, expressly provides that a corporation is a "person" who may become a partner. Because there is no express provision to the contrary, corporations may also be partners in limited partnerships. This conclusion was reinforced by an amendment to the Washington limited partnership act that anticipated a vote by the limited partners on the "transfer of a majority of the voting stock of a corporate general partner." The court distinguished *Delaney* on the ground that the corporation and the limited partnership were set up contemporaneously, and the sole purpose of the corporation was to operate the limited partnership. The *Delaney* court was concerned that the limited partners who controlled the corporation were obligated to operate the corporation for the benefit of the partnership.

This is not the case here. The pattern of operation of [the corporation that was the only general partner of the limited partnership in question] was to investigate and conceive of real estate investment opportunities and, when it found such opportunities, to cause the creation of limited partnerships with [itself] acting as the general partner. [The limited partnership in question] was

251. 526 S.W.2d at 546.
252. 562 P.2d 244 (Wash. 1977).
253. Id. at 245.
only one of several limited partnerships so conceived and created. [The two limited partners] did not form [the corporate general partner] for the sole purpose of operating [the one limited partnership in question]. Hence, their acts on behalf of [the corporation] were not performed merely for the benefit of [the one limited partnership].

Despite this attempt to distinguish *Delaney* on its facts, it was clear that the Supreme Court of Washington differed in its basic approach to the issue. Whereas *Delaney* sought to give substance to the requirement of one general partner by insisting that there be meaningful personal liability, the *Frigidaire* court felt that the concern with minimum capitalization may arise anytime a creditor deals with a corporation. Given that a corporation may be the sole general partner, "this concern about minimum capitalization, standing by itself, does not justify a finding that the limited partners incur general liability for their control of the corporate general partner." The court said that if a corporate general partner is inadequately capitalized, creditors are protected under the "piercing-the-corporate-veil" doctrine of corporate law. However, when the limited partners control the corporation only in their capacities as agents for it, and no creditors are misled into thinking they are acting on their own behalf, the *Frigidaire* court will respect the separate corporate existence and refuse to impose personal liability on the limited partners.

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257. 562 P.2d at 246. The dissent more directly rejected the reasoning of the Texas court that,

because the limited partners acted as officers of the corporate general partner, they "were obligated to their other partners to so operate the corporation as to benefit the partnership." 517 S.W.2d at 426. We find no inherent wrong in this. Persons in the position of the individual defendants in this case would be bound to act in the best interests of both the corporate general partner and the limited partners under the guidelines of RCW 25.08.120. The dual capacities are not inimical as asserted.


258. 562 P.2d at 246.

259. A somewhat different approach was taken in Mursor Builders, Inc. v. Crown Mountain Apartment Assocs., 467 F. Supp. 1316 (V.I. 1978). The court noted the "literal" approach of *Delaney* that focused on "control" and seemed to indicate sympathy for the *Frigidaire* approach that considered "creditor reliance."

However, third party reliance is not the sole criterion. Some meaning must be given to the language embodied in [the control limitation]. I do not hold that merely by acting as officers of a corporate general partner, limited partners become subject to general liability. Rather, I hold that where, as herein, the corporate officers co-mingle partnership funds with personal funds, fail to maintain complete corporate and partnership financial records, utilize corporate and part-
C. The Revised Uniform Limited Partnership Act

By the 1970's, the limited partnership had become a well-established and extremely popular form of business organization. It offered limited partners the freedom from personal liability which a shareholder enjoys and tax treatment as members of a partnership. The new popularity of the limited partnership, particularly as a vehicle for delivering "tax shelter" to investors, created pressure for revision of the barebones U.L.P.A. Accordingly, a Revised Uniform Limited Partnership Act (Revised Act) was adopted by the National Conference of Commissioners on Uniform State Laws in 1976.260 The Revised Act is a more detailed statute than the U.L.P.A., and was intended both to clarify prior law and to make certain important substantive changes.

I. Formation and Failure to File

The Revised Act provides: "In order to form a limited partnership two or more persons must execute a certificate of limited partnership."261 The Revised Act certificate must set forth essentially the same kind of information as under the U.L.P.A. The certificate is intended to serve two basic functions: first, to place creditors on notice of the facts concerning the capital of the partnership and the rules regarding additional contributions to and withdrawals from the partnership; second, to clearly delineate the time at which persons become general partners and limited partners. The Revised Act provides that the certificate shall be filed in the office of the Secretary of the State and that:

A limited partnership is formed at the time of the filing of the certificate of limited partnership in the office of the Secretary of State or at any later time specified in the certificate of limited partnership if, in either case, there has been substantial compliance with the requirements of this section.262

262. Id. § 201(b) at 168.
The Revised Act appears to make it more difficult to argue that a limited partnership has been formed notwithstanding the failure to file a certificate. The Revised Act, unlike the U.L.P.A., specifies that a limited partnership is formed "at the time of the filing of the certificate of limited partnership." On the other hand, the Commissioners' Comment to the formation section states that it is based upon prior law. Furthermore, the language that "[i]n order to form a limited partnership two or more persons must execute a certificate" suggests that it is the execution of the certificate, and not the recording of the certificate that is the minimal necessary act. Similarly, the Commissioners' Prefatory Note states that the certificate of limited partnership "is a statutory prerequisite to creation of the limited partnership;" it does not specify that the statutory prerequisite is the filing of the certificate. Finally, the Revised Act defines the term "limited partner" to mean "a person who has been admitted to a limited partnership as a limited partner in accordance with the partnership agreement and named in the certificate of limited partnership as a limited partner." Once again, there is no mention of the filing of the certificate. The Commissioners' Comment to this definition contains the following statement: "[T]he definition makes it clear that being named in the certificate of limited partnership is a prerequisite to limited partner status. Failure to file does not, however, mean that the participant is a general partner or that he has general liability." This language, although ambiguous, arguably suggests that a person can become a limited partner by being named in the certificate even if the certificate is not filed. On the other hand, it may simply mean that an investor is not automatically liable as a general partner merely because failure to file has resulted in nonformation of a limited partnership. The section that deals with people who mistakenly believe they are limited partners also indicates that liability as a general partner does not automatically follow from a fail-

263. Id. § 201, Commissioners' Comment, at 169. See section VI B, 3, supra, for conflicting authority under the U.L.P.A.
264. Id. Commissioners' Prefatory Note at 159.
265. Id. § 101(6) at 163.
266. Id. Commissioners' Comment at 164.
267. See B. Lane & D. Fakl, Limited Partnerships: Legal and Business Aspects of Organizations, Operation and Dissolution, 24 CORPORATE PRACTICE SERIES 12 (BNA 1981): "Under the Revised ULPA, recording a certificate is an absolute prerequisite to limited partnership status, for as the Commissioners' Comment states, one of the purposes of the recording requirement is to clearly delineate the time at which persons become general partners and limited partners."
2. **Person Erroneously Believing Himself a Limited Partner**

The Revised Act provisions concerning people who erroneously believe that they are limited partners are only slightly different from those under the U.L.P.A.

§304. [Person Erroneously Believing Himself Limited Partner]

(a) Except as provided in subsection (b), a person who makes a contribution to a business enterprise and erroneously but in good faith believes that he has become a limited partner in the enterprise is not a general partner in the enterprise and is not bound by its obligations by reason of making the contribution, receiving distributions from the enterprise, or exercising any rights of a limited partner, if, on ascertaining the mistake, he:

1. causes an appropriate certificate of limited partnership or a certificate of amendment to be executed and filed; or
2. withdraws from future equity participation in the enterprise.

(b) A person who makes a contribution of the kind described in subsection (a) is liable as a general partner to any third party who transacts business with the enterprise (i) before the person withdraws and an appropriate certificate is filed to show withdrawal, or (ii) before an appropriate certificate is filed to show his status as a limited partner and, in the case of an amendment, after expiration of the 30-day period for filing an amendment relating to the person as a limited partner under Section 202, but in either case only if the third party actually believed in good faith that the person was a general partner at the time of the transaction.

This section is derived from U.L.P.A. section 11. The “good faith” requirement in the first sentence of section 304(a) is new. Subsection (a)(2) “was intended to clarify an ambiguity in the prior law by providing that a person who chooses to withdraw from the enterprise in order to protect himself from liability is not required to renounce any of his then current interest in the enterprise so long as he has no further participation as an equity participant.”

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268. Id. § 304 at 175-76.
269. Id. § 304 at 175-76 (emphasis added).
270. Id. § 304, Commissioners’ Comment at 176. It is not clear what the distinction is
agraph (b) "preserves the liability of the equity participant prior to withdrawal (and after the time for appropriate amendment in the case of a limited partnership) to any third party who has transacted business with the person believing in good faith that he was a general partner." 271

3. Limited Partners Can Contribute Services

One of the most significant changes made by the Revised Act is that limited partners may now contribute services for their partnership interests. Under the U.L.P.A., "[t]he contributions of a limited partner may be cash or other property, but not services." 272 Under the Revised Act, a limited partner may receive an interest not only for services performed, but for a promise to perform services in the future: "The contribution of a partner may be in cash, property, or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services." 273 A description and statement of the agreed value of the services contributed by each partner and which each partner has promised to contribute in the future must be included in the certificate of limited partnership. 274 In the case of a promise to perform services, the value stated in the certificate may determine the liability of a partner who fails to honor his agreement:

Except as provided in the certificate of limited partnership, a partner is obligated to the limited partnership to perform any promise . . . to perform services, even if he is unable to perform because of death, disability or any other reason. If a partner does not make the required contribution of . . . services, he is obligated at the option of the limited partnership to contribute cash equal to that portion of the value (as stated in the certificate of limited partnership) of the stated contribution that has not been made. 275

between his "then current interest in the enterprise" and "further participation as an equity participant."

271. Id.
273. R.U.L.P.A. § 501, 6 U.L.A. at 179 (1982 Supp.). See also § 101(2), at 163: "'Contribution' means any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to perform services, which a partner contributes to a limited partnership in his capacity as a partner."
274. Id. § 201(a)(5) at 168.
275. Id. § 502(a) at 179-80.
Furthermore, if the partnership agreement fails to provide how profits and losses and distributions are to be allocated among the partners, they will be allocated on the basis of the value stated in the certificate of the contributions made by each partner to the extent they have been received by the partnership and have not been returned.

4. The "Control" Limitation

Uncertainty about the "control" limitation under U.L.P.A. section 7 has been viewed as one of the major disadvantages of doing business in the limited partnership form. The Revised Act begins with a basic statement of the control limitation that is very much like U.L.P.A. section 7:

Except as provided in subsection (d) [dealing with the improper use of a limited partner's name in the partnership name], a limited partner is not liable for the obligations of a limited partnership unless he is also a general partner or, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.276

This language was intended "to insure that judicial decisions under the prior uniform law remain applicable to the extent not expressly changed."277 The Revised Act then continues with a much more extensive treatment of the control limitation than under the U.L.P.A. First, the Revised Act provides that "if the limited partner's participation in the control of the business is not substantially the same as the exercise of the powers of a general partner, he is liable only to persons who transact business with the limited partnership with actual knowledge of his participation in control."278 Because of the difficulty in determining when the "control" limitation is violated, the drafters thought it was unfair to impose general partner's liability on a limited partner except to the extent that a third party had knowledge of his participation in control. On the other hand, the "is not substantially the same as" test was introduced "in order to avoid permitting a limited partner to exercise all of the powers of a general partner while avoiding any direct dealings with third parties."279

276. Id. § 303(a) at 174.
277. Id. § 303, Commissioners' Comment at 175.
278. Id. § 303(a) at 174.
279. Id. § 303, Commissioners' Comment at 175.
Second, the R.U.L.P.A. provides a “safe harbor” by listing certain activities that a limited partner may carry on for the partnership without being deemed to have taken part in the control of the business. A limited partner does not participate in the control of the business solely by being a contractor for or an agent or employee of the limited partnership or of a general partner, consulting with or advising a general partner with respect to the business of the limited partnership, acting as a surety for the limited partnership, or approving or disapproving an amendment to the partnership agreement. In addition, a limited partner does not take part in control solely by voting on one or more of the following matters:

(i) the dissolution and winding up of the limited partnership;
(ii) the sale, exchange, lease, mortgage, pledge or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business;
(iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;
(iv) a change in the nature of the business; or
(v) the removal of a general partner.280

This list of “safe” activities is not intended to be exclusive.281 As will be discussed below, the addition of so-called “democracy rights” for limited partners may make a limited partnership look more like a corporation than a partnership for federal income tax purposes.

VII. TAX CLASSIFICATION OF LIMITED PARTNERSHIPS

A. Short Summary

The category of partnership for federal income tax purposes is broader than the category of partnership under state law. Recall that “partnership” is a residual category: it includes any business group or venture that is not a corporation or a trust or estate.282 Recall, also, that the limited partnership began as a corporate antecedent to offer venture capitalists shareholder-type freedom from personal liability. Given that a corporation can be a general part-

280. Id. § 303(b) at 174-75.
281. Id. § 303(c) at 175.
The question arises: how is a limited partnership, particularly a limited partnership that has no other general partner than a corporation, classified for tax purposes? Is the corporate antecedent with a sole corporate general partner not a corporation for tax purposes? If it is not, then it falls within the residual category of tax partnership.

The short and, to many practitioners, the sweet of it is that, under the present classification regulations, as interpreted by a major Tax Court decision in which the Service has indicated its acquiescence, it appears virtually impossible for any U.L.P.A. limited partnership, including one that has a sole corporate general partner, to be treated as anything other than a partnership for tax purposes. The relevant regulations were drafted at a time when the Treasury resisted efforts by certain unincorporated professional associations to be classified as corporations for tax purposes. Although unincorporated, these associations were structured and documented in an attempt to make them look as much like corporations as possible. The goal was to have the organizations classified as corporations for tax purposes to permit them to deduct outlays for various fringe and retirement benefits. The Treasury resisted these efforts by drafting regulations that made it virtually impossible for these organizations to achieve corporate classification. The regulations narrow the definition of a corporation for tax purposes and open wide the residual category of partnership, making it virtually impossible for any Uniform Act general or limited partnership to ever be classified as anything other than a partnership for federal income tax purposes. There are two basic features of the regulations that reflect the strong bias toward partnership classification. First, they identify four characteristics that tend to be found in a "pure corporation" and state that three of the four must be found before an organization will be classified as a corporation. This "numerical supremacy test" provides that, if only two of these characteristics are present, partnership classification results. Second, the regulations define these characteristics in bizarre

283. See infra section VI B, 4 for unusual equivocation on this point in Texas.
284. Regulations under the Revenue Act of 1916 first took the position that all limited partnerships were taxable as corporations. Reg. 33, Art. 62. However, these regulations were soon replaced by regulations that applied a "resemblance" test. Reg. 45, Arts. 1505, 1506 (1918). For a history of the classification question, see Sexton & Osteen, Classification as a Partnership or an Association Taxable as a Corporation, 24 TUL. TAX INST. 95 (1975). Compare Heritage Hills v. Zion's First National Bank, 601 F.2d 1023 (9th Cir. 1979), in which it was held that a limited partnership composed entirely of corporations was not a corporation for purposes of Chapter 12 of the Bankruptcy Act.
ways. The bizarre definitions are biased toward making it virtually impossible for more than two of these characteristics to ever be found in any U.P.A. general partnership or any U.L.P.A. limited partnership. The Treasury drafted a regulation that was a weapon against the professional association. Once that weapon was on the books, it attracted the attention of people who wanted to market tax shelters to high-bracket investors. Tentatively at first, they dusted off old books on limited partnerships and began using them as devices to "pass through" losses to passive investors, investors with no personal liability. The private sector, particularly the real estate industry, became delighted with the Treasury's weapon. The limited partnership was "born again" and rapidly achieved unprecedented prominence.

*Larson v. Commissioner,* is the major Tax Court decision that allows taxpayers to rely on the Treasury's regulations to achieve partnership classification for limited partnerships, including those with sole corporate general partners. Before discussing the regulations, which will be done in the context of *Larson,* two pre-*Larson* Revenue Procedures will be discussed. Each sets out conditions that must be present before the Service will give an advance ruling on the tax classification of a limited partnership. It would seem, particularly after *Larson,* that their conditions should not be viewed as substantive requirements. However, the Service continues to issue private letter rulings that purport to condition partnership classification on compliance with their conditions. In so doing, the Service seems to be resisting what appears to be the unavoidable consequence of *Larson:* that every U.L.P.A. limited partnership will be classified as a partnership for tax purposes, and that every limited partner will be a member of the partnership for tax purposes.

### B. Advance Rulings: Revenue Procedure 72-13

In Revenue Procedure 72-13, the Service stated conditions that must be present before it will issue advance rulings on the tax classification of limited partnerships that have a corporation as the sole general partner. First, the limited partners may not own, directly or indirectly, individually or in the aggregate, more than twenty percent of the corporate general partner or any affiliates. Second, a net worth requirement is imposed upon the corporation.

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286. 1972-1 C.B. 735.
If the corporate general partner has an interest in only one limited partnership and the total contributions to that partnership are less than $2,500,000, the net worth of the corporate general partner at all times must be at least fifteen percent of the total contributions or $250,000, whichever is less. If the total contributions are $2,500,000 or more, the net worth of the corporate general partner at all times must be at least ten percent of the total contributions. In computing its net worth, the corporate general partner's interest in the limited partnership and accounts and notes receivable from and payable to the partnership are excluded. If the corporate general partner has interests in more than one limited partnership, these net worth requirements will be applied separately for each partnership, and the general partner must at all times have a net worth at least as great as the sum of the amounts required for each separate limited partnership. Third, the purchase of a limited partnership interest by a limited partner cannot entail either a mandatory or discretionary purchase or option to purchase any type of security of the corporate general partner or its affiliates.

Although technically only a statement of when advance rulings would be given, Revenue Procedure 72-13 suggested that the Service was going to aggressively challenge the tax classification of limited partnerships. Furthermore, in situations in which an advance ruling was a practical necessity, the requirements had the same effect as binding rules of law. Many in the tax bar felt that the requirements were substantively unfounded. Consider, for example, the net worth requirement for the corporate general partner. Years later, the American Law Institute would report that Revenue Procedure 72-13's net worth requirement would be a good way to revise the definition of the corporate characteristic of limited liability, impliedly rejecting the idea that it is a reasonable application of the present regulations.

287. As this article was going to press, the Service announced it will conduct a study of the rules on tax classification, with special emphasis on the significance of the characteristic of limited liability. Ann. 83-4, 1983-2 I.R.B. 31 (Jan. 10, 1983), provides, in part:

This study will consider the possible application of the minimum capitalization requirement of Revenue Procedure 72-13, 1972 C.B. 735, to all entities seeking classification as partnerships for federal tax purposes. That requirement could be applied either as an advance ruling policy or as a substantive rule. The study also will reconsider the IRS' acquiescence in the (sic) Phillip G. Larson, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1, to the extent the acquiescence is inconsistent with that minimum capitalization requirement.


289. FEDERAL INCOME TAX PROJECT, 92 (Tent. Draft No. 7, 1981) [hereinafter cited as
C. Advance Rulings: Revenue Procedure 74-17

In Revenue Procedure 74-17, the Service announced that unless the following "operating rules" are complied with, it would "ordinarily" decline to issue a requested ruling or determination letter:

.01 The interests of all of the general partners, taken together, in each material item of partnership income, gain, loss, deduction or credit is equal to at least one percent of each such item at all times during the existence of the partnership. In determining the general partners' interests in such items, limited partnership interests owned by the general partners shall not be taken into account.

.02 The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the partnership.

.03 A creditor who makes a nonrecourse loan to the limited partnership must not have or acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor.

Once again, this revenue procedure was met with criticism from practitioners as imposing on limited partnerships requirements that had no foundation in law. Indeed, these "operating rules" to obtain tax classification rulings and determination letters seem to have little to do with the existing regulations on tax classification. Instead, they seem aimed at other features of tax shelters the Service finds offensive, such as special allocations of deductions and losses that divert tax benefits from promoters to investors, the use of nonrecourse loans by promoters that are more properly characterized as contributions to capital, and various techniques for claiming front-end write-offs and accelerating deductions into the earlier years of the partnership.

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T.D. No. 7]: "The limited liability characteristic can be revised to provide a substantial net worth requirement. Section 72-13 provides a reasonable rule for this purpose."
291. Id. at 439.
293. Rev. Proc. 75-16, 1975-1 C.B. 676, outlines information that is required but frequently omitted in requests for rulings on the tax classification of limited partnerships:
.01 General
1. The name and identification number of the organization.
D. The Numerical Supremacy Test

If a limited partnership is not an "association" taxable as a cor-

2. A description of the business of the organization.
3. The date and place where the partnership certificate was or will be filed.

.02 Partnership Agreement
1. The partnership agreement and all amendments to it.
2. A statement whether the State in which the organization is formed has adopted, as applicable, the Uniform Partnership Act or the Uniform Limited Partnership Act.
3. A list of all substantial differences between the applicable State Act and the Uniform Act.
4. A copy of the applicable State partnership acts and all amendments thereto pursuant to which the organization was or will be formed.

.03 Partnership Certificate.
1. The partnership certificate filed or to be filed with the State in which the organization is formed.

.04 Registration Statement.
1. The registration statement filed or to be filed with the Securities and Exchange Commission. (A draft is acceptable.)
2. If a registration statement is not required to be filed with the Securities and Exchange Commission, then documents filed or to be filed with any agency engaged in the regulation of securities, whether Federal or State, and any private offering memorandum. (Drafts are acceptable.)
3. A description of all arrangements made with regard to the marketing of interests in the organization, such as arrangements with brokers, underwriters, and dealers.

.05 Net Worth
1. A representation of the net worth of the general partner(s).
2. Financial data to support the representation including, for example, audited balance sheets or unaudited balance sheets with a representation that it is prepared in accordance with generally accepted accounting principles.

.06 Promotional Material.
1. An outline or a highlighted copy of all promotional material used to sell interests in the organization, particularly including statements made regarding the probable tax consequences of the arrangement and the effect of the requested ruling upon such tax consequences.

.07 Creditors' Interests.
1. A detailed description of all creditors' interests in the organization or its assets, other than security interests and rights to repayment.
2. A detailed description of all benefits that creditors may receive, such as rights of conversion or exchange into any other interest, rights of recourse against property other than the property being developed with the loan proceeds, or benefits that accrue to neighboring property owned by creditors because of the loan of money to the organization.

.08 Capital Contribution.
1. A statement indicating the amount of the capital contribution made or to be made both by the general partner(s) and the limited partner(s) to the organization, and, if a general partner is also a limited partner, the capacity in which the contribution was or will be made.

.09 Profits and Losses.
poration, it will fall into the residual category of partnership for
tax purposes. The regulations list

a number of major characteristics ordinarily found in a pure cor-
poration which, taken together, distinguish it from other organi-
zations. These are: (i) associates, (ii) an objective to carry on busi-
ness and divide the gains therefrom, (iii) continuity of life, (iv)
centralization of management, (v) liability for corporate debts
limited to corporate property, and (vi) free transferability of
interests.\textsuperscript{294}

The regulations also state that, in addition to these "major" fac-
tors, "other factors may be found . . . which may be significant in
classifying an organization as an association, a partnership, or a
trust.\textsuperscript{295} However, there is no indication in the regulations what
these "other factors" might be. After they are vaguely alluded to,
they are apparently dropped from consideration as the regulations
proceed to discuss tax classification of limited partnerships solely
in terms of four factors. Because

associates and an objective to carry on business and divide the
gains therefrom are generally common to both corporations and
partnerships, the determination of whether an organization which
has such characteristics is to be treated for tax purposes as a
partnership or as an association depends on whether there exists


\begin{enumerate}
  \item A detailed explanation of the extent of participation of the general
        partner(s) and the limited partner(s) in the profits and the losses of the
        organization, and if a general partner is also a limited partner, the capacity
        in which profits and losses are or will be shared.
  \item A statement indicating whether there will be any shift in the propor-
        tion of the profit and loss sharing ratio during the course of the operation of
        the organization and, if so, the details of the shift and the business reasons
        for it.
\end{enumerate}

10 \textit{Negative Capital Accounts}.

1. A statement indicating whether the amount of any negative capital
balance on the part of a general partner or a limited partner will be paid by
such partner to the organization upon dissolution, liquidation, or termina-
tion of the organization.

11 \textit{Distribution}.

1. A statement describing the manner and method of intended distribu-
tions of assets, including cash, to the partners.

2. A statement describing the distribution scheme of assets upon termi-
nation and/or dissolution of the organization after the payment of debts.


295. \textit{Id.}
The regulations purport to cite the Supreme Court's decision in *Morrissey v. Commissioner*\(^{297}\) with approval as they begin with a declaration that an organization will be treated as an association if it "more nearly resembles" a corporation than a partnership.\(^{298}\) Under an "overall resemblance" test, for example, the extent to which the two particular corporate features were present might completely overwhelm all other considerations. The "association regulations," however, also known as the "Kintner"\(^{299}\) regulations, clearly reject such an approach, and adopt instead a "numerical supremacy" test: "An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics."\(^{300}\) In the event of a tie, partnership classification results.\(^{301}\)

*Larson v. Commissioner*,\(^{302}\) is the leading case on tax classification of limited partnerships, and probably will remain the leading case as long as the present regulations are in effect. The Tax Court concluded that there was a two-to-two tie on the four major corporate characteristics: each of the two limited partnerships involved was found to have the corporate characteristics of centralized management and free transferability of interests, as defined in the regulations, and lacked the corporate characteristics of continuity of life and limited liability, as defined in the regulations. In the case of a tie, the Tax Court held, the Service could not classify the limited partnership as a corporation for tax purposes. Nor would the court find "other factors" that would tip the balance away from partnership to corporate classification. In short, *Larson* confirms the short-and-sweet interpretation of the association regulations: if you want your limited partnership taxed as a partnership, simply assure yourself that any two of the four major corporate characteristics are eliminated. As we shall see, the bizarre definitions of the

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299. United States v. Kintner, 216 F.2d 418 (9th Cir. 1954.).
301. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if the limited partnership has no other characteristics which are significant in determining its classification, such limited partnership is not classified as an association [but as a partnership.]

*Id.*

four characteristics appear to make the elimination of least two of
at them relatively easy.

E. The Facts of Larson

The first decision issued by the Tax Court in Larson held that
the two limited partnerships before it were, for federal income tax
purposes, corporations. The result was that the tax losses that had
been claimed by the limited partners belonged, not to them, but to
their corporations. The Tax Court "withdrew" this initial opinion,
and some months later issued Larson v. Commissioner, known af-
fectionately by some as Larson II, which reached the opposite re-
sult and held that both limited partnerships were indeed partner-
ships for tax purposes, that the limited partners were members of
the partnerships for tax purposes, and, hence, that the partners-
ships' tax losses could be passed through to them. The case is sig-
nificant not only for its unusual history, but also for its extensive
discussion of how the association regulations apply to fairly typical
tax shelter limited partnerships.

An examination of one of the two limited partnerships involved
in Larson is sufficient to indicate that the Tax Court had before it
a fairly typical real estate partnership. Mai-Kai was formed in
1968 under California's version of the U.L.P.A. to own and operate
a student apartment complex. Mai-Kai had as its sole general part-
er a corporation ("GHL") that had been formed to organize "real
estate syndications" as limited partnerships. GHL, which had a
paid-in capital of $21,300 and negligible cash on hand, managed
and administered the properties of both partnerships. Upon the
formation of Mai-Kai, GHL transferred to Mai-Kai, as its contri-
bution to capital, the right to acquire "real estate syndications" as limited partnerships. GHL, which had a
paid-in capital of $21,300 and negligible cash on hand, managed
and administered the properties of both partnerships. Upon the
formation of Mai-Kai, GHL transferred to Mai-Kai, as its contri-
bution to capital, the right to acquire the apartment complex.
GHL neither claimed credit for this contribution of contract rights
nor was required to make any other capital contributions. Accord-
ingly, its total capital contribution was listed and carried on Mai-
Kai's books and records as zero. The limited partnership interests
in Mai-Kai were divided into ten units of $9,500 per unit and sold
to a total of eight limited partners who contributed a total of
$95,000 cash. After its formation, Mai-Kai purchased the apart-
ment complex by giving a $450,000 note and deed of trust for the
full amount of the purchase price. The note was nonrecourse by
virtue of the California Code of Civil Procedure, which provided
that there could be no deficiency judgment upon foreclosure of a
purchase-money mortgage.

The limited partnership agreement provided that the partner-
ship business would be managed by GHL, which received a monthly management fee of five percent of gross receipts. GHL was also given the right to obtain financing or refinancing for the partnership property and receive mortgage loan fees not to exceed two percent of the amount of each loan. No limited partner could withdraw his capital contribution without the consent of GHL, but could withdraw his “capital account” upon the termination of the partnership. The partnership agreement made detailed provision for the allocation of “profits, losses and distributions.” “Profits” was defined to mean the taxable income of the partnership, which was to be allocated twenty percent to the general partner and eighty percent to the limited partners. The agreement’s language on the allocation of losses reflected an ambiguity that is present in many leveraged partnerships:

All losses of the partnership shall be allocated entirely to the Limited Partners in proportion to their capital contributions, subject however to the limitation of liability of each Limited Partner to the amount of his individual investment in the partnership. All losses of the partnership in excess of the total capital contributions of the Limited Partners shall be borne entirely by the General Partner.

The language appears to result from mixed motive. It apparently intends both to allocate all tax losses to the limited partners and to reiterate their status as limited partners liable only to the extent of their contribution. It was not intended to mean that they would only be allocated tax losses up to the amounts of their contribution. Indeed, by the end of the second year of partnership operations, the limited partners had been allocated losses in excess of their cash investment. Cash flow and distributions of proceeds from any sale of partnership property were to be allocated twenty percent to the general partner and eighty percent to the limited partners. The allocations of “profits” (taxable income), cash flow and distributions were subject to a “payback” priority to the lim-

303. In highly-leveraged limited partnerships, allocation of deductions or losses typically give the limited partners negative capital accounts within the first few years of partnership operations. The significance of negative capital accounts should be anticipated and provided for in the partnership agreement. See generally Weidner, Partnership Allocations and Capital Accounts Analysis, 42 Ohio St. L.J. 467 (1981).
304. 66 T.C. at 164.
305. The Service apparently did not argue that the allocation of all tax losses to the limited partners ran afoul of section 704(b).
itied partners: it was agreed that “the General Partner shall not participate in the cash flow or profits of the project until such time as a Limited Partner (assuming a 50% tax bracket) has been returned his initial investment through a combination of cash flow and operating losses.”

GHL was not to sell or encumber its interest as general partner or enter into any agreement that would involve anyone else “becoming interested with it in the partnership.” Limited partners were not to transfer their right to income without the prior written consent of the GHL, which could “not unreasonably withhold such consent.” The agreement provided, on the other hand, that, the “capital interest” of each limited partner was subject to a right of first refusal in the remaining limited partners if GHL determined that the price offered by a proposed transferee was less than the fair market value of the interest. If the remaining limited partners chose not to exercise that right, the transfer could be effected on the condition precedent that the transferee sign such documents as GHL deemed necessary or desirable to effect the admission of the transferee as a substituted limited partner.

The partnership was to continue for a period of thirty-three years unless extended for such longer term as might be determined by the election of limited partners entitled to sixty percent or more of the profits allocable to the limited partners. The partnership could terminate sooner upon any of the following events:

(a) A disposition [by] the partnership of its entire interest in the real property.
(b) The adjudication of bankruptcy of the General Partner or otherwise as provided by the Uniform Limited Partnership Act, unless the business is continued by a General Partner elected in place thereof.
(c) A determination by the election of Limited Partners entitled to sixty per cent (60%) or more of the profits of the partnership allocable to the Limited Partners that the partnership shall terminate.
(d) The removal of the General Partner by the vote of Limited Partners entitled to sixty per cent (60%) or more of the profits of the partnership allocable to the Limited Partners. In such event, there shall be a distribution of assets * * * unless the Lim-

306. 66 T.C. at 164. Such "payback" periods are common, and have often been inserted in transactions at the insistence of state securities law commissioners. The basic idea is to give the general partner incentive to protect the interests of the limited partners by making sure that he only reaps his profit after they have recovered theirs.
ited Partners, by an affirmative vote of Limited Partners owning 100% of the profits in the partnership allocable to the Limited Partners, elect to form a new partnership to continue the partnership business.\textsuperscript{307}

Andrew Carnegie presumably would have been horrified by these last two causes for termination.\textsuperscript{308}

\textbf{F. Continuity of Life}

The regulations define the corporate characteristic of continuity of life in terms of "dissolution" of the partnership:

An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist.\textsuperscript{309}

Dissolution is in turn defined in terms of a theoretical dissolution under state law:

\textbf{[D]issolution of an organization means an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law. For example, since the resignation of a partner from a general partnership destroys the mutual agency which exists between such partner and his copartners and thereby alters the personal relation between the partners which constitutes the identity of the partnership itself, the resignation of a partner dissolves the partnership.}\textsuperscript{310}

This basic definition of dissolution reflects the definition in the U.P.A., which applies to limited partnerships unless the limited partnership statute provides to the contrary.\textsuperscript{311} "The dissolution of a partnership is a change in the relation of the partners caused by \textit{any partner} ceasing to be associated in the carrying on as distinguished from the winding up of the business."\textsuperscript{312} The point of dis-

\textsuperscript{307} 66 T.C. at 165.
\textsuperscript{308} \textit{See infra} section VI A.
\textsuperscript{310} \textit{Treas. Reg.} § 301.7701-2(b)(2) (1977).
\textsuperscript{312} U.P.A. § 29, 6 U.L.A. at 364 (emphasis added).
solution does not necessarily have any significance under state law. Dissolution is basically an event that will trigger the process of "winding up" a partnership, leading to its termination, unless the partners have agreed that the event will not trigger the winding up process. The U.P.A. provides that dissolution is caused by a variety of events, including the death or bankruptcy of any partner. Indeed, it provides that dissolution may be caused by the express will of any partner at any time, even if the partnership agreement provides to the contrary.

The regulations state that it does not matter if the partners draft away the consequences of a technical dissolution, so long as the technical dissolution takes place:

An agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization. Thus, there may be a dissolution of the organization and no continuity of life although the business is continued by the remaining members.

Nor does it matter if the members agree that none of them shall cause a dissolution of the organization. As just stated, under the U.P.A., any general partner can dissolve the partnership at will at any time, even in contravention of the partnership agreement. Even though the partner who dissolves in contravention of the agreement has lesser rights than one who dissolves in accordance with the agreement and can be liable for his breach of the agreement, the regulations indicate that this power to dissolve precludes a finding of the corporate characteristic of continuity of life:

[I]f the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if, notwith-

313. U.P.A. § 30, 6 U.L.A. at 367: "On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed."
standing such agreement any member has the power under local law to dissolve the organization, the organization lacks continuity of life. Accordingly, a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life.318

This last sentence has been referred to as "the shorthand test" to determine whether a limited partnership has continuity of life.319 It appears, however, not to be a test but a flat rule that U.L.P.A. limited partnerships will never have the corporate characteristic of continuity of life.

The U.L.P.A. modifies the U.P.A. by making some provision for partners to draft away a technical dissolution: "The retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners, (a) Under a right to do so stated in the certificate, or (b) With the consent of all the members."320 The continuity of life regulations blatantly, and somewhat ambiguously, track this U.L.P.A. provision: "If the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership, unless the remaining general partners agree to continue the partnership or unless all remaining members agree to continue the partnership, continuity of life does not exist."321 Does the opportunity to draft away a technical dissolution under the U.L.P.A., or its exercise, mean that a U.L.P.A. limited partnership has the corporate characteristic of continuity of life? No, said the Court of Claims in Zuckman v. United States.322 First, under the facts before it there was a sole corporate general partner. If it withdrew, which it had the power although not the right to do, there would be "no remaining general partners exclusively entitled under the ULPA to continue the business."323 More basically,

under the rule announced in Glensder Textile Co. v. Commissioner, expressly adopted by the Treasury in its final regulations, the mere reservation in the limited partnership agreement of a

322. 524 F.2d at 735.
323. Id.
power in the remaining general partners to continue the business on a general partner’s withdrawal, constitutes only a “contingent continuity of existence,” insufficient to satisfy the regulation’s corporate standard.324

In Larson the Tax Court agreed. It emphasized that the U.L.P.A. provisions for drafting away dissolution on the “retirement, death or insanity” of a general partner do not mention the bankruptcy of a general partner. Thus, the U.P.A. rule would still control and the partnership would be dissolved on the bankruptcy of the general partner. The fact that under the Mai-Kai partnership agreement a new general partner might be chosen to continue the business did not affect the court’s conclusion. The government argued that the limited partners could anticipate bankruptcy of GHL and elect a new general partner. The Tax Court felt that this element does not detract from the hard fact that if GHL became bankrupt while it was the general partner of ... Mai-Kai, there would at best be a hiatus between the event of bankruptcy and the entry of a new general partner so that, from a legal point of view, the old partnerships would have been dissolved. Moreover, at least in the case of Mai-Kai, a vote of 100 percent of the limited partners was required to elect a new general partner. Glensder Textile Company held that such contingent continuity of life did not resemble that of a corporation. [The association regulations] incorporate this conclusion.325

The court recognized that its application of the regulations to the event of bankruptcy made it unlikely that a limited partnership will ever have the corporate characteristic of continuity of life, and suggested the regulations be amended.326

324. Id. (citations omitted).
325. 66 T.C. at 175 (citations omitted).
326. Because it disposed of the continuity of life issue solely on the ground that bankruptcy would cause the prohibited dissolution, the court did not find it necessary to address other arguments made by the Service. One was that, under California law, GHL did not have the power to dissolve. Another was that California’s amendments to the U.L.P.A. provisions concerning dissolution were so extensive that the California statute was no longer “corresponding to” the U.L.P.A. The California amendments anticipated rights in limited partners to vote to remove or replace general partners, but did not specify that any voting on their part could prevent dissolution in the event of bankruptcy. See Rev. Rul. 74-320, 1974-2 C.B. 404.
G. Centralization of Management

The regulations provide that an organization has centralized management if any person or group has "continuing exclusive authority to make the management decisions necessary to the conduct of the business. . . . Thus, the persons who are vested with such management authority resemble in powers and functions the directors of a statutory corporation." 327 Centralization of management is more likely to be found in an organization that has many members than in a smaller organization. 328 The persons who have the continuing exclusive authority need not be members of the organization and may hold office as a result of periodic selection by the members or may be self-perpetuating in office. 329 The regulations state that general partnerships cannot achieve effective concentration of management powers "because of the mutual agency relationship between members." 330 Usually, any act within the scope of partnership business binds all the partners. Even if the partners agree among themselves to vest management powers in an exclusive few, the agreement is ineffective against outsiders who had no notice of it. The following has been described as the regulations' "shorthand test" 331 to determine whether a limited partnership has centralized management: "In addition, limited partnerships subject to a statute corresponding to the Uniform Limited Partnership Act, generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners." 332 The Tax Court in Larson said the purpose of this rule was to distinguish between centralization of management in the corporate sense and centralization of management in a limited partnership sense. If a general partner has a "meaningful proprietary interest," said the court, the corporate characteristic will not be present; he will be acting in his own interest and "not merely in a representative capacity for a body of persons having a limited investment and a limited liability." 333

The Larson court concluded that there was centralized manage-

328. Id.
331. Zuckman, 524 F.2d at 737.
332. Id. (quoting Treas. Reg. § 301.7701-2(c)(4) (1977) (emphasis added)).
333. 66 T.C. at 177. (citation omitted) (emphasis omitted).
ment because GHL had no meaningful proprietary interest.\textsuperscript{334} It said that GHL had failed to prove that its capital interest had any value in the years in question, and its subordination to the payback to the limited partners left GHL with no present right to income during those years. GHL failed to persuade the court that its right to future profit had present value. Finally, the right of the limited partners to remove the general partner meant that "GHL's right to participate in future growth and profits was wholly contingent on satisfactory performance of its management role, and not at all analogous to the independent proprietary interest of a typical general partner."\textsuperscript{335} The taxpayers had argued that the power of removal and control could be given to limited partners under the U.L.P.A., that California's version of the U.L.P.A. (which makes specific reference to such a power)\textsuperscript{336} is a statute corresponding to the U.L.P.A. and that, accordingly, the "shorthand test" required a finding that there was no centralized management. First, the court said the "shorthand test" for centralized management says only that U.L.P.A. limited partnerships generally lack centralized management. Second, and more importantly, it said that, by reserving the right to remove the general partner, the limited partners "took themselves out of the basic framework of the U.L.P.A. and hence out of the shelter of the regulation."\textsuperscript{337}

\textbf{H. Limited Liability}

The regulations provide that an organization has the corporate characteristic of limited liability "if under local law there is no member who is personally liable for the debts of or claims against the organization."\textsuperscript{338} Personal liability is present if "a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization

\textsuperscript{334} There is little in the regulations to indicate when the limited partners own "substantially all" of the interests in the limited partnership. Treas. Reg. § 301.7701-3(b)(2) Example (1) (1960), considers only the partners' relative capital contributions to conclude that substantially all of the interests in the organization are owned by the limited partners. The limited partners contributed a total of $5,000,000, whereas the three general partners contributed a total of only $300,000 plus their personal liability. While it might be obvious that $300,000 is a much smaller sum than $5,000,000, it is not so obvious that it is too small to constitute a "meaningful proprietary interest."

\textsuperscript{335} 66 T.C. at 178. (footnote omitted).


\textsuperscript{337} 66 T.C. at 179.

are insufficient to satisfy the creditor's claim."\(^{339}\) It does not matter if the member who is personally liable is the beneficiary of an assumption or indemnification agreement:

A member of the organization who is personally liable for the obligations of the organization may make an agreement under which another person, whether or not a member of the organization, assumes such liability or agrees to indemnify such member for any such liability. However, if under local law the member remains liable to such creditors notwithstanding such agreement, there exists personal liability with respect to such member.\(^{340}\)

The regulations state a "shorthand test" for the presence of the corporate characteristic of limited liability:

In the case of a general partnership subject to a statute corresponding to the Uniform Partnership Act, personal liability exists with respect to each general partner. Similarly, in the case of a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act, personal liability exists with respect to each general partner, except as provided in subparagraph (2) of this paragraph.\(^{341}\)

Subparagraph (2) establishes a conjunctive test: personal liability exists with respect to a general partner unless "he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization and when he is merely a 'dummy' acting as the agent of the limited partners."\(^{342}\) Or, as the Tax Court put it in Larson, "personal liability exists [with respect to the general partner] if the general partner either has substantial assets or is not a dummy for the limited partners."\(^{343}\) The regulations do not give any "net worth" test for substantial assets of the kind that is contained in Revenue Procedure 72-13,\(^{344}\) nor do they indicate when a general partner is a dummy. Because the elimination of either one of these factors is sufficient to conclude that personal liability exists with respect to the corporate general partner, the Larson court was content to conclude that GHL was no dummy. The limited partners' removal rights did not render

\(^{339}\) Id.
\(^{340}\) Id.
\(^{341}\) Id.
\(^{343}\) 66 T.C. at 180.
\(^{344}\) See infra section VII B.
GHL a dummy; GHL was a moving force in the transaction rather than a screen to conceal the active involvement of the limited partners. With one minor exception, the persons controlling GHL were independent of and unrelated to the limited partners.

The regulations appear to say that, whenever there is no personal liability with respect to the general partner because both prongs of the conjunctive test are met, there is personal liability with respect to the limited partners: "Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners." As Judge Simpson pointed out in his dissent in Larson, this interpretation renders the test a nullity; no limited partnership will ever have the corporate characteristic of limited liability. Or, as put in Zuckman v. United States:

In short, the regulation draws a tight, albeit opaque, circle by declaring that where the general partner of a limited partnership has no assets, only two alternatives may follow: (1) if it is not a "dummy", then it is personally liable; or (2) if it is a "dummy", then the limited partners for whom it acts as agent and who in turn serve as its principal, are personally liable. In either case, the limited partnership cannot have limited liability, inasmuch as at least one of its "members" — whether general or limited — must at all times bear personal liability.

I. Free Transferability of Interests

The regulations provide that an organization has the corporate characteristic of free transferability of interests if each member "or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization." The member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization.

Thus, the characteristic of free transferability of interests does not exist in a case in which each member can, without the consent

346. 66 T.C. at 199.
347. 524 F.2d 729, 741 (Ct. Cl. 1975) (footnote omitted).
of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization. Furthermore, although the agreement provides for the transfer of a member's interest, there is no power of substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization.349

Under the U.P.A., no person can become a member of a general partnership without the consent of all the partners.350 A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee to interfere in the management of the partnership or to require any information or account of partnership transactions or to inspect the partnership books.351 The assignment does entitle the assignee to receive the profits to which the assigning partner would otherwise be entitled.352 If the assigning partner intends to end the partnership relation, the partnership is dissolved.353

Under the association regulations, unless “substantially all” of the interests in the partnership are owned by the limited partners, the general partner's interest must also be freely transferable in order for the corporate characteristic to be present. As the Zuckman court concluded:

In the absence of an agreement to the contrary, a sole general partner of a limited partnership may assign his interest and substitute another for himself without the consent of the limited partners, but such assignment and substitution will result in a technical dissolution of the partnership unless the right to continue the business is specifically accorded the substituted general partner by the limited partnership certificate.354

349. Id.
352. Id.
353. U.P.A. § 27, Official Comment, 6 U.L.A. at 353:
[Early] authorities on the whole state that the mere assignment dissolves the partnership. Many such assignments, however, are merely by way of collateral security for a loan, the assigning party in no wise intending to end the partnership relation. If he neglects his personal relation the other partners may dissolve the partnership under section 31 of this act. But the mere fact of assignment without more should not be said in all cases to be an act of dissolution.
354. 524 F.2d at 743.
Because there was no such provision in the certificate and the general partner had a significant interest, the *Zuckman* court concluded that free transferability was not present.

In *Larson*, the Tax Court concluded that "substantially all" of the interests in the partnership were in the limited partners, so it considered only the transferability of their interests, and not that of the general partner.\(^{355}\) Under the U.L.P.A., a limited partner's interest is assignable,\(^{356}\) subject to any provisions in the partnership agreement.\(^{357}\) The U.L.P.A. distinguishes between an assignee who becomes a substituted limited partner and one who does not. A substituted limited partner is an assignee who is admitted to all the rights of the limited partner who assigned his interest.\(^{358}\) An assignee has the right to become a substituted limited partner if all the members (except the assignor) consent thereto or if the assignor is empowered by the certificate to give the assignee that right.\(^{359}\) An assignee who does not become a substituted limited partner has no right to require any information or account of the partnership transactions or to inspect the partnership books; he is only entitled to receive the share of profits or other compensation by way of income, or the return of his contribution, to which his assignor would have been entitled.\(^{360}\)

The regulations provide vaguely that if each member can transfer his interest to a nonmember,

only after having offered such interest to the other members at its fair market value, it will be recognized that a modified form of free transferability of interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.\(^{361}\)

No mention is made of the calculus of "less significance." It would appear that the only time it would matter would be if two of the

\(^{355}\) 66 T.C. 159 (1976).


other corporate characteristics were present and one was eliminated. The question would be whether a “modified” form of free transferability would be enough to tip the balance to achieve numerical supremacy. However, given the bizarre definitions of continuity of life and limited liability, it is hard to conceive of a situation in which two corporate characteristics other than free transferability will be found to be present.

The Zuckman court stated that “the existence of a mere formal or nominal condition will not prevent [a] member’s interest from being freely transferable within the meaning of the regulation,” and the Larson court agreed. The partnership agreements in Larson permitted the assignment of a limited partner’s income interest with the consent of the general partner, which consent could not be withheld unreasonably.

The requirement of consent, circumscribed by a standard of reasonableness, is not such a restriction on transfer as is typical of partnership agreements; nor is it the sort referred to by the regulations. In our opinion, the limited partners’ income rights were freely transferable.

[Taxpayers] also argue that transferability is limited by the requirement that, in the event of a proposed assignment, a limited partner’s capital interest first be offered to other members under certain circumstances. While an assignment for less than fair market value could be prevented in this manner, there was no requirement that such an offer be made if an interest was to be sold to a third party at fair value. Thus, there was no “effort on the part of the parties to select their business associates,” as is characteristic of the usual partnership arrangement. We think that these interests possessed considerably more than the “modified” form of free transferability referred to in subparagraph (2) of the regulation.

In short, the restrictions on an assignee for fair consideration becoming a substituted limited partner “were procedural rather than substantive,” and the corporate characteristic of free transferability was present.

362. 524 F.2d at 743.
363. 66 T.C. at 183 (citations omitted).
364. Id.
J. Other Factors

Because Zuckman concluded that none of the four corporate characteristics, as defined in the regulations, was present, it found it unnecessary to identify "other factors" that might be relevant to the issue of the tax classification of limited partnerships. In Larson, on the other hand, the court found a two-to-two split on the four major characteristics: centralized management and free transferability of interests were present; but continuity of life and limited liability were absent. The court stood by the "numerical supremacy" test in the regulations that condition corporate classification on the presence of more corporate than noncorporate characteristics. The Service urged the court to find "other factors" to break the tie and conclude the organizations had more corporate characteristics than not. The court refused to find "other factors" that were significant one way or the other, noting the importance of predictability in applying the classification regulations. When the Service finally acquiesced in Larson, it listed certain factors that would not be considered "other factors."

K. Developments in the Wake of Larson

At several points, the opinions in Larson almost begged the Treasury to amend the classification regulations and eliminate their extreme bias toward partnership classification. The Treasury finally issued proposed new regulations with two basic features: (1) they eliminated the mechanical "numerical supremacy" test; and (2) they defined the corporate characteristics in more practical, common-sense ways. The extreme bias toward partnership classification would be over. If adopted, these regulations clearly would classify certain limited partnerships as corporations for tax purposes. Within a matter of hours, however, the proposed regulations were withdrawn. The political reaction had been swift and intense. At least in the short run, any basic change in the rules would have to be made by Congress. In 1978, the Carter administration recommended to Congress that limited partnerships be

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365. 66 T.C. at 185 n.22: "Indeed, considering the importance of predictability in applying [the] regulations, we would not be inclined to give such lesser characteristics controlling weight unless their materiality was unmistakable, a situation which does not obtain in this case."
classified as corporations for tax purposes if they have in excess of fifteen limited partners. The proposal got nowhere. At the time of this writing, there is nothing to suggest that Congress is about to act to classify limited partnerships as corporations.

1. Acquiescence in Larson, "Other Factors" and the Service’s Position

In light of the withdrawal by the Treasury of its proposed new classification regulations and continued inaction on the subject by Congress, the Treasury finally acquiesced in Larson in 1979. In so doing, it issued Revenue Ruling 79-106, which lists factors that the Service will not consider as "other factors" that have significance (independent of their bearing on the six major corporate characteristics) in determining the tax classification of limited partnerships:

(1) The division of limited partnership interests into units or shares and the promotion and marketing of such interests in a manner similar to corporate securities,
(2) the managing partner's right or lack of the discretionary right to retain or distribute profits according to the needs of the business,
(3) the limited partner's right or lack of the right to vote on the removal and election of general partners and the right or lack of the right to vote on the sale of all, or substantially all, of the assets of the partnership,
(4) the limited partnership interests being represented or not being represented by certificates,
(5) the limited partnership's observance or lack of observance of corporate formalities and procedures,
(6) the limited partners being required or not being required to sign the partnership agreement, and
(7) the limited partnership providing a means of pooling investments while limiting the liability of some of the participants.

The Ruling emphasized that the Larson court did not conclude that "other factors" are never relevant; it simply failed to find any significant "other factors" in the facts before it.

In summary, there is a good argument that the present classifica-
tion regulations, as interpreted by Larson, make it impossible for any U.L.P.A. or Revised Act limited partnership to ever be classified as a corporation for tax purposes. This conclusion follows from the numerical supremacy test, from the bizarre definitions given to the corporate characteristics of continuity of life and limited liability, and from the failure of anyone to identify the relevant "other factors" that would tip the balance toward corporate classification. Nevertheless, the Service continues to insist that it might be able to identify "other factors," and continues to condition favorable rulings of partnership classification on compliance with the conditions of Revenue Procedure 72-13, if there is a sole corporate general partner, and on Revenue Procedure 74-17.

2. Regulation Changes After 1980

In October, 1980, the Treasury proposed new regulations to clarify that references in the association regulations "to the ULPA shall be deemed to refer to that Act both as originally promulgated and as revised in 1976. Thus, the same classification rules will apply to entities organized under a statute corresponding to the revised ULPA as apply to entities organized under a statute corresponding to the original ULPA." This seems to be a retreat from the Service's more aggressive, pre-Larson position that state changes to the U.L.P.A. could seriously jeopardize tax classification. In particular, these proposed regulations discuss the effect of limited partners' removal rights on the presence or absence of the corporate characteristic of centralized management:

[I]f all or a specified group of the limited partners may remove a general partner, all the facts and circumstances must be taken into account in determining whether the partnership possesses centralized management. A substantially restricted right of the limited partners to remove the general partner (e.g., in the event of the general partner's gross negligence, self-dealing, or embezzlement) will not itself cause the partnership to possess centralized management.

This provision addresses the fact that the Revised Act states that a limited partner does not violate the "control" limitation simply by voting to remove a general partner. The proposed addition, however, makes no mention of the effect of the right of removal on the characteristic of free transferability of interests.

In November of 1980, the Treasury issued a proposed amendment to the association regulations that would make it impossible for limited liability companies to be classified as partnerships for tax purposes. A limited liability company is a fairly recently imported form of business organization that insulates all members from personal liability. The proposed regulation, which has had its effective date repeatedly postponed, provides that "the term 'partnership' can apply only to an organization, some member of which is personally liable under applicable local law for debts of the organization." For purposes of this rule, "only liability arising solely from membership in the organization shall be taken into account; liability of a member as a guarantor on an obligation will be disregarded." Accordingly, limited liability companies are to be taxed as corporations, not as partnerships. The notice of the proposed change specifically provides that no change is intended with respect to limited partnerships:

"[E]ntities organized under statutes corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act shall continue to be classified under existing rules since those statutes make general partners personally liable for partnership debts. The fact that general partners may make other arrangements to insure themselves against loss as a result of partnership debts does not obviate the existence of personal liability under the applicable law."  

It is not at all clear how the limited liability company is functionally distinguishable from a limited partnership with a nominally capitalized sole corporate general partner. If and when that becomes clear, perhaps some justification will be found for taxing one

376. Prop. Reg. § 302.7701-2(a)(2)-(4), U.S. Tax Cas. Advance Sheets (CCH) 8922 (1981). As this article was going to press, the proposed amendment was withdrawn. Ann. 83-4, supra n.287.
378. Id.
as a corporation and the other as a partnership.

3. The American Law Institute's Proposals

In March of 1982, the American Law Institute (ALI) approved its Federal Income Tax Project final draft on Subchapter K. The years preceding had produced a series of recommendations covering the entire spectrum of partnership tax issues. The Project's Proposal O would classify virtually all limited partnerships as partnerships for tax purposes:

**Proposal O — Partnership Classification**

1. **General Rule**
   
   A partnership organized and operated under the Uniform Partnership Act or the Uniform Limited Partnership Act, as either act is substantially in effect in any State, and not publicly traded within the meaning of Paragraph 2 below, shall be treated as a partnership for Federal income tax purposes.

2. **Definition of Publicly-Traded Partnerships**
   
   An interest in a limited partnership shall be considered publicly-traded only if at any time in the partnership's existence, interests in the partnership are traded in an established securities market.

Because Proposal O avoids "the difficult definitional questions that must now be considered in classifying a limited partnership," it promotes "simplicity in the interpretation and administration of the revenue laws." In addition, the drafters felt that there were several reasons why Proposal O "appears to reach an appropriate result." There have apparently been relatively few attempts to impose a corporate tax on the income of a U.L.P.A. limited partnership. The recent tax classification battles have focused on the limited partnership as a vehicle for passing tax losses through to limited

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380. *Id.* at 65.
381. *Id.*
382. In *Glensder Textile*, 46 B.T.A. 176 (1942), acq. 1942-1 C.B. 8, the government attempted to tax the income of a limited partnership organized under New York's version of the U.L.P.A. "Although the Service thereafter appears to have pursued the issue against certain partnership associations organized under laws different from U.L.P.A, there were few attempts to impose a corporate tax on a ULPA entity." *T.D. No. 7, supra* note 289, at 67 (citing *Giant Auto Parts, Ltd.*, 13 T.C. 307 (1949), *supp. op.*, 14 T.C. 579 (1950) and Treas. Reg. § 301.7701-3(c) (1977)).
partners. The ALI’s recommendation on tax classification must be viewed in the context of companion ALI proposals for more effective partnership audits, rules to prevent the pass-through of tax benefits in certain limited partnerships, and rules requiring loss allocations among limited partners to have substantial economic effect.\(^{383}\) Given these companion proposals directed at inappropriate loss pass-throughs and allocations, “the remaining question is whether [the limited partnership] should be subjected on the one hand to a corporate tax regimen, with its profits taxed directly and its owners taxed only on distributions or, whether, on the other hand, its income should be taxed to its owners on a pass-through basis.”\(^{384}\) In short, the companion ALI proposals strip the tax classification issue of much of its present significance and result in a tax classification rule that is directed toward the profitable partnership.

The policy judgment of the ALI: permit freer access to Subchapter K. The basic perception was that the corporate tax system, with a tax on the entity income followed by a shareholder tax on dividends and on disposition of stock at a gain, and the pass-through model of partnerships, are trade-offs: “For entities that are economically similar to partnerships, a direct tax on the owners of the entity is considered an adequate substitute for the combined corporate and shareholder level tax applied to corporations.”\(^{385}\)

There are a number of specific examples in which pass-through taxation has been considered appropriate. Partnerships, of course, have long been exempted from tax, even though they may have many members and substantial income. The present regulations, for example, classify as a partnership an organization that has 900 limited partners.\(^{386}\) Large and highly profitable law partnerships may present the most pleasing example to present readership. In addition, there are extremely large joint ventures between and among large corporations, such as the nuclear plant in Madison Gas, which produce sizable income yet are free from any tax at the entity level. The basic point, again, is that such economically significant ventures are permitted to escape entity taxation because a


\(^{384}\) T.D. No. 7 supra note 289, at 64.

\(^{385}\) Id. at 85-86. “The converse is also true. There are few inhibitions on selection of a corporate tax system by incorporation of a business that might otherwise be conducted in partnership form.” Id. at 86 n.*.

\(^{386}\) Treas. Reg. § 301.7701-3(b)(2), Example (2).
pass-through tax is considered an adequate substitute.\textsuperscript{387} Mutual funds and real estate investment trusts, which also represent large amounts of capital, are also exempted from the corporate tax; their earnings are taxed on a pass-through basis. Many small corporations are able to minimize or eliminate their taxable income by paying their shareholders salaries, rent, interest and similar expenses. This effectively removes the tax burden from the corporation and places it on the shareholders.

The Subchapter S corporation is probably the best illustration of the continued and increasing willingness of Congress to provide the option of a pass-through model of taxation. Under Subchapter S, Congress has for years exempted many small corporations from the corporate income tax. Instead of a tax at the entity level, the income of a Subchapter S corporation is taxed to its shareholders. Congress has defined Subchapter S corporations in terms of the number of shareholders and types of income. Although Congress initially allowed only ten shareholders, it has made Subchapter S available to corporations with unlimited income.\textsuperscript{388} Most recently, the Subchapter S Revision Act of 1982 increased the permissible number of shareholders to 35 and made a series of sweeping changes to the Subchapter S rules.\textsuperscript{389} In short, the new Act simplifies and eases the rules for eligibility for Subchapter S status and makes the rules that govern Subchapter S corporations and their shareholders more like the partnership rules than ever. This most recent decision by Congress to ease access to Subchapter S is an analogy that supports the ALI proposals for freer access to Subchapter K.

\textsuperscript{387} T.D. No. 7 supra note 289, at 89 n.* "The decade of the '70's saw extensive consideration of integration proposals which could shift some or all of a corporation's tax burden to its shareholders. For a useful discussion of integration proposals, see McClure, MUST CORPORATE INCOME BE TAXED TWICE? (Brookings, 1979)."

\textsuperscript{388} T.D. No. 7 supra note 289, at 87 n.3: "Income limits were probably not placed on Subchapter S corporations because (1) the number of shareholders was originally limited to ten and (2) the provision was not generally considered to be beneficial to shareholders in tax brackets substantially in excess of the then 52 percent corporate rate."