REPORT #564

TAX SECTION

New York State Bar Association

COMMITTEE ON PARTNERSHIPS

Report on Issues Concerning Tax Treatment of

Master Limited Partnerships for Federal Income Tax Purposes

Table of Contents

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Introduction

When considering the appropriate income tax treatment of publicly traded partnerships (master limited partnerships or "MLPs"), opinions range from one extreme to the other. Treasury itself has been on both sides of this issue. In 1977 it proposed pass-through treatment for all business entities, including publicly traded corporations.[1] In 1983, it endorsed current law treatment of MLPs as partnerships.[2] In 1984, Treasury proposed taxing MLPs as corporations but did so at the same time as it endorsed significant integration of the corporate and individual tax systems.[3] In 1986, Treasury reversed its position and proposed that all publicly traded partnerships be taxed as corporations.[4]

Among tax practitioners, the views also range across an entire spectrum. There are those whose opinions are based on a strict technical interpretation of the law. There are those whose views are shaped more by their opinions on tax policy. Ironically, both supporters and opponents of the current treatment of MLPs may be found from one end of this spectrum to the other. At the risk of oversimplifying this issue, the following attempts to summarize four major categories of views

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1 Blueprints For Basic Tax Reform, Department of the Treasury, at 69 (Jan. 17, 1977).

2 Statement of Ronald A. Perlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, before the Committee on Finance, U.S. Senate, Hearing on Preliminary Report on the Reform and Simplification of the Income Taxation of Corporations (Oct. 24, 1983) (hereinafter referred to as the "Perlman Statement").

3 Tax Reform for Fairness, Simplicity, and Economic Growth, Department of the Treasury (Nov. 1984) (hereinafter referred to as "Treasury I").

4 Statement of J. Roger Mentz, Assistant Secretary (Tax Policy) Department of the Treasury, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives (June 9, 1986) (hereinafter referred to as the "Mentz Statement").

within the Partnership Committee of the Tax Section of the New York Bar.

1. The Strict Integrationists.

This group is comprised of those who are convinced that the present two-tier tax imposed on corporate income has provoked a dangerous corporate trend: leveraged buy-outs, leveraged recapitalizations and junk bonds. Since MLPs are not subject to double taxation, they will not contribute to this trend: and may in fact provide a more stable alternative to corporate managers.

2. The MLP Proponents.

This group agrees that the current system of corporate taxation is flawed from a policy standpoint. But this group believes that pending issuance of Treasury's Subchapter C report and a viable system of corporate tax integration, MLPs should not be outlawed for several policy reasons.

a. Substantially all capital raised from the public through MLPs is used by corporations sponsoring the MLPs to pay off indebtedness. Thus, MLPs enable corporations to strengthen their financial condition by issuing securities which impose no risk of default on the MLP or its corporate sponsor. This group believes that, in light of the ever-increasing use of leverage in the corporate sector, MLPs should be encouraged, not condemned.

b. MLPs enable corporations to highlight the true value of selected assets, thereby enhancing shareholder values and fending off hostile takeovers.

c. By offering liquidity, MLPs give small investors the opportunity to invest on an equal after-tax basis with wealthy investors.

3. The MLP Pragmatists.

This group acknowledges that MLP equity is beneficial as a matter of tax policy when used as a substitute for corporate debt. If used in that manner, they believe that MLPs should not be adverse to the fisc since corporate profits paid out as interest on corporate debts are not subject to double taxation. And to the extent corporations pay interest to tax-exempt and foreign investors, that interest is not taxed at all. In contrast, profits allocated to MLP investors are subject to one full tax without regard to the status of the partner as taxable, tax exempt or foreign.

TO prevent potential abuse and to ease compliance, however, this group recommends that:

a. partnership tax status be available to an MLP only if:
   (1) MLP units to be publicly traded have been issued for cash;
   (2) the MLP distributes all of its taxable income currently;
   (3) the MLP does not:
      (i) make a Section 754 election;
      (ii) incur substantial indebtedness; or
      (iii) make special allocations of any items of income or loss differing from the

allocations of income or loss generally; and

(4) the MLP agrees to be subject to partnership level collection of tax deficiencies.

b. losses, if any, sustained by MLPs should not flow through to limited partners.

c. Congress amend Section 469 to make clear that MLP income is not passive income.

4. The Corporate Traditionalists.

This group does not believe that the tax policy benefits of MLPS tauted by the MLP proponents and acknowledged by the MLP Pragmatists should be relevant when determining the tax status of MLPs. Since MLPs more closely resemble large corporations than they do small partnerships, this group believes that they should be taxed as corporations.

Summary of Conclusions

1. Under the existing Treasury Regulations, MLP's formed under state statutes conforming to the Uniform Limited Partnership Act are considered partnerships for income tax purposes.

2. From the standpoint of sound tax policy, we believe that MLPs should continue to be treated as partnerships. We have reached that conclusion primarily because substantially all equity raised from the public by corporations utilizing MLPs is used to pay corporate debt. When used in that manner, MLPs fulfill a valuable role in the capital markets and should be encouraged. Unless it is shown conclusively that MLPs are causing substantial revenue loss from the corporate tax sector, we

believe this benefit outweighs the technical arguments made by those who advocate taxing MLPs as corporations.

With respect to perceived revenue loss from the use of MLPs, we seriously question whether it is significant for the following reason. One level of tax is imposed on income allocated to all partners in an MLP, whether those partners are individuals, corporations, foreigners or otherwise exempt institutions. Similarly, one level of tax is imposed on income paid in the form of interest on corporate debt and to the extent that interest is paid to tax exempt institutions and pension funds, it is not taxed at all.

3. With respect to tax compliance difficulties associated with MLPs, much progress has been made, primarily through the partnership level audit procedure and the institution of nominee reporting. To reduce tax collection difficulties we recommend that MLPs be subject to a form of partnership level deficiency assessment procedure.

4. As a final point we urge that Treasury or Congress confirm that income from an MLP is not passive income for purposes of Section 469.

The following report briefly summarizes the evolution of the current corporate and partnership classification system as well as the recent studies and proposals for change to that system. It then discusses the three principal arguments voiced by those who advocate taxing MLPs as corporations and the technical and policy responses thereto made by advocates of current law. Finally, the report proposes a number of statutory and regulatory changes that should be considered by Congress and the Treasury to improve

administration of, and compliance with, the tax law by MLPs and their partners.

I. PARTNERSHIP AND CORPORATE CLASSIFICATION

A. Statutory and Regulatory Evolution

Since 1894, the Code and its predecessors have imposed a separate tax on corporations and "associations," but nave specifically excluded partnerships from this treatment.[5] The separate corporate tax originally was sanctioned as an excise tax on the state law privileges associated with operating in corporate form.[6] Since partnerships did not avail themselves of the corporate privileges on which the excise tax was being levied, they were not subjected to the separate tax.

With the adoption of the Sixteenth Amendment, and the imposition in 1913 of a national income tax,[7] the two-tier tax that applied to the owners of corporations (and associations),

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[5] Act of 1894, Ch. 349, 28 Stat. 509, Sec. 32, Aug. 27, 1894; Seidman's Legislative History of Federal Income Tax Laws 1861-1938, 1020, 21 (1938).

[6] The tax imposed on corporations under the Act of 1894 was struck down by the Supreme Court as unconstitutional in Pollack v. Farmer's Loan & Trust Co., 158 U.S. 601 (1895), on the basis that it was a "direct" tax that had to be apportioned among the states in proportion to population. Responding to this objection, the Act of 1909 imposed a tax on corporations (and similar associations) for carrying on business. The Supreme Court upheld this revised approach in Flint v. Stone Tracy Co., 220 U.S. 107 (1911), holding that the 1909 tax was not a direct tax, but rather an "excise" or "indirect" tax upon the privilege of doing business in a corporate capacity.

[7] Act of 1913, Ch. 16, 38 Stat. 114 (Oct. 3, 1913).

and the single-tier tax applicable to partners of partnerships, became a permanent part of our tax landscape.

Since the corporate tax originated as a tax on state law corporate privileges, the Treasury Department approached the entity classification issue by focusing on the presence (or absence) of the most significant of these privileges. This "corporate resemblance" approach was formalized, to a large extent, in the case of Morrissey v. Commissioner,[8] in which the Supreme Court identified what it believed to be the principal corporate characteristics. These characteristics are (i) associates, (ii) an objective to carry on a business or financial enterprise and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) limited liability, and (vi) free transferability of interests.

During this period of time, classification as a corporation was generally perceived as favorable to the fisc and adverse to the taxpayer since it resulted in the imposition of a corporate tax. Thus, the Treasury's early attempts at classification regulations were heavily biased in favor of corporate classification. As certain taxpayers (especially professional groups) began to realize that taxable income at the corporate level could be minimized through the payment of salaries and other expenses and that corporate treatment afforded the entity the privilege of certain pension and profit-sharing benefits otherwise not available, they began intentionally to structure their unincorporated associations to be taxed as corporations.

[8] 296 U.S. 344 (1935).

In 1960, responding primarily to the taxpayer's victory in United States v. Kintner,[9] in which a professional service organization was held to be properly classified as a corporation, the Treasury Department promulgated the current regulations under Section 7701[10] to govern the classification of business organizations. The current classification regulations, like earlier versions, embody the criteria set forth in the Morrissey decision. The principal difference between the current regulations and the prior classification regulations is that the current regulations place more emphasis on state partnership law and establish a numerical supremacy test that requires that more corporate than noncorporate characteristics be present before corporate classification results. The corporate characteristics as applied by the current regulations are discussed in more detail below.

B. The Current Classification Regulations

The origin of the existing classification regulations is the Supreme Court decision in Morrissey v. Commissioner.[11] There, in considering whether a business trust should be classified for purposes of federal taxation as an association taxable as a corporation or as a trust, the Supreme Court elaborated on six characteristics which it considered to be relevant in distinguishing corporations from other entities. Those characteristics were (i) associates, (ii) an intent to carry on a business and divide the profits therefrom, (iii) continuity of life, (iv) centralized management, (v) liability for debts of the

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[9] 216 F.2d 418 (9th Cir. 1954).

[10] Unless otherwise indicated, all “Section” or “§” references are to the Internal Revenue Code of 1986, as amended, and all “Treas. Reg.” or “regulations” references are to the regulations thereunder.

[11] Supra, 296 U.S. at 344.

organization limited to its assets and (vi) free transferability of interests. The current Treasury classification regulations under Section 7701 use those criteria. The first two, associates and an intent to carry on a business and divide the profits, are determinative when distinguishing traditional trusts, which are taxable as trusts, from business trusts, which are taxable as partnerships or corporations. The four remaining criteria, centralized management, continuity of life, free transferability of interests and limited liability (the corporate characteristics), are determinative when distinguishing partnerships from associations taxable as corporations.

When determining the existence of the corporate characteristics, the classification regulations place substantial emphasis on state partnership law. In addition, the classification regulations do not apply a subjective "corporate resemblance" test by weighing the various corporate characteristics according to their economic and legal significance. Instead, they use a numerical supremacy test to determine "corporate resemblance" by providing that "an unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics."[12] In other words, the classification regulations provide that a business organization will not be taxed as a corporation for federal income tax purposes unless the organization possesses at least three of the four corporate characteristics. If two or fewer corporate characteristics are present, the entity will be treated as a partnership.[13] As the following discussion will illustrate, it is the strong emphasis on state partnership law, combined with

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[12] See Treas. Reg. §301.7701-2(a)(3).

[13] See Treas. Reg. §301.7701-2(a)(1).

the numerical supremacy test for determining corporate resemblance, that facilitate classification of master limited partnerships as partnerships for income tax purposes.

1. Centralized Management

Centralized management of a business organization is present whenever any person or group of persons, by election, appointment or otherwise, has the continuing exclusive authority to conduct the operation of a business, without having to obtain the consent or approval of the members of the organization.[14] Under this standard, a general partnership is easily distinguished from a corporation in that each member of the partnership has the authority to bind both the partnership and all other partners, unlike a board of directors or shareholders in a corporation. Because limited partners do not generally have authority to bind their partnership, it may be said that the requisite agency relationship does not exist in the typical limited partnership. Thus, some degree of centralized management exists in every limited partnership. The classification regulations, however, provide a gloss on the definition of centralized management based upon a standard adopted by the Board of Tax Appeals in Glendser Textile Co. v. Commissioner.[15] Under that standard, if the general partner of a limited partnership owns a meaningful proprietary interest in the partnership, i.e., the limited partners do not own substantially all the interests in the partnership, centralized management as a corporate characteristic does not exist.[16] Under the foregoing standard, the primary distinction between the corporate and limited partnership

[14] Treas. Reg. §301.7701-2(c).

[15] 46 B.T.A. 176 (1942), acquiesced, 1942-1 C.B. 8.

[16] Treas. Reg. §301.7701-2(c)(4).

structure is that a corporate board of directors administers the corporation's affairs in a representative capacity. In a limited partnership in which the general partner owns a substantial interest, the general partner will be viewed as managing the partnership for his own proprietary benefit as well as the benefit of the limited partners.

2. Continuity of Life

The classification regulations provide that the corporate characteristic of continuity of life exists if the business organization is not legally dissolved under state law upon the death, insanity, bankruptcy, retirement, resignation or expulsion of any member.[17] This standard relies on state partnership law and the presence of a technical dissolution (i.e., an alteration of the legal identity of an organization by reason of a change in the relationship of its members) rather than an actual cessation of business or liquidation of the organization. An organization structured as a limited partnership will not possess continuity of life if it is dissolved upon the death, retirement or insanity of a general partner.[18] This is the result even if the remaining general partners or some or all remaining limited partners may elect to reconstitute and continue the partnership. Once again, the classification regulations follow the Glendser Textile decision by using the concept of “contingent continuity” to distinguish corporations from partnerships. The rationale of the concept is simply that as long as the power to perpetuate the organization is vested in the partners and not in the partnership

[17] Treas. Reg. §301.7701-2(c)(1).

[18] Treas. Reg. §301.7701-2(c)(1). In this regard, the classification regulations contain a “safe harbor” provision that limited partnerships formed under a statute similar to the Uniform Limited Partnership Act lack continuity of life. Treas. Reg. §301.7701-2(c)(3).

itself as an entity, continuity is not assured, as it is in the corporate context.

3. Free Transferability of Interests

The corporate characteristic of free transferability of interests exists if those members of the organization owning substitution of a transferee as a new limited partner requires the[19] consent of the general partner, the partnership interest is not freely transferable for purposes of the classification regulations, provided the general partner may arbitrarily withhold such consent. On the other hand, if the general partner may not unreasonably withhold such consent, free transferability may be assumed.[20]

4. Limited Liability

The classification regulations provide that an organization lacks the corporate characteristic of limited liability if at least one of its members is personally liable for the claims or debts of the organization.[21] In the case of a general partnership subject to a statute corresponding to the Uniform Partnership Act, personal liability exists with respect to all of the partners.[22] In the case of a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act, personal liability is presumed to exist with respect to the general partner. Such personal liability will not exist with respect to a general partner of a limited partnership, however,

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[19] not automatically sever the mutual agency relationship between the transferor and the other partners, nor does it create a mutual agency between the partners and the transferee.

[20] See Larson v. Commissioner, 66 T.C. 159, 183 (1976), acquiesced, 1979-1 C.B. 1.

[21] Treas. Reg. § 301.7701-2(d)(1).

[22] Id.

if the general partner, whether an individual or a corporation, has no “substantial” assets (exclusive of any interest in the limited partnership) and is merely a “dummy” acting as an agent of the limited partners.[23] The classification regulations expressly provide that the substantiality of a general partner's assets is determined without regard to the magnitude of the liabilities of the limited partnership.

5. Other Classification Criteria

Finally, the classification regulations provide that “other factors” may be found in some cases which may be significant in classifying an organization as an association or a partnership.[24] In Larson v. Commissioner,[25] the Tax Court found that certain of these “other factors” were elements of the major characteristics and that such other factors therefore were not of critical importance in classifying limited partnerships as partnerships or associations. Although the approach taken in the classification regulations of relying on strict numerical application rather than a subjective “balancing” approach to corporate resemblance has been criticized, the courts have determined classification issues based on a strict, literal application of the regulations.[26]

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[23] Treas. Reg. 5 301.7701-2(d)(2), A general partner need not have any substantial assets subject to the claims of creditors and thus is still avoided, provided the general partner is not dominated or controlled by the limited partners. See Zuckman v. United States, 524 F.2d 729 (Ct. C1. 1975); Larson v. Commissioner, 66 T.C. 159 (1976), acquiesced, 1979-1 C.B. 1.

[24] Treas. Reg. § 301.7701-2(a)(1).

[25] 66 T.C. 159 (1976), acquiesced, 1979-1 C.B. 1.

[26] See Zuckman v. United States, 524 F.2d 729 (Ct. C1. 1975); Larson v. Commissioner, 66 T.C. 159 (1976), acquiesced, 1979-1 C.B. 1.

C. Studies of, and Proposed Changes to, the Current Classification Regulations

After adopting the current classification regulations in 1960, the Treasury Department has, for the most part, left the regulations unchanged. However, during that period and, in particular, during the past 10 years, there have been several significant developments relating to the partnership/corporation classification issue. It is worthwhile to review these developments.

1. The 1977 Proposed Regulations

Early in 1977, the Treasury Department proposed new regulations that would have substantially altered the standards utilized in distinguishing partnerships from corporations, and eliminated the bias in the regulations against corporate classification. Bowing to heavy criticism, the new proposed regulations were promptly withdrawn.[27] Reportedly the result of more than a decade of study by the Treasury Department,[28] these proposed regulations would have made it far more difficult for an entity to be classified as a partnership.

2. President Carter's Proposals

In January 1978, President Carter proposed to tax as a corporation any limited partnership with more than fifteen limited partners, unless substantially all (i.e., more than 90 percent) of its assets consisted of subsidized low-income

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[27] Prop. Treas. Reg. §§ 301.7701-1 through 301.7701-3, 42 Fed. Reg. 1038 (Jan. 5, 1977), withdrawn, 42 Fed. Reg. 1489 (Jan. 7, 1977).

[28] See 3 BNA Daily Tax Rep. G-5 (Jan. 5, 1977).

housing.[29] This proposal would have applied to all limited partnerships formed after the date of enactment. Congress gave little, if any, serious consideration to this proposal, and the Revenue Act of 1978, as enacted, did not contain any change in the classification rules for limited partnerships.

3. The Proposed Limited Liability Company Regulations

In 1980, the Internal Revenue Service (the "IRS") issued proposed regulations that would have automatically classified any organization as an association (taxable as a corporation) if under local law no member of the organization was personally liable for debts of the organization.[30] Specifically, the proposed regulations would have classified as an association an unincorporated organization known under local law as a limited liability company, where the local law provided that no member of the organization was personally liable for any debts of the organization. The Notice of Proposed Rulemaking stated clearly state law version of the UPA or ULPA.[35] The ALI gave consideration to limiting its unrestricted access proposal in three circumstances: (i) where there are a large number of partners, (ii) where the general partner has a relatively small net worth, and (iii) where the interests in the partnership are publicly traded. The ALI determined that unrestricted access to partnership tax status should be permitted regardless of the number of partners or the net worth of the general partner. However, the ALI did modify its proposal to exclude publicly

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[29] See Staff of Joint Committee on Taxation, 95th Cong., 2d Sess., Summary of the President's 1978 Tax Reduction and Reform Proposals 6 (Comm. Print 1978).

[30] Prop. Treas. Reg. §§ 301.7701-2(a)(2), 301.7701-2(a)(3), and 301.7701-2(a)(4) (1980).

[35] ALI Federal Income Tax Project, Subchapter K, Proposals on the Taxation of Partners (1984), pp. 366-381.

traded partnerships. The reasons cited for this exclusion were the perceived administrative and audit problems of publicly traded partnerships, and the concern that, given time, publicly traded partnerships would bear an indistinguishable resemblance to publicly held corporate industrial giants.

5. Senate Finance Committee Staff's Recommendations

In 1983, the Senate Finance Committee Staff's preliminary report on Subchapter C contained a proposal that would tax as a corporation any limited partnership with interests traded on an established securities exchange.[36] The report stated that large, centralized business organizations ought to be subject to an entity tax because of their similarity to large corporations. The Treasury Department, testifying on the preliminary report, opposed the Staff's classification proposal on several grounds. First, it was beyond the scope of the Subchapter C Project. Second, marketability of interests should not be a critical factor in entity classification. Third, the administrative problems of large partnerships were manageable. Fourth, MLP opponents' concerns relating to the disincorporation of America were overblown.[37] In 1985, the Finance Committee Staff deleted the classification proposal from its final report,[38] in part because of the Treasury Department's concern that the classification issue was beyond the scope of the Subchapter C Project, and in part because the proposal was subsumed within the

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[36] The Reform and Simplification of the Income Taxation of Corporations, Preliminary Report of the Staff of the Senate Finance Committee (1983).

[37] See Perlman Statement, supra note 2.

[38] The Subchapter C Revision Act of 1985, A Final Report Prepared by the Staff of the Committee on Finance, United states senate, S. Prt. 99-47, May 1985.

“35 partner rule”[39] that had been advanced by Treasury in the intervening two years.

6. Treasury's Tax Reform Proposals

In November 1984, the Treasury Department released the Treasury I report detailing its proposals for tax reform. One of these proposals was to tax as corporations limited partnerships with more than 35 limited partners. The Treasury based its position principally on a corporate resemblance argument, stating that large limited partnerships offer many of the investment and legal characteristics of a corporation and thus should be taxed as such. Treasury also touched on (i) the audit and administrative problems, (ii) the use of limited partnerships as a vehicle for generating passive losses, and (iii) the potential shift of investment capital from the corporate sector. Six months later, in May 1985, the President's official tax reform proposal, as prepared by the Treasury Department, was submitted to the Congress without any mention in it of the 35-partner proposal.[40] The reasons for this deletion were not indicated.

7. Treasury's 1986 Testimony Before the Rangel Committee

In June 1986, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means (the “Rangel Committee”), the Treasury Department testified in favor of taxing publicly traded partnerships as corporations.[41] Treasury made three principle arguments in support of its proposal. First, it cited the administrative and audit problems of large

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[39] See infra I.C.6. of this Report.

[40] The president's Tax Proposals to the Congress for Fairness Growth, and Simplicity (May 1985) (hereinafter referred to as “Treasury II”).

[41] See Mentz Statement, supra note 4.

partnerships. Second, it identified certain non-tax business uncertainties, complexities, and risks associated with operating in partnership form, stating that "[t]he inefficiencies borne by an entity and its owners are not irrelevant to the choice of appropriate tax rules." Third, it focused on corporate resemblance contending that publicly traded partnerships behave like corporations in all material respects and, thus, to tax them differently would both raise questions of fairness and challenge the integrity of the corporate tax base.

8. 1987 Hearings by the Rangel Committee

On June 30 and July 1, 1987 the Rangel Committee will hold hearings regarding the tax treatment of MLPs. In announcing the hearings, Chairman Rangel indicated that the Committee will review the present law as it applies to MLPs as well as the current uses of MLPs as a method of raising capital and conducting business. The hearings will emphasize perceived changes in taxpayer behavior as a result of the Tax Reform Act of 1986 (the "1986 Act") and the implications such changes may have regarding projected revenue collections from the corporate sector.

II. CURRENT ARGUMENTS AGAINST PARTNERSHIP STATUS FOR MLPs - COMMENTS AND RECOMMENDATIONS

A. Policy Considerations.

One of the major issues concerning the tax treatment of MLPs is whether pass-through taxation is good or bad tax policy. The alternative is to impose a corporate tax on all enterprises that are denied access to a viable scheme of pass-through taxation. The evils of the current corporate tax are well understood and

acknowledged,[42] even by those who advocate taxing MLPs as corporations. In his testimony before the Rangel Committee in having a single tax system, individual taxpayer-voters will be more aware of their actual tax burden so they will be better informed as to their true share of the price we pay for civilized society. Whether corporate income taxes are deemed imposed on the corporation's shareholders, its employees, or its customers, they are an economic cost ultimately imposed on individuals. Yet each of these constituencies likely perceives that the tax burden is imposed elsewhere. If the needs of government require additional tax revenue, individual taxpayers should be aware of the corresponding tax costs. Only in that way can they decide, through the electoral process, whether the attendant benefits of government spending are worth the burden. Unfortunately, failure to integrate the corporate tax system, either using a dividend relief approach or the partnership model, seems based upon one overriding political factor - the government needs the revenue raised by the current two-tier tax on corporate income.[44]

Those advocating taxation of MLPs as corporations rather than partnerships generally make three arguments:

1. that MLPs will cause the disincorporation of the United States business system, producing unacceptable revenue losses;

2. that MLPs closely resemble publicly held corporations and therefore should be taxed as such; and

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[42] See Charles E. McLure, Jr., Must Corporate Income be Taxed Twice?, Brookings Institution (1979); George F. Brenk and Joseph A. Pechman, Federal Tax Reform: The Impossible Dream?, Brookings Institution (1975) pp. 90-104.

[44] Mentz Statement, supra note 4, at 25.

3. that MLPs impose an unacceptable administrative burden on the tax collection system.

AS a related concern, some believe that MLPs may be used to generate passive activity income which may be sheltered by otherwise deferred passive losses -- at a substantial revenue cost.

The following discussion addresses each of these points and highlights certain technical and policy concerns they raise. Finally, a series of recommendations are made to improve the administration of the current law with respect to MLPs and their partners.

1. The "Disincorporation of us Business" Concern.

Those who have proposed taxing MLPs as corporations have asserted that such treatment is necessary to preclude the "disincorporation"[45] of American business. The implicit assumption is that federal tax revenues will be diminished substantially as a result of a reduction in the corporate tax base attributable to MLPs.

Potential loss of tax revenue is indeed a problem of national concern. Although we are not economists, we question

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[45] The term "disincorporation" apparently was first introduced by a Forbes magazine article entitled "Disincorporation America" published in August 1983. There, the author predicted a significant movement out of corporate form into MLP form. Similar Forbes articles were published in June and October, 1986. Yet in its most recent article on MLPs published in December, 1986 ("A Little Problem"), Forbes acknowledged that, in light of General Utilities repeal, the disincorporation "risk" to the fisc is not nearly as substantial as its prior articles suggested.

whether the decision to tax all publicly traded partnerships as corporations corporation cannot issue stock bearing an after-tax yield comparable to that of debt unless it earns additional pretax income sufficient to pay the corporate level tax on that income.

The savings option certainly does not maximize government revenue because corporate earnings not paid out currently are not subjected to the shareholder level tax on dividend income. Although upon initial consideration the promotion of savings does not seem an improper policy consideration, the lesson corporate managers have learned in recent years is that corporations which retain income in the form of liquid assets pending the acquisition of a new business instead of spending the income immediately or paying dividends are inviting targets for hostile takeovers. Thus, the savings option is not often a wise business choice, and it is rarely made.

The debt option has the most negative impact of all on corporate tax revenue and it creates dangerous instability in the national economy. At the corporate level, the earnings generated by the newly raised capital are offset, for the most part, by interest deductions. At the creditor level, interest income is subject to taxation only if the creditor is not a tax-exempt institution, pension fund, or foreign investor. Thus the optimum method of raising capital in the corporate sector is to raise it by issuing debt to tax-exempt entities. Corporate level income paid out as interest thus escapes all taxation.

The fact of the matter is that corporations now rely most heavily upon debt capital as a substitute for equity capital because it is much more tax efficient and economical to do so. For example, during the same five year period that corporations

raised [$162] billion in corporate equity, corporations raised [$368] billion in debt -- much of that through “junk” bonds or quasi-debt instruments in many cases bearing risks commensurate with equity. The failure to integrate the corporate tax system while at the same time permitting the unlimited deduction of interest on corporate indebtedness is one of the driving forces behind the recent surge of leveraged buy-outs and corporate debt recapitalizations since a corporation heavily capitalized with debt will be worth much more on an after-tax basis than the identical corporation capitalized with equity in the traditional manner.

Unfortunately capital raised through corporate debt appears on books as debt, thus subjecting the corporation to the risk of bankruptcy if its income is insufficient to make the required payments of interest and principal. The debt option makes short-term economic sense, but it creates long-term economic instability.

Master limited partnerships offer an equity alternative to business managers who otherwise would capitalize their business with substantial debt. From a tax revenue standpoint, this alternative should not be adverse to the fisc compared to the debt option but may in fact raise more tax revenue because,

unlike debt, partnership equity (even though held by tax-exempt institutions and foreigners)[46] subjects the partner to one full level of taxation. The primary economic benefit achieved by raising capital through an MLP rather than a debt offering is that MLP capital is in the form of equity. We believe that the benefit of long-term economic stability, both to the business sector and the economy as a whole, justifies preserving the MLP option as a means of raising capital.

The current corporate tax system readily lends itself to the reduction of the statutory tax burden on corporate equity. It is common knowledge that few corporations pay taxes at an effective rate approaching the maximum corporate rate. The current corporate tax system forces corporations to rely heavily on debt as a substitute for corporate equity because the cost of debt -- interest -- is fully deductible and reduces corporate level

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[46] The UBTI rules, contained in §§ 511 - 515, were enacted to eliminate any competitive advantage that a tax-exempt person engaged in a business might enjoy over a fully taxable person. Thus, the result of the UBTI rules is that an otherwise tax-exempt institution becomes taxable on its allocable share of partnership taxable income because, in general, a partner in a partnership is treated as being engaged in the activity (or trade or business) of the partnership. Additionally, even if the partnership does not generate UBTI, a tax-exempt institution is required to file federal income tax returns if its allocable share of gross UBTI exceeds $1,000.

Similar considerations apply to foreign investors who own interests in MLPs. As partners in a partnership conducting a U.S. trade or business, foreign investors are deemed to be engaged in a U.S. trade or business (I.R.C. § 875). Foreign partners who invest in MLPs, therefore, are subject to U.S. taxation on their distributive share of the MLP's profits. (§§ 871(b) and 882(a)). They must file U.S. tax returns (5 6012) and distributions to them are subject to withholding. (§ 1446). Equity-flavored debt structures avoid these problems. Interest received from investment in debt instruments is free from tax if it qualifies as "portfolio interest" under §§ 871(h) and 881(c); alternatively, interest may be subject to reduced taxation under an applicable tax treaty.

taxes.[47] It seems clear that the current corporate tax system forces a business operated in corporate form to have a more highly leveraged capital structure than would the same business operated in MLP form. All of the income earned by an operating MLP allocable to its partners is taxable at least once, whether the partner is an individual, a corporation, a foreigner or a tax exempt institution. In contrast, a substantial percentage of income earned by corporations today is not taxable at all since it is paid to tax exempt institutions and foreign investors as interest.

Considered in the light of current business realities, the MLP alternative for raising capital should not be compared to the stock option but to the debt option. The MLP alternative provides a means of raising capital in the form of equity rather than debt. In this light, the MLP alternative to the corporation seeking capital is not chosen for tax avoidance reasons, but rather is chosen for sound nontax business reasons. If a partnership is treated like a corporation, it will act like a corporation. It will increase its debt load, reduce dividends and look for other ways to shelter taxable income.

MLPs formed to date have been used by corporations

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[47] Indeed, it has been argued, and we agree, that the principal driving force behind leveraged buy-outs and leveraged recapitalizations has been the resulting elimination of the corporate-level tax, which dramatically increases the value of the corporation.

predominantly to repay or avoid corporate debt.[48] The following example illustrates how a typical MLP is used by a corporate sponsor to pay off its indebtedness.

> Example: Corporation X has an operating business with assets worth $1,000 and long-term liabilities of $400; thus, its net worth is $600. Corporation X earns $100 of operating income (not including interest on its debt) on its $1000 worth of assets, i.e. a 10% pretax return. It must pay interest at a rate of 10% on its $400 indebtedness. Thus, on $100 of operating income, $40 must be used to pay interest on its debt, leaving the corporation with $60 of net taxable income.
>
> Corporation X contributes these assets, subject to the $400 of liabilities, to an MLP in exchange for MLP units worth $600 - the net value of the contributed assets. Thereafter, the MLP issues new MLP units to investors in exchange for $400. Thus, 60% of the MLP interests are still held by X and 40% of the MLP interests are held by the public. The MLP uses the $400 contributed by the public to pay off the $400 debt shifted by Corporation X to the MLP. Thus, the business conducted by Corporation X is now conducted by the MLP which has $1,000 worth of assets and no debt.
>
> The $400 worth of MLP units issued to the public are entitled to a 10% priority yield out of the MLP's income (i.e., the first $40 of income), before a matching 10% yield ($60) is paid to Corporation X.
>
> Thus, if the business now conducted by the MLP continues to earn $100, 40% or $40 would be treated as a priority distribution of taxable income to the public investors as their yield on the $400 contributed. The remaining $60 would be allocated to X Corporation. If the business only earns $60, all $60 will be allocated to the public investors. Nothing will be allocated or distributed to X Corporation. If no income is earned, nothing will be allocated or distributed to the public unitholders or to X Corporation.

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48 Of the [46] MLPs formed which have raised cash, [23] expressly stated that the use of proceeds was to retire corporate debt. Of the remaining [23], nearly all raised funds which went to the corporate sponsor (in a secondary offering or in a sale of assets) to retire corporate debt. By dollar value, it is estimated that more than 95% of the cash proceeds raised by MLPs went to retire or avoid corporate debt.

It is important to realize that the amount of corporate debt in the United States has increased dramatically in recent years by reference to every standard. For example, according to the Federal Reserve Board, as a ratio of debt to GNP, debt has increased from 1.35 to 1.7 since 1980. More to the point, the Federal Reserve Board also states that, during the same time period, corporate debt has grown from 95% to 117% of corporate net worth. It goes without saying that a significant cause of this increased reliance on corporate debt rather than equity is the fact that our current corporate tax system rewards debt and penalizes equity.

There are substantial nontax reasons why corporations want to raise equity capital through an MLP in lieu of borrowing.

1. Unlike corporate debt which has fixed due dates for payments of interest, MLP distributions, though similar to interest, are legally contingent upon the general partner declaring the distribution. Unlike corporate debt which has a specified maturity and must be repaid, MLP equity has no maturity. As securities issued to raise capital, MLP units are the safest form of equity to issue from the standpoint of a business.

2. Even though most MLP equity is structured to resemble debt in an economic sense, MLP equity does not appear as debt on the balance sheet of the corporate sponsor of the MLP. Use of an MLP, therefore, enhances a corporation's credit rating and economic stability.

3. Unlike the case with traditional bonds or institutional financing which often contain substantial restrictive covenants (for example, prohibition or restrictions on payment of dividends), MLP equity imposes no such restrictions on the corporate sponsor of the MLP. Thus, an MLP affords a corporation maximum flexibility in its business affairs.

4. A corporation that has assets with a low book value but high fair market value and cash flow may contribute those assets to an MLP and sell a minority interest in the MLP to the public. By establishing a public market value for the selected assets in this manner, the corporation may be able to enhance the value of its common stock. In the last several years several large corporations have done exactly that as a defense against hostile takeovers.

5. Corporations use MLPs to expand their capital market access to reach small investors by providing those investors with quasi-debt type securities having liquidity. Unlike corporate bonds and non-traded partnership equity where the price of the initial investment may range from $5,000 to $25,000 or more, the price per unit of most MLPs ranges from $5 to $30. Because of the relatively low unit price, MLPs attract investors of moderate means.[49]

To the extent that corporate debt is replaced by partnership equity, it would seem that little if any tax revenue is lost since debt and partnership equity are subject to single tier tax regimes. As discussed previously, a conversion of corporate debt to partnership equity should result increase in an increase tax revenues to the extent that the corporate debt was held by tax-exempt institutions, pension funds or foreign investors. Since a large portion of the corporate debt market is dominated by such investors, a dollar of tax revenue lost at the corporate level because of an interest deduction is unlikely to be replaced by a dollar of tax revenue imposed on interest income. To the extent MLP equity is used to replace or avoid corporate debt, tax

[49] Even assuming that the MLP alternative remains available, we suspect that most businesses will continue to opt for more traditional means of raising capital. This is because (i) institutions are reluctant to invest in MLPs because of (a) the relative illiquidity of the MLP marketplace for large blocks of MLP units, and (b) the tax on unrelated business taxable income; (ii) operational restraints (underwriters usually insist that MLPS be confined to single-purpose businesses to support current cash distributions; (iii) administrative costs associated with reporting and filing requirements; and (iv) underdeveloped state and foreign partnership laws.

revenues should be increased, not decreased.[50]

There is much to be said for a tax system that rewards financing business enterprises with equity rather than debt. In this regard, Congress should think long and hard as to whether the United States economy is well served by denying businesses the ability to raise capital by selling partnership equity when the most cost-effective alternative is to issue even more corporate debt. Corporations can go bankrupt if their income is insufficient to pay their debts as they come due. No corporation raising capital through an MLP will ever go bankrupt if the MLP is unable to make a contemplated cash distribution to its partners: whether because of a downturn in business, a recession, or otherwise. Limited partners in an MLP who do not receive expected distributions can get angry. But unlike creditors, they cannot sue.

An analysis of each type of MLP formed to date further supports our belief that MLPs have not decreased, and will not decrease, tax revenues. In a liquidation of a corporation into an MLP (a "liquidation MLP"), a two-tier tax is incurred immediately. Prior to the 1986 Act, the tax at the corporate level was limited to the recapture of certain items.[51] As previously noted, after the 1986 Act and the repeal of General Utilities, a liquidation into an MLP will be treated as a fully

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[50] Most MLPs use very little debt. While it is commonplace for corporations to have 4 to 1 or higher debt-equity ratios, an MLP debt-equity ratio even approaching 1 to 1 is rare. For example, a corporate buyer in a leveraged buyout often is capitalized with more than 90% debt while those few MLPs formed to purchase similar assets have 50% or less debt.

[51] Recapture items included depreciation recapture under §§ 1245 and 1250., intangibles recapture under § 1254, LIFO inventory recapture under § 336 and investment credit recapture under s 47.

taxable transaction to a corporation with the same tax cost as a sale of all corporate assets for cash. Both before and after the 1986 Act, a liquidation is a taxable transaction to the shareholders. Thus, liquidations prior to 1987 triggered significant tax revenues and a liquidation after 1986 will trigger even more significant tax revenues. Importantly, those revenues will be recouped through basis utilization (via depreciation or amortization) only over a substantial period of years, if at all.[52]

Similarly, an MLP which has been formed to purchase corporate assets for cash (an "acquisition MLP") should accelerate corporate tax revenues. Those revenues will result from the purchase by the MLP and the sale by the corporation of assets. Moreover, the proceeds received by the selling corporation from the sale of assets remains in corporate solution to be reinvested. That, in turn, will generate additional revenues in the form of corporate taxes on income from such reinvestment.

An MLP formed through the consolidation of existing small partnerships to obtain liquidity (a "roll-up MLP") obtains assets which were not in corporate solution in the first place. Thus, no loss of revenues attributable to the movement of assets out of corporate solution results. Though it could be asserted that, absent the MLP form, the roll-up would have been into a corporation and, therefore, the roll-up MLP is a lost opportunity to add to the corporate tax base, the assertion is based on what

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[52] Notably, any liquidation of a corporation engaged in an ongoing business will involve nondepreciable assets such as goodwill and going concern value, particularly under the newly required residual valuation method of § 1060. Furthermore, the depreciable lives of most assets (particularly real estate and long-life equipment) were increased under the 1986 Act such that the present value of future depreciation deductions has been significantly reduced.

we believe is an erroneous assumption that those in the consolidated partnerships would willingly bear any burden to obtain the liquidity of a publicly traded vehicle. We do not believe that is the case. Consequently, it is questionable that roll-up MLPs result in lost tax revenues.

The MLP formed by a corporate contribution of assets to a partnership as described in the prior example has been the most widely used form of MLP in the last several years. It involves only a contribution of assets to a partnership and a sale of limited partnership interests to the public. This structure involves no movement of value or net worth out of corporate solution at all. After formation of the MLP, MLP interests equal in value to the assets contributed remain in corporate solution owned by the corporate sponsor of the MLP. Therefore, no tax revenue should be lost unless it can be established that partnership equity issued to the public substitutes for corporate equity and that the corporate equity would have generated additional tax revenues. As discussed previously, we suspect that is not the typical case. MLP equity is not being used in the marketplace as a substitute for corporate equity. Substantially all of it is being used as a substitute for corporate debt. Indeed, for most corporate sponsors of drop down MLPs, use of the MLP form or use of corporate debt are the only choices available to raise capital either because (i) the corporate sponsor would not have been willing to suffer the dilution associated with a stock sale, (ii) a stock sale would have been too costly on an after-tax basis or (iii) the corporate sponsor would have been unable to sell stock under then current market conditions. Neither use of the MLP form or a corporate debt issue converts corporate equity to noncorporate equity.

Of course, to the extent an MLP has been used as a vehicle to distribute appreciated corporate assets to shareholders by dividend, partnership equity has replaced corporate equity. Such a conversion accelerates tax revenues, however, because of the two-tier tax imposed on such transactions. Future appreciation does escape the corporate-level tax but only after a substantial "toll" charge. Because of the tax cost of this transaction, we suspect few if any MLP interests will be distributed as dividends in the future.

Finally, were MLPs taxed as corporations, some enterprises seeking liquidity for small public investors would simply find other methods of achieving liquidity without the cost associated with an entity level tax. For example, many MLPs which have been formed would have been formed instead as regulated investment companies ("RICs") or real estate investment trust ("REITs"), without substantially altering their investment activities. Neither RICs or REITs incur a corporate level tax. Others might use the new real estate mortgage investment conduits ("REMICs") which are also pass-through entities. It cannot be said, therefore, that all MLPs which have been formed would have adopted the subchapter C corporate form instead.[53] Many businesses would simply have chosen another form of pass-through entity or have utilized other forms of liquidity in order to avoid the corporate level tax. To the extent that such other forms are available, we suspect that little tax revenue is likely to be gained by treating MLPs as corporations for tax purposes.

While it is obvious that enhancement (or protection) of revenues is not a tax policy matter but, rather, is a budgetary

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[53] Several of the most-often discussed MLPs were formed by a liquidation of an S corporation, e.g., Boston Celtics, L.P. and N. V. Homes. Had the MLP form not been available, neither would have issued corporate equity instead.

matter, we believe it appropriate for Treasury to concern itself with tax revenues. But revenue estimations should be based on business realities, and the business reality here is that absent the MLP alternative corporate managers will raise most of their capital in the form of debt -- a choice detrimental to the fisc and to the stability of the national economy. If treated like corporations, MLPs will act like corporations now act - they will use excessive leverage to pay modest taxes, find other pass-through vehicles, forego liquidity or obtain another, less costly, sources of liquidity.

2. The "Close Resemblance to Corporations" Concern.

Among those few members of the Partnership Committee who believe MLPs should be taxed as corporations, the reason most often given is that MLPs look more like corporations than they do traditional partnerships. Members in favor of MLPs reply that (i) small corporations and small partnerships have more in common than large corporations and large partnerships, yet no one suggests imposing a corporate tax on small partnerships,[54] and (ii) there little intellectual rationale for distinguishing MLPs from other large (but nontraded) public and private partnerships and singling them out for double taxation does little more than impose an enormous penalty on investor liquidity.

The corporate resemblance argument may be divided into two quite disparate propositions: (i) all business enterprises should be subject to two levels of tax, subject to a "small business" exception; and (ii) even if the corporate tax is not sound from a

[54] Said another way, they question whether a partnership becomes less like a partnership when its interests are traded in the same way they question whether a corporation becomes less like a corporation when its shares are not traded.

tax policy perspective, (a) it is a permanent feature of our tax landscape, and (b) the Treasury needs the revenue.

The principal virtues and vices of a two-tier tax have been discussed previously. From the standpoint of ideal tax policy, there is little to support the conclusion that a two-tier tax on business income should be the norm and integration or pass-through taxation the exception.[55]

As previously noted, proposals have been presented in the past to reclassify as corporations those partnerships that (i) are publicly traded, (ii) are publicly registered, or (iii) have more than a certain number, e.g. partners. These proposals are often based on the premise that partners in traditional partnerships are generally involved in its affairs and are more closely identified with its activities than are small shareholders in large corporations. Supporters of pass-through treatment for partnerships with these characteristics, however, have responded to such proposals by asserting that they unfairly discriminate against small investors as compared to wealthy or institutional investors.

With regard to proposals to reclassify as corporations those partnerships whose interests are freely traded on various stock exchanges or on the over-the-counter market, supporters of MLPs point out that drawing a distinction based on the publicly-traded characteristic of MLPs is irrational and discriminatory in that it is little more than a penalty tax on liquidity. They point out that the likely result of reclassifying publicly traded partnerships as corporations and subjecting them to an entity-level tax would be that existing MLPs would simply delist from

[55] See Mentz Statement, supra note 4, at 25.

the stock exchange and the public unitholders' interests become illiquid. As for similar partnership offerings in the future, they would be done as public offerings but the interests offered would not be listed for trading. Consequently, small investors who are able to invest in MLPs because they offer necessary liquidity not afforded by other partnership offerings would be denied the opportunity to invest in a business subject to a single tax if the "publicly traded" distinction were to be adopted for purposes of classifying partnerships as corporations. At the same time, wealthy individuals and institutional investors could still purchase interests in partnership businesses subject to a single tax because they generally do not have the same need for liquidity as do small investors. By providing liquidity, an MLP affords an investment opportunity for many small investors that would not otherwise be available.

Supporters of MLPs point out that, other than the "public trading" aspect of MLPs, many large publicly registered but unlisted partnerships (i) have thousands of partners, (ii) are just as large or larger than most MLPs in terms of the amount of capital invested and the amount of income, (iii) and conduct the same types of businesses as do many MLPs. They point out that there are hundreds of publicly registered but unlisted partnerships having more than 1,000 partners,[56] a number of which have capital contributed by limited partners approaching $500,000,000.[57] Investors in such partnerships are no more involved in, or identified with, that partnership's affairs than

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[56] As of 1980, there were already 676 partnerships with more than 1,000 partners. Those partnerships had gross receipts of nearly $6 billion and net income of nearly $1.5 billion. See A Preliminary Report on The Reform and Simplification of the Income Taxation on Corporations, submitted to the Sen. Comm. on Finance, 98th Cong., 1st Sess. 51(n.60) Comm. Print 98-95 (Sept. 22, 1983).

[57] This amount of equity exceeds the amount of cash equity raised by over 90% of all MLPs.

are limited partners in an MLP or shareholders in a corporation of a similar size. Moreover, the “delisting” antidote likely to be used by MLPS in the case of the adoption of a “publicly traded” distinction (whereby they would merely delist), likely would not cure or even substantially alleviate the present audit, compliance and collection problems that exist with MLPs.

With regard to proposals to draw the line of double taxation between all partnerships that are publicly registered (whether or not traded) and those partnerships raising capital through private placements, the same arguments may be made again – (i) that forcing limited partnerships to capitalize themselves through private, rather than public, offerings results in clear discrimination against small investors because federal and state securities laws require that substantially all of the interests in large private partnerships be sold only to accredited investors,[58] (ii) limited partners in large privately underwritten partnerships typically are no more involved in, or identified with, the partnership's affairs than are partners in publicly-registered partnerships or shareholders in a corporation of similar size; (iii) there are private partnerships that are as big or bigger than most publicly registered partnerships[59] in terms of both numbers of partners and the amount of equity, and (iv) the same audit and compliance problems that exist in publicly registered partnerships are also present in large private partnerships.

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[58] Generally, to be accredited for this purpose, an investor must have a net worth in excess of $1,000,000 or income in excess of $200,000.

[59] There are partnerships capitalized through private offerings to accredited investors that have more than 1000 partners and have raised capital in excess of $300 million.

Proposals to draw the line of double taxation between partnerships having more or less than a certain number of partners (e.g., 35) would be consistent with the standards for S corporations. In addition, compliance and enforcement at this point should be materially easier than with other reclassification proposals. On the other hand this rule would also discriminate against the small and middle income investors in favor of the ultrawealthy or institutional investors. In other words, if a limit is placed on the number of investors, a partnership that needs to raise a large amount of capital to begin a business will not be able to attract small and middle income investors who can afford to invest only a limited amount of dollars.

If a line dividing corporations and partnerships is to be drawn at all based on size, perhaps a net worth or a net income test would be a more viable approach than adoption of an arbitrary standard based upon the numbers of partners.

3. Issues Regarding Administrative Complexity of, and Compliance Concerns Arising From, MLPs.

In deciding whether MLPs should be taxed as partnerships or as corporations, an important consideration must be whether the pass-through method of taxation has a material effect on taxpayer compliance or the ability of the IRS to administer the tax laws. In the Treasury testimony it was pointed out that "[u]tillization of [the partnership] model for complex entities, the interests in which are widely held and frequently transferred, creates difficulties both for the Internal Revenue Service and for the partnerships and partners themselves."[60] We agree. But we do not believe the integrated tax system relied upon by MLPs and the

[60] Mentz Statement, supra note 4.

nontax benefits MLPs offer to certain businesses and to the economy[61] should be outlawed as a result. Rather, the current administrative and compliance difficulties should be corrected.

Our conclusions are consistent with the Perlman Statement, supra note 2, in which the then Deputy Assistant Secretary for Tax Policy, discussing the audit complexity of MLPs, stated:

> "We believe that many of these problems have been eliminated or substantially reduced as a result of the partnership level audit provisions contained in TEFRA. The administrative problem most often associated with publicly traded limited partnerships is the perceived difficulty in allocating various tax items among partners when there are multiple transfers of partnership interests during the taxable year or where partnership interests are held in street name. These allocation problems are faced with greater or lesser degree by every partnership and we are not convinced that the mechanics of making these calculations are insuperable; nor are we aware of any significant abuses that have been linked to publicly traded limited partnerships. Indeed, we suspect that the reporting requirements imposed upon publicly traded and registered partnerships and the public scrutiny that these organizations receive make them less likely to engage in abusive activities than partnerships with fewer partners."

This section of the Report identifies and evaluates those compliance and administrative problems facing MLPs and their unitholders. After consideration of the issues identified to date, we believe that improvements can and should be made to the existing statutory and regulatory partnership compliance regime. We believe it is preferable to implement these recommendations and obtain the benefits of increased compliance than it is to take the drastic step of subjecting these entities to another level of taxation. Indeed, we believe with certain changes in the substantive rules of Subchapter K, proper implementation of compliance provisions already in place and the development of others suggested herein, MLPs and their unitholders can achieve a rate of compliance that is as high as comparably sized corporations and small and medium-sized partnerships.

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[61] See Section II.A.1. supra.

The administrative issues we have identified can be divided into four categories:

(1) MLP compliance with the substantive rules of Subchapter K;

(2) MLP information reporting to unit holders and the IRS;

(3) MLP audit issues; and

(4) MLP collection issues.

As discussed in more detail below, legitimate concerns have been voiced in each of these areas. Some have used these concerns to justify taxing MLPs as corporations. In analyzing how these concerns affect a decision on entity classification, however, we do not think it is enough simply to identify the problems. The seriousness of the concerns and an analysis of whether they are unique to MLPs should also be considered. As will be seen from the discussion that follows, many of the identified concerns do raise legitimate tax policy issues unique to MLPs. Yet many other concerns identified to date affect all partnerships, not just MLPs. Moreover, some of the administrative and compliance issues that are unique to MLPs arise only because the draftsmen of the applicable statutory or regulatory provisions did not have MLPs in mind. Other problems are created by statutes or regulations that are obsolete or reflect questionable tax policy decisions which we urge Treasury to reevaluate.

Most of the discussion to date regarding administrative and compliance issues surrounding MLPs has focused on problems created or aggravated by the frequency with which MLP units

trade, the need to maintain fungibility of MLP units or other circumstances that are common, if not unique, to MLPs. These issues are discussed in detail below. It should also be pointed out, however, that there are other features unique to MLPs which tend to improve their compliance rate as compared to that of corporations and that of small to medium-sized partnerships. For instance, for a partnership to comply with the technical issues discussed in part (a) below requires a high level of sophistication and significant administrative and economic investment. MLPs are able to afford the investment necessary to obtain sophisticated tax advice. Many small and medium-sized partnerships are not. In addition, it is said that, in general, MLPs tend to take less aggressive tax reporting positions than do similarly situated corporations for several reasons. First and foremost, MLPs want to avoid audit adjustments that lead to deficiency notices being delivered to all of their unitholders, a concern not typically faced by corporations. Second, the small individual investors who invest in MLPs do not demand and apparently will not pay significantly more for MLP units that offer substantially sheltered cash flow than those with little or no sheltered cash flow.[62]

Supporters of MLPs do not suggest that MLP compliance will, in fact, some day be better than that of other business organizations. Rather, they argue that it is too early to say with certainty how MLP compliance will compare to those other organizations. As discussed below, significant steps to improve

[62] A review of MLP unit values indicates that a great majority are influenced almost exclusively by cash yield considerations, as if they were debt instruments, not by the percentage of their cash distributions that may be sheltered by noncash business deductions from depreciation or depletion. These few MLPs (also exclusively in the oil and gas business) that have generated net tax losses certainly were not structured to do so. And in any event, the enactment of the passive loss rules now precludes any MLP from passing tax benefits through to the typical investor.

partnership, including MLP, compliance and to reduce the IRS administrative burden have been taken in recent years, and more are recommended in the discussion that follows. After these rules have been implemented, we recommend that a study of MLP compliance be undertaken by the IRS. Until these rules have been implemented and their success or failure documented, however, we do not believe compliance or administrative issues should be used fairly as a basis for the extreme remedy of taxing MLPs as corporations.

(a) MLP Compliance With Substantive Rules of Subchapter K.

(i) Are the Need for Fungibility and the Rules of Sections 704, 743, and 755 Compatible?

The issues under Sections 704, 743, and 755 that make fungibility difficult for MLPs should not be viewed as relevant for MLPs only. They are important to all partnerships. Indeed, we believe resolving these issues in a manner that will make them compatible with MLPs and their need for fungibility would represent a significant improvement in Subchapter K generally.

Upon formation of an MLP or any other partnership, Section 704 may cause partnership interests to have differing tax characteristics, even where there is only one economic class of partnership interest. Such dissimilarities do not necessarily defeat fungibility. Fungibility exists as long as any partnership interest purchased through the exchange possesses the same tax characteristics to the buyer, regardless of the tax characteristics that interest had in the hands of the seller. Under current law, even when a Section 754 election is in effect, literal application of certain technical rules of Sections 704, 743, and 755 can result in a buyer holding a partnership interest that is identical, as an economic matter, but that possesses

substantially differing tax characteristics depending on the identity of the seller of that interest. This anomaly exists for all partnerships, not just MLPs.[63] Only the most sophisticated purchaser will think to consider this possibility, much less try to decipher the maze of issues presented by Sections 704, 743, and 755 and the current Treasury regulations thereunder.

For the most part, the technical rules that result in this anomaly have been justified by a preference for the entity approach to Subchapter K, usually in the interests of avoiding a perceived complexity otherwise arising under a pure aggregate approach in which each partner would be taxed as if he directly conducted (and owned) his proportionate share of the partnership's business (and its assets). Often times the perceived complexity being avoided has involved issues of valuation of assets. As will be more fully described in the following pages, we believe that Subchapter K would operate in a more logical and understandable way, and that the tax policy considerations which underlie Sections 704 and 754 would be better effectuated, if all tax dissimilarities were eliminated when partnership interests, entitled to the same economic participation, are acquired at a time that a Section 754 election is in effect. A purchaser under such circumstances should, to the extent possible, be treated as if he had acquired a direct interest in the partnership's underlying business and assets, regardless of whether he purchased his interest from the partnership, from a partner who contributed appreciated property to the partnership, or from one who contributed cash. Such treatment will permit MLP units to be fungible, but more

[63] The tax complexity is merely heightened in the case of MLPs because of the inability to determine the identity of the typical seller.

importantly it will eliminate distortions and incongruities that otherwise are faced by all partnerships.

a. Sections 704(b),704(c) and 743 and the Ceiling Rule.

(1) Section 704(b). Adjustment of capital accounts to reflect the fair market value of properties, whether upon contribution of such properties to a partnership or on the admission of new partners to a partnership holding such properties, is essential to maintaining the relative economic positions of the partners. Moreover, the Section 704(b) regulations now require that appreciated or depreciated property contributed to a partnership be reflected in the capital account of the contributing partner at its fair market value (rather than its tax basis).[64] The Section 704(b) regulations also provide that partnership property may be revalued upon the admission of new partners to an existing partnership and the existing partners' capital accounts adjusted to reflect the fair market value of such property.[65] Once a partner's capital account has been adjusted to reflect the fair market value of a contributed or revaluation property, the capital accounts must be

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[64] Treas. Reg. § 1.704(b)(2)(iv)(d)(1).

[65] The unrealized appreciation or depreciation reflected -&on the contribution of a property contributed to a partnership will be referred to as-"booked-in" or "precontribution" appreciation or depreciation; the partners contributing such property as "contributing" partners; and the property itself as a "contributed" property. The unrealized appreciation or depreciation reflected by the revaluation of an existing partnership property upon the admission of new partners-will be referred to as "booked-in" or "preadmission" appreciation or depreciation; the existing partners whose capital accounts are adjusted to reflect such appreciation or depreciation as "revaluation" partners; and the existing property that is adjusted as a "revaluation" property. Appreciation or depreciation that accrues after a revaluation, such that it has not been reflected in the partners' capital accounts, will be referred to as "unbooked" or "postcontribution" appreciation or depreciation, in the case of a contributed property, and "unbooked" or "postadmission" appreciation or depreciation, in the case of a revaluation property.

[66] Treas. Reg. § 1.704-1(b)(2)(iv)(g)(1).

subsequently adjusted for “book” depreciation, depletion, amortization and gain or loss with respect to any such property.[66] Generally, once a book value is established for a property, federal income tax principles are applied in determining the method of depreciation, depletion or amortization applied to such property for book purposes, substituting book basis for tax basis.[67]

(2) Section 704(c). Adjustments to capital accounts upon the contribution or revaluation of properties will result in differences between the amounts in the partners' book capital accounts, which reflect the fair market value of properties, and their tax capital accounts, which only reflect recognized tax consequences. Section 704(c) requires that items of depreciation or depletion and gain or loss attributable to a contributed property be allocated for federal income tax purposes in a manner that eliminates the disparity between the book value of such property and its tax basis (“book/tax disparity”). In addition, the Section 704(b) regulations require that, upon a revaluation of properties immediately prior to the admission of new partners, items of depreciation or depletion and gain or loss attributable to such properties must be allocated in accordance with Section 704(c) principles to eliminate the book/tax disparity resulting from such revaluation.[68]

The Committee Reports to the 1984 Act state that the primary motivation in making the application of Section 704(c)(2) mandatory was to prevent the shifting of tax consequences

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[67] Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3).

[68] Treas. Reg. § 1.704-1(b)(4)(i), This allocation of items attributable to a revaluation property shall be referred to as a “reverse 704(c)11 allocation.

attributable to precontribution gain or loss from the contributing partners to the noncontributing partners that would occur if a proportionate allocation of such precontribution appreciation or depreciation was applied for federal income tax purposes in allocating the income or loss from operation, or gain or loss from sale, of such property.[69] The Executive Committee strongly supports that objective. The Section 704(b) regulations as finalized in 1985, however, have given Section 704(c) the broader purpose of aligning book and tax consequences through the elimination of all book/tax disparities. The consequence of such alignment is to eliminate the potential for any shifting of tax consequences between contributing (or revaluation) partners and noncontributing (or newly admitted) partners - a goal we heartily endorse.

For purposes of making Section 704(c) (or reverse 704(c)) allocations of depreciation or depletion, each noncontributing (or newly admitted) partner is allocated a share of the partnership's tax depreciation or depletion equal in amount to the book depreciation or depletion he is allocated, and the contributing (or revaluation) partner is allocated what is left. By allocating the noncontributing (or newly admitted) partner tax depreciation equal to his book depreciation, such partner receives the equivalent of an “inside” basis in such property equal to such partner's economic cost in such property. On the other hand, by allocating to the contributing (or revaluation) partner less tax depreciation than book depreciation in the case of an appreciated property (or more tax depreciation than book depreciation in the case of a depreciated property) while

[69] Partners whose capital accounts have not been adjusted to reflect (i) precontribution appreciation or depreciation with respect to a contributed property, will be referred to as “noncontributing” partners and (ii) preadmission appreciation or depreciation with respect to a revaluation property, will be referred to as “newly admitted” partners.

allocating to him his proportionate share of gross income derived from the contributed (or revalued) property, such partner should be required to recognize the precontribution (or preadmission) appreciation or depreciation in such property, subject to his share of any subsequent changes in value, over the life of the property. If such property fails to produce income equal to its book value during its economic life, the Section 704(c) (or reverse 704(c)) allocation also insures that the contributing (or revaluation) partner will not be shifted any of the noncontributing (or newly admitted) partner's tax loss attributable to the property's decline in value.

> Example 1: Assume that A and B form an equal partnership AB. A contributes depreciable rental property with a tax basis of $600 that is valued at $1,000 on the contribution date. B contributes $1,000 in cash. If the property is held for its entire economic life, Section 704(c) would require that B be allocated $500 of tax depreciation (to match his $500 of book depreciation) and that A be allocated the remaining depreciation of $100 (resulting in A receiving $400 less tax depreciation than book depreciation). If, over its economic life, the property produced $1,000 of gross rental income, in accordance with its agreed value, B would be sheltered from the recognition of any taxable income (just as he would recognize no economic income) and A would recognize $400 of taxable income (to match the $400 of economic income for which he was credited on contribution). Without the Section 704(c) allocation, $200 of precontribution gain would have been shifted from A to B.
>
> If the property only produced $600 of gross income (reflecting a $400 postcontribution decline in value), the Section 704(c) allocation would result in B recognizing a tax loss of $200 (matching his $200 share of the postcontribution economic loss) and A recognizing $200 of taxable income (matching his $400 of precontribution economic income, reduced by his $200 of postcontribution economic loss). Without the Section 704(c) allocation of depreciation, B's $200 share of the $400 postcontribution tax loss would have been shifted from B to A.

For purposes of making a Section 704(c) (or reverse 704(c)) allocation of gain or loss, any gain recognized for tax purposes on the sale of a contributed (or revalued) property with booked-in appreciation will be allocated to the contributing (or revaluation) partners up to an amount equal to any unamortized

booked-in appreciation at the time of its sale. The residual gain will be allocated in the same manner as its corresponding book gain is allocated. Any loss recognized for tax purposes on the sale of a contributed (or revalued) property with booked-in depreciation will first be allocated to the contributing (or revaluation) partners up to an amount equal to any unamortized booked-in depreciation at the time of its sale. Any residual loss will be allocated in the same manner as its corresponding book loss is allocated.

> Example 2: Assume in example 1 that A and B form an equal partnership AB. A contributes land with a tax basis of $600 that is valued at $1,000 on the contribution date. B contributes $1,000 in cash. If AB sells the land for $1,000, Section 704(c) would require that all of the tax gain of $400 recognized by AB on the sale be allocated to A (to match the $400 of economic income credited to him on contribution). Since B would not recognize any economic gain or loss from the sale (based on his effective economic cost of $500 in the land), he would not be allocated any tax gain or loss either.
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> Example 3: Assume in example 2 that the land A contributed had a tax basis of $1,500 on the contribution date. If AB sells the land for $1,000, Section 704(c) would require that all of the tax loss of $500 recognized by AB on the sale be allocated to A (to match the $500 economic loss charged to him on contribution). B, who would not have recognized any economic gain or loss from the sale (based on his effective cost of $500 in the land), would not be allocated any tax gain or loss.

It should be noted that Section 704(c) and reverse 704(c) allocations of depreciation or depletion and gain or loss work in concert to provide a noncontributing (or newly admitted) partner the equivalent of a “full-cost” inside basis in the partnership’s assets as if such person had directly acquired an undivided interest in such assets from the contributing (or revaluation) partner. Such result occurs because Section 704(c) brings the tax consequences in line with the economic (“book”) consequences. Unfortunately, such alignment is disrupted by the requirement in the current Treasury Regulations (promulgated when the requirement now in Section 704(c) was only voluntary) that the

total depreciation, depletion, gain or loss allocated to partners under Section 704(c) cannot exceed the amount of depreciation or depletion allowable to, or gain or loss realized by, the partnership (the "ceiling rule"). The same limitation is imposed on reverse 704(c) allocations under Revenue Ruling 75-458.[70]

Ceiling rule limitations on depreciation or depletion occur when contributed (overvalued) property has total tax basis that is less than the economic cost incurred by the noncontributing (or newly admitted) partners with respect to their share of the value of such property. Such ceiling limitation on depreciation or depletion results in the noncontributing (or newly admitted) partners being denied tax depreciation or depletion equal to the economic depreciation or depletion such partners actually realize. [71] Conversely, the contributing (or revaluation) partners receive an unfair tax windfall. Such is the result since the current Treasury Regulations do not require that they recognize, for tax purposes, the economic gain or loss they actually derive from such property (which recognition would have occurred if their tax depreciation or depletion had been fully adjusted to reflect such economic result).[72] In the event an appreciated contributed (or revaluation) property produces an operating income stream, over its economic life, which reflects its book value, the ceiling limitation causes a shifting of tax consequences attributable to a portion of the precontribution (or preadmission) appreciation from the contributing (or revaluation) partners to the noncontributing (or newly admitted) partners.

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[70] 1975-2 C.B. 258.

[71] Treas. Reg. § 1.704-1(c)(1) (Ex. 2 and 3).

[72] Id.

> Example 4: Assume that A and B form an equal partnership AB. A contributes a building with a tax basis of $400 that is valued at $1,000 on the contribution date. B contributes $1,000 in cash. The building produces $1,000 of gross rental income (reflective of its book value) over its economic life. If the building is held by AB throughout its entire economic life, the Section 704(c) ceiling rule will limit B's tax depreciation to $400 even though he has incurred $500 of economic depreciation. A would be allocated no tax depreciation. The ceiling rule prohibits a combined allocation of $500 tax depreciation to B (to match his economic depreciation) and an allocation of an additional $100 of income to A (as an offset to the "excess" depreciation otherwise allocated to B). The gross income, which is not subject to allocation under Section 704(c), will be allocated $500 to A and $500 to B in accordance with their economic sharing. Thus, A would be allocated net taxable income from the building of $500 (while he actually recognized economic income of $600). On the other hand, B would be allocated net taxable income from the building of $100 (while he actually realized no economic income). As a result of the ceiling rule, the existing Treasury Regulations permit A to shift the tax consequences attributable to $100 of his precontribution appreciation in the building to B.[73]

Ceiling rule limitations on gain or loss occur when precontribution appreciation or depreciation in a contributed (or revalued) property is offset by postcontribution changes in the value of such property. The noncontributing (or newly admitted) partners cannot recognize tax losses or gains to correspond to the economic losses or gains, respectively, realized by such partners upon a sale of such property for less than its adjusted book value (in the case of a property with booked-in appreciation) or more than its adjusted book value but less than its tax basis (in the case of a property with booked-in depreciation). On the other hand, the contributing (or revaluation) partners are prevented from fully recognizing a tax gain or loss equal to the economic gain or loss they realize from such property. Although as an economic matter the postcontribution changes in value are shared proportionately by the partners, the ceiling rule has the effect of shifting away from the noncontributing (or newly admitted) partners their share of such postcontribution changes in value to the extent such

[73] Id.

changes in value offset precontribution appreciation or depreciation.

> Example 5: Assume that A and B form an equal partnership AB. A contributes land with a tax basis of $500 that is valued at $1,000 on the contribution date. B contributes $1,000 in cash. If AB sells the land for only $800, B would have actually incurred an economic loss of $100 (his effective cost in the land of $500 less his share of proceeds of $400). As an economic matter, A would realize a $400 gain (his share of total proceeds of $900 (including his share of B's contributed cash) less his cost in the land of $500). Due to the ceiling rule, however, the current Treasury Regulations would provide that only the $30 tax gain actually recognized on the sale be allocated to A. AB would not be allowed to allocate to B a $100 tax loss (to match his economic loss) and treat A as if he had recognized a $400 gain on such sale (to net to the actual $300 gain recognized by AB). As a result of the ceiling rule, the tax consequences attributable to B's $100 share of total postcontribution depreciation of $200 has been shifted to A.[74]

> Example 6: Assume in example 5 that the land A contributes had a tax basis of $1,500 on the contribution date. If AB sells the land for $1,200, B would have actually incurred an economic gain of $100 (his share of the sale proceeds of $600 less his effective cost in the land of $500). As an economic matter, A would realize a $400 loss (his cost in the land of $1,500 less his share of total proceeds of $1,100 (including his share of B's contributed cash)). Due to the ceiling rule, however, the current Treasury Regulations under Section 704(c) would provide that only the $300 tax loss actually recognized on the sale be allocated to A. AB would not be allowed to allocate to A an additional $100 tax loss (to match his $400 economic loss) and to allocate to B an additional $100 tax gain (to match his $100 economic gain). As a result of the ceiling limitation, B's $100 share of total postcontribution appreciation of $200 has been shifted to A for tax purposes.[75]

So long as the ceiling limitation is allowed to supersede the alignment of economic and tax consequences, it would appear that only through special curative tax allocations of residual items of income, gain, loss or deduction (not otherwise required

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[74] Id.

[75] Id.

for the elimination of book/tax disparities) can the distortions caused by the ceiling limitations be corrected.[76] With respect to appreciated properties that are ceiling limited either as to depreciation or depletion or as to gain or loss, such curative allocations would take the form of increased allocations of income or gain to contributing (or revaluation) partners or increased allocations of deduction or loss to noncontributing (or newly admitted) partners. With respect to depreciated properties that are ceiling limited as to gain or loss, such curative allocations would take the form of increased allocations of income or gain to the noncontributing (or newly admitted) partners or increased allocations of deduction or loss to the contributing (or revaluation) partners. In neither case would such curative allocations alter allocations for book purposes, but would only be made for federal income tax purposes.

> Example 7: In example 4 A contributed a building with a tax basis of $400 and a value of $1,000. In that case B was allocated only $400 of tax depreciation (even though he incurred $500 of economic depreciation). As a direct result B has to report $100 of net taxable income (while he actually realized no economic income). On the other hand, A received only $500 of taxable net income (while he actually realized $600 of economic income). Although the current Treasury Regulations would not allow the allocation to B of an additional $100 of "phantom" depreciation, we believe that the partners should be allowed to agree among themselves to share the gross income (from either this property or some other source) in a manner which compensates B for this lost depreciation and forces A to pay tax on his true economic income. If the property produces $1,000 of gross income over its economic life, the partners could agree to allocate, for tax purposes only, such gross income $600 to A and $400 to 8. Over the life of the property, A would be allocated $600 of taxable income (matching his $600 of economic income) and B would be allocated no taxable income (matching his economic income). Such curative allocation of gross income would have corrected the $100 ceiling rule distortion that would otherwise have been imposed on B. As an alternative to achieve the same result Treasury could permit the ceiling distortion to be eliminated through a disproportionate allocation

[76] For an excellent detailed analysis of Section 704(c), Section 743(b), the ceiling limitation and the use of curative allocations, see Marich & McKee, Sections 704(c) and 743(b): The Shortcomings of Existing Regulations and the Problems of Publicly Traded Partnerships, 41 Tax L. Rev. 627 (1986) (hereinafter cited as Marich & McKee).

of an expense item attributable to another source (such as the cash contributed by B), for the benefit of B.

Example 8: In example 5 A contributed land with a tax basis of $500 and a value of $1,000. In that case, on the sale of the land for $800 B would be allocated no tax loss (even though he incurred a $100 economic loss) and A would be allocated a tax gain of $300 (while he actually realized a $400 economic gain). We believe that the partners should be allowed to agree among themselves to allocate to A an additional $200 of income attributable to another source (such as interest on B's capital contribution). Such income would be allocated to A to correct the distortions created by the ceiling rule. Thus, A would be allocated taxable income of $500 (to match his $500 economic income) and B would be allocated no taxable income or loss and would realize no economic gain or loss (such tax and economic consequences reflecting the additional allocated interest income).

The curative allocation approach is by no means a perfect solution to elimination of disparities caused by the ceiling rule. Curative allocations can only reverse ceiling distortions if such allocations are not reflected in the partners' book capital accounts, and, thus cannot have "economic effect" under the Section 704(b) regulations. Such allocations are only supportable under Section 704(c) principles because such allocations reflect inherently sound tax policy by eliminating book/tax disparities, and preventing (or reversing) a potential shift of tax consequences among other partners that may substantially differ from the underlying economic arrangement.[77] In order to effectively reverse ceiling limitation distortions through curative allocations, a taxpayer must have adequate items

[77] Both the House and Senate Committee Reports state that it is anticipated that the Section 704(c) regulations wil permit partners to agree to a more rapid elimination of book/tax disparities than is required under Section 704(c), assuming that no tax avoidance potential exists. In addition, such reports note that it may appropriate to amend Treas. Reg. § 1.704-1(c)(2) (Ex. 2) to provide for an allocation of gain from the sale of the property, in excess of the precontribution gain, to the contributing partner in an amount which would make up for the noncontributing partner receiving tax depreciation deductions less than the economic depreciation he actually suffered due to the application of the ceiling rule.

of gross income or expense to supplement the Section 704(c) (or reverse 704(c)) allocations. Moreover, certain conventions must be adopted under which a partner receiving the benefit of a curative allocation is treated for certain purposes, including the determination of such partner's distributive share of partnership tax preference or recapture items, as if he was actually allocated the item of income, gain, deduction or loss that was ceiling limited.[78] Finally, we believe any new Treasury Regulations under Section 704(c) should condition the use of such curative allocations on a showing that such allocations are not resulting in tax avoidance because of certain character and timing benefits. Despite the existence of these potential problems, as long as the ceiling limitation rule is left intact and a deferred sale approach to Section 704(c) (discussed below) is not provided, the curative allocations appear to be the only means available (under the existing regulatory framework) for providing tax uniformity among partnership interests where ceiling-limited properties are involved.

The other approach to dealing with contributed properties that forces tax consequences to follow book consequences and, thus, avoids the complex distortions caused by the ceiling rule, is commonly referred to as the "deferred sale" approach.[79] This approach was endorsed by the Executive Committee in its report dated _____ 1985. Under the deferred sale approach, the contributing (or revaluation) partner would be treated as selling

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[78] Without such conventions, identity of tax characteristics with the interests of the other partners would not be achieved.

[79] Although there are actually two versions of the deferred sale approach, distinguished as "partial" and "full," the two versions differ only with respect to the treatment of the contributing (or revaluation) partner and the net tax consequences to all partners is generally the same under both approaches. The text describes the mechanics of a "full" deferred sale approach. For a complete discussion of both versions of the deferred sale approach, see Marich & McKee at 682.

the contributed (or revaluation) property to the partnership at its fair market value. The partnership acquires a fair market value tax basis in the property and the contributing (or revaluation) partner is allocated a deferred gain or loss equal to the difference between the fair market value and the basis of such property. The contributing (or revaluation) partner's recognition of this deferred gain or loss will subsequently be triggered by (1) the partnership's depreciation, depletion or other amortization of the contributed (or revaluation) property, (2) the partnership's disposition of such property or (3) the contributing (or revaluation) partner's disposition of all or part of his partnership interest. Although the deferred sale approach and curative allocations should reach the same result, assuming an adequacy of income or expense items to facilitate the curative allocations, there is a substantive difference between the two approaches in dealing with ceiling rule problems. The deferred sale approach results in an effective repeal of the ceiling rule, while the curative allocation respects the rule but attempts to reverse its distorting impact.

> Example 9: In example 4 A contributed a building with a tax basis of $400 and a value of $1,000. Under the deferred sale approach A is treated as if he sold the building to AB for $1,000, realizing deferred gain of $600. AB would acquire a $1,000 tax basis in the building. If the building is depreciated at an annual 10% rate, AB has a $100 depreciation deduction each year allocated equally between A and B. If the building's gross income of $1,000 was realized at the same annual rate, A would recognize $60 of net taxable income each year ($60 deferred gain, $50 of gross income and $50 of tax depreciation). This would match his $60 of economic income each year. B would recognize no net taxable income each year ($50 of gross income, $50 of tax depreciation), matching his economic income. If the building failed to produce any gross income, unlike a curative allocation, the result under the deferred sale approach would be unaffected.

> Example 10: In example 5 A contributed land with a tax basis of $500 and a value of $1,000. Under the deferred sale approach A would realize a deferred gain of $500 and AB would have a tax basis in the land of $1,000. If the land declines in value and is sold for $800, the partnership recognizes a $200 tax loss which is allocated equally between A and B. A recognizes a net tax gain of

$400 (deferred gain of $500 and his allocated tax loss of $100), which matches his economic gain of $400. B recognizes his allocated tax loss of $100, matching his economic loss of $100.

The apparent policy underlying the ceiling limitation was based upon a preference for the entity approach to Subchapter K. It was designed as a means of avoiding the perceived valuation pressures brought about by creating an item of artificial income as a result of a revaluation of property. Such problems were presumably avoided by relying on the basis and amount realized computations of the partnership, both such numbers being fixed and absolute in amount. Avoidance of precise asset valuations no longer seems to justify the distortions created by the ceiling rule, as such asset valuations appear to now be required in any event by the Treasury Regulations under Section 704(b).

As stated, the application of Section 704(c) principles, and the valuation required thereby, are now mandatory upon both the contribution of property and the revaluation of property in connection with the admission of new partners.[80] In addition, under the 1986 Act, partners will be required to use the residual method of allocating Section 743 (b) adjustments. [81] That method generally requires reasonably precise valuations of partnership properties to determine whether a portion of the basis adjustment must be allocated to goodwill, going concern value, or other intangible assets. Thus, it is questionable whether continued application of the ceiling rule based on valuation concerns is justified. Moreover, the priority given under the Section 704(b) regulations to the alignment of economic and tax consequences seems to more than justify a repeal of such rule. Thus, the deferred sale approach may be the optimum solution. In the event, however, Treasury determines that the ceiling rule is necessary,

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[80] Treas. Reg. § 1.704-1(b)(4)(i).

[81] § 1060.

in nonabusive situations partners should at least be allowed to avoid its distortions through the use of curative allocations with respect to both ceiling-limited depreciation or depletion and ceiling limited gain or loss.

(3) Section 743. The dissimilarities caused by the ceiling rule between a contributing (or revaluation) partner's interest and a noncontributing (or newly admitted) partner's interest would be of little concern to a purchasing partner if such dissimilarities were eliminated by the Section 743(b) adjustment. In fact, they would be of no more concern than the fundamental distinction created between such interests by the Section 704(c) (or reverse 704(c)) allocations. Such ceiling limitation disparities, and the dissimilarities between otherwise identical interests that ensue therefrom, are preserved, however, from each transferor to his transferee even when a Section 754 election is made.

Section 743(a) of the Code sets out the general rule that there will be no adjustment to the basis of a partnership's assets upon the transfer of an interest in that partnership. Section 743(b), however, provides that the basis of partnership assets will be adjusted upon a sale or exchange of a partnership interest (or upon the death of a partner) if an election under Section 754 has been filed by the partnership. The principal purpose of the basis adjustment provided by Section 743(b) when a partnership interest is transferred by sale or exchange or upon death is to put the transferee in the position he would have been in had he acquired a direct interest in the partnership's underlying assets. This prevents a buyer from recognizing taxable gain or deductible loss (attributable to periods before he became a partner) which his seller would have already recognized on the sale.

The Section 743(b) adjustment is measured by the difference between the transferee's adjusted basis in his partnership interest (his "outside basis") and his proportionate share of the adjusted basis of the partnership property (his "inside basis"). In determining inside basis, any allocation under Section 704(c) must be taken into account.[82] Section 704(c) attempts to align book and tax consequences by allocating unrecognized tax consequences, the economic corollary to which has already been reflected in capital accounts, to the partners whose capital accounts have been adjusted to reflect such economic corollary. The substantive effect of Section 704(c) allocations, as discussed previously, is to give the partners whose capital accounts have not been so adjusted greater inside basis (in the case of appreciated property) or lesser inside basis (in the case of depreciated property) than is reflected in their proportionate shares of the partnership's total inside basis. This disproportionate sharing of inside basis is taken into account under the Section 743 regulations by establishing that the tax basis capital account of a transferee partner (inherited from his transferor) is determinative of such transferee's inside basis where the partnership holds properties subject to Section 704(c) allocations.[83] A reverse 704(c) allocation accomplishes the same thing.[84]

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[82] § 743(b) and Treas. Reg. § 1.743-1(b)(1).

[83] Treas. Reg. § 1.743-1(b)(2)(i) (Ex. 2 and 3).

[84] Although the § 743 regulations are silent as to whether these § 704(b) allocations are taken into account in determining a transferee partner's inside basis, it is generally accepted that the § 743 regulations should be interpreted to take such allocations into account.

Reliance on tax basis capital accounts as a measure of inside basis in the context of a partnership holding ceiling-limited properties violates sound tax policy by ensuring that ceiling rule distortions continue to infect the partnership's assets upon a transfer of partnership interests. If a noncontributing (or newly admitted) partner's depreciation, depletion or other amortization of inside basis has been limited by the ceiling rule, any buyer purchasing that interest will inherit the same shortfall in tax depreciation or depiction. That buyer, like the seller, however, will be fully protected under Section 704(c) from an unwarranted shifting of tax consequences upon a sale of the property so long as such sale is for an amount not less than the book value of the property. This preservation of ceiling rule distortions results from the fact that the noncontributing (or newly admitted) partner's tax basis capital account overstates the transferee partner's share of inside basis since such tax basis capital account fails to reflect the fact that the inside basis associated with this interest is ceiling limited. If the transferee partner purchases the interest of the contributing (or revaluation) partner, the tax basis capital account inherited by such transferee understates the actual inside basis attributed to such transferor because it fails to reflect the unrecognized tax consequences that have been shifted to the noncontributing (or newly admitted) partner due to the ceiling limitation.

> Example 11: Assume that A and B form an equal partnership, AB. A contributes depreciable rental property having a tax basis of $400 that is valued at $1,000 on the contribution date. B contributes $1,000 in cash. The property produces $1,000 of gross rental income over its economic life. Due to the property's basis being ceiling limited, absent curative allocations of income or resort to the deferred sale approach supra, over the economic life of the property B will incur $500 of economic depreciation but will be allowed only $400 of tax depreciation. As a result, B would recognize $100 of taxable net income (even though he would realize no economic net income). On the other hand, A would recognize $500 of taxable net income, while he would realize $600 of economic net income (having effectively shifted the tax liability with respect to $100 of precontribution gain to B under the ceiling rule).

The Section 743(b) adjustment will not operate to eliminate ceiling rule aberrations. If in example 11 above, B sells his partnership interest to D for $1,000, D1s adjustment will be zero ($1,000 purchase price less $1,000 tax capital).[85] Such adjustment leaves D with the same potential $100 ceiling limitation disparity that B had. (Had B sold his interest for more than $1,000, D's Section 743(b) adjustment would be required, in its entirety, to provide coverage on D's share of postcontribution appreciation reflected by such increased purchase price). On the other hand, if A sells his interest to C for $1,000, C's § 743(b) adjustment will be $600 ($1,000 purchase price less $400 tax capital). With such adjustment depreciated over the life of the property, C will incur $500 of economic depreciation and no economic net income, but will be entitled to $600 of tax depreciation and $100 of tax loss. Thus, the $100 ceiling disparity has survived the transfers and has been inherited by the original partners' transferees.[86]

As discussed, when the ceiling limitation applies to gain or loss from the sale of contributed (or revaluation) property, it

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85 For simplicity of illustration, this example does not take into account the effect of § 708(b)(1)(B).

86 The opportunities for abuse by taxpayers taking advantage of the current Treasury Regulations under § 704(c) is obvious. A high bracket taxpayer could contribute high value but low basis ceiling limited property to a partnership. A low bracket taxpayer, a taxpayer having loss carryovers, would contribute cash or high basis property. The ceiling rule would artificially deflect tax liability from the high bracket partner to the low bracket partner. Furthermore, the high bracket partner could sell its interest in the partnership to other high bracket taxpayers (presumably receiving a premium price therefor). Those buyers would inherit the same tax windfall from the ceiling rule as the original contributing partner. The fact that this loophole continues to exist is confirmed by the legislative history of Section 704(c). There taxpayers are explicitly told they may continue to rely on the existing (and now outdated) Treasury Regulations under Section 704(c) until Treasury promulgates new regulations. S. Rpt. 98-169, Vol. I, 98th Cong. 2d Sess. (1984).

results in a shifting of the tax consequences attributable to postcontribution (or post admission) gain or loss from the noncontributing (or newly admitted) partners to the contributing (or revaluation) partners. It does so despite the fact that the partners have agreed to share such gain or loss, as an economic matter, proportionately. Because the Section 743(b) adjustment is computed assuming that changes in value are shared for tax purposes in the same manner as they are shared for economic purposes, such adjustment fails to take into account the shifting between the noncontributing (or newly admitted) partners and the contributing (or revaluation) partners that results from the ceiling rule.[87]

> Example 12: Assume that A and B form an equal partnership, AB. A contributes land with a tax basis of $500 that is valued at $1,000 on the contribution date. B contributed $1,000 in cash. If the land declines in value to $500 and is sold, B would incur an economic loss of $250. But due to the ceiling rule under Section 704(c), B would not be allocated any tax loss. Conversely, A would realize an economic gain of $250. But due to the ceiling rule, A would not be allocated any tax gain under Section 704(c). A Section 743(b) adjustment will not alter this distortion. If, after the land had declined in value to $500, B sells his partnership interest to D for $750 D will have a negative Section 743(b) adjustment of $250 (purchase price of $750 less $1,000 tax capital). As will be discussed, under current Treasury Regulations absent the approval of the IRS District Director, it is unlikely that this adjustment can, or should, be allocated to the land (especially in the absence of a curative allocation) and would more likely be suspended.[88] If A sells his partnership interest to C for $750, C will have a positive Section 743(b) adjustment of $250. Such adjustment is also likely to be suspended (especially in the absence of a curative allocation).89[89]

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87 Because the § 743(b) adjustment is determined, in part, by a buyer's purchase price (which reflects the economic sharing of postcontribution (or postadmission) changes in value), such adjustment is attempting to offset: (i) in the case of a buyer from a noncontributing (or newly admitted) partner, a postcontribution gain or loss that does not exist because it has been shifted to the contributing (or revaluation) partners and (ii) in the case of a buyer from a contributing (or revaluation) partner, a precontribution gain or loss that does not exist because it has been offset by a shifting of the postcontribution gain or loss of the noncontributing (or newly admitted) partners.

88 See Treas. Reg. § 1.755-1(a)(1)(i).

89 Id.

> Example 13: Assume that A and B form an equal partnership, AB. A contributes land with a tax basis of $1,500 that is valued at $1,000 on the contribution date. B contributes $1,000 in cash. The land subsequently appreciates to $1500 and is sold. B would realize an economic gain of $250. But due to the ceiling rule under Section 704(c), B would recognize no tax gain. Conversely, A would incur a $250 economic loss. But A would not be allocated any tax loss. The Section 743(b) adjustment will not eliminate these ceiling rule distortions. If B sells his partnership interest to D for $250, D will have a positive Section 743(b) adjustment of $250. If A sells his partnership interest to C for $1,250, C will have a negative Section 743(b) adjustment of $250. Under current Treasury Regulations it would appear likely that both C and D would be required to suspend their inside basis adjustments.[90]

A literal application of the Section 743 regulations to ceiling-limited property results in a Section 743(b) adjustment which fails to provide a buyer partner with a full-cost basis (based on the purchase price of his interest) in the underlying assets of the partnership. In fact, the prescribed method for computing the adjustment produces a tax windfall for some and a tax hardship for others by preserving for buyer partners the inherent ceiling rule distortions imposed on their sellers, or even creating new distortions, with respect to interests in a partnership holding property that is subject to a (or reverse 704(c)) allocation.

b. Depreciation of a Section 743(b) Adjustment.

The Section 743(b) adjustment is attributed solely to a purchaser of a partnership interest. It is not added to the partnership asset basis that is allocated among all the partners (the “common basis”). With respect to property which is not subject to ACRS or MACRS, the Section 167 regulations provide that the transferee’s depreciation with respect to a positive adjustment is limited to either the straight-line method (in the case of most realty) or the 150% declining balance method (in case of personality), as if the adjustment were attributable to

[90] Id.

those methods applicable to "used" property.[91] Although no clear authority exists, it would appear that general practice among tax practitioners has been to depreciate a positive adjustment over the remaining depreciable life of the underlying property, rather than assessing a new useful life based on a facts and circumstance determination.[92] The Section 167 regulations provide that a negative basis adjustment be amortized into income at a redeter- mined rate derived from the rate applied to common basis. That income will offset an equal amount of partnership depreciation on common basis available to the buyer.[93]

With respect to recovery property, however, the Section 168 proposed regulations provide that a positive adjustment is only eligible for the ACRS rates if it relates to recovery property of the partnership.[94] In such case, contrary to the perceived general practice applied to nonrecovery property, the proposed Section 168 regulations, if finalized in their current form, would require that such positive basis adjustment be written off over a new recovery cycle, rather than over the remaining recovery period applied to the common basis of the underlying property.[95] The regulation further provides that, consistent with the Section 167 regulations, a negative adjustment be amortized into income at a redetermined rate derived from the rate applied to common basis. Under both the Section 167 regulations (due to

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91 Treas. Regs. §1.167(c)-1(a)(6).

92 New York State Bar Association, Tax Section, "Report of the Committee on Depreciation and Investment Credit on the Proposed Regulations on the Accelerated Cost Recovery System under Section 168 of the Code," April, 1984 ("Tax Section Report on Depreciation").

93 Treas. Reg. §1.167(c)-1(a)(6). This concept is analogous to the deferred sale approach to reconciling book/tax disparities discussed previously.

94 Prop. Treas. Reg. § 1.168-4(d)(8).

95 Prop. Treas. Reg. § 1.168-2(n).

its “used” property characterization varying the applicable method) and the proposed Section 168 regulations (due to its “new” property characterization commencing a new recovery cycle), the depreciable rate associated with a positive Section 743(b) adjustment will differ from the rate applied to a partnership’s common basis in the very same recovery property.

Partnership interests will share common basis for federal income tax purposes in differing amounts depending upon whether such interest bear the burden, or receive the benefit, of Section 704(c) and reverse 704(c) allocations. As a result, purchasers of these same interests will receive differing amounts of Section 743(b) basis adjustments depending upon whether the partnership interest purchased was originally issued for property or money. Assuming that no partnership property is ceiling limited, the Section 743(b) adjustment, when added to the common basis associated with that partnership interest, should give the buyer an inside basis in the partnership’s properties which reflects the exact price paid for his interest, regardless of whether the partnership interest purchased was originally issued for property or money. Application of either Treasury Regulation Section 1.167(c)-1(a)(6) or Proposed Treasury Regulation Section 1.168-2(n), however, will create depreciation and cost recovery differences between interest which carry different amounts of

common basis and Section 743(b) positive basis adjustments.[96]

In applying the used or new property characterization to the entire positive Section 743(b) adjustment, the regulations fail to take into account the relationship between the Section 704(c) (and reverse 704(c)) allocations and the Section 743(b) adjustment.

The Section 743(b) adjustment attributable to an interest with respect to which the underlying capital account has been adjusted for unrealized appreciation or depreciation and to which will be allocated the unrecognized tax consequences attributable to such “booked-in” appreciation or depreciation under Section 704(c) principles serves a dual purpose. One layer of the Section 743(b) adjustment, designed to give the buyer of that interest inside basis, which will offset the future tax consequences relating to the booked-in appreciation or depreciation attributed to such interest. This adjusts the partner’s share of inside tax basis to an amount equal to his share of the current book value of the property. The other layer of the Section 743(b) adjustment is designed to give the buyer inside tax basis which will offset the tax consequences relating to the “unbooked” appreciation or depreciation which has accrued since the contribution (or the most recent revaluation) of the property for which the interest was originally issued which has not been reflected in any partner’s book capital account. This further adjusts the buyer’s share of inside tax basis from his share of current book value to

[96] Since negative basis adjustments are amortized into income at a redetermined rate derived from the rate applied to common basis, such adjustments do not appear to create the same depreciation dissimilarities that result from positive basis adjustments (whether attributable to booked-in or unbooked depreciation). Moreover, such dissimilarities would not result from positive basis adjustments if the deferred sale approach to 5 704(c) (and reverse 704(c)) allocations were available. Under that approach, common basis is effectively shared proportionately.

his share of the current fair market value of the property. The two components of the Section 743(b) adjustment combine to adjust the buyer's share of tax basis to equate to his share of the current fair market value of the partnership's property (as reflected by the purchase price of his interest).

On the other hand, the Section 743(b) adjustment attributable to an interest with respect to which the underlying capital account has not been adjusted for unrealized appreciation or depreciation (as for example a partnership interest issued for cash) is solely to give the buyer inside tax basis which offsets the tax consequences relating to his share of unbooked appreciation or depreciation. The buyer of such an interest must rely solely on the Section 704(c) (or reverse 704(c)) allocations to provide coverage on the tax consequences attributable to any booked-in appreciation or depreciation reflected in the capital accounts of other partners. With respect to this interest, the Section 704(c) (or reverse 704(c)) allocations should be made to work in concert with the Section 743(b) adjustment to provide the partner with an inside basis that equates to his share of the fair market value of the properties.

We believe that the legislative history of Section 743 directly supports this relationship between Section 704(c) and Section 743. It is clear from the legislative history that both the House amendments and the Senate amendments to what became Section 743(b) originally used what would have been a pure aggregate approach to Section 743(b). Both would have required that the basis adjustment be added to the common basis of the assets.[97] Because the Senate version had introduced Section 704(c)(2), the predecessor to what is now Section 704(c), it

[97] H. Rep. No. 1337, 83d Cong., 2d Sess. (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954).

expressly limited the Section 743(b) adjustment to common basis to that portion of the Section 743(b) adjustment attributable to already booked-in appreciation.[98] Such adjustment to common basis would be allocated among the partners in the same manner it would have been allocated had it been part of common basis at the point of revaluation, when such booked-in appreciation was realized as an economic matter. Only the portion of the adjustment attributable to unbooked appreciation would have been personal to the transferee.

The Conference Committee recognized that the pure aggregate approach included in the House and Senate versions for computing Section 743(b) adjustments was appropriate when Section 704(c)(2) (the predecessor to what is now Section 704(c)) applied but would be inappropriate when Section 704(c)(1) applied (as in effect prior to the 1984 Act). In modifying the original method by which the section 743(b) adjustment was to be computed, based on the difference between the buyer's purchase price and the seller's outside basis, to a method based on the difference between the buyer's purchase price and his actual share of inside basis, the Conference Committee was forced to abandon the approach of adjusting common basis by the Section 743(b) adjustment. Such modification was dictated by problems related exclusively to the distorting potential in what became Section 704(c)(1). There is clear support throughout the Conference Report, however, that the draftsmen only revised the Senate bill to accommodate the special problem raised by Section 704(c)(1). They intended to retain the pure aggregate approach of the Senate version for purposes of dealing with Section 704(c)(2) allocations.

When partnership property is revalued, the inherent appreciation reflected by such revaluation is realized, as an

[98] S. Rep. No. 1622, 83d Cong., 2d Sess. 399, Ex. 2 (1954).

economic matter, by the contributing (or revaluation) partner at that time. The tax basis attributable to the realization of such inherent appreciation arises, as an economic matter, at the same time. Section 721, however, extends for tax purposes nonrecognition treatment on a revaluation triggered by a contribution of property to a partnership. Consistent with that rule, Section 723 requires that the contributed property retain its historical tax basis in the hands of the partnership. Section 721 also accounts for the fact that the inherent appreciation that has inured to existing partners as an economic matter upon a revaluation of partnership properties triggered by the admission of a new partner, is not taxed currently. Similarly, the tax basis of such properties is not stepped up to fair market value. Section 704(c) ensures that the partners who receive the benefit of a deferral upon a revaluation of a contributed (or revaluation) property will bear the ultimate tax cost of such deferral.

As was noted in the Tax Section Report on Depreciation[99], any determination of the proper method of depreciating a Section 743(b) basis adjustment must address whether such basis adjustment which was designed to equalize inside and outside basis, in light of this statutory interplay, did so by treating the adjustment as a new acquisition of property. In the case of a positive Section 743(b) basis adjustment attributable to an interest burdened by a Section 704(c) (or reverse 704(c)) allocation, viewing the Section 743(b) adjustment as “used” property under Section 167, or “new” property under Section 168, would only seem appropriate when applied to the layer of the adjustment which offsets unbooked appreciation, not the appreciation already booked up under Section 704(c). As the Section 743 legislative history clearly demonstrates, the layer

[99] Note 92 supra.

of the adjustment which offsets booked-in appreciation under section 704 (c) is intended to merely provide basis to offset appreciation that has already accrued, as an economic matter, prior to the event that initially gave rise to the revaluation of the underlying property. When the partnership interest with an underlying capital account that reflects booked-in appreciation is sold, such appreciation is taxed to the selling partner (since the basis of that interest reflects the same element of booked-in appreciation). Since, at the time of such sale, the seller has realized the final benefits of the Section 721 deferral and has borne fully the tax cost of such deferral (through the combination of reduced depreciation under Section 704(c) and the gain recognition for tax purposes on the sale of his interest), no continuing impact from the seller’s deferral of gain should be inflicted upon the buyer of that interest by applying a depreciation rate to his inside basis different from that which would have applied had the transferor’s economic realization been taxed at the time of the book-up. Thus, this portion of the Section 743(b) basis adjustment is nothing more than a mechanical adjustment designed to offset the toll charge exacted on the property contributing seller by Sections 723 and 704(c) for the deferral of any tax on the booked-in appreciation. Moreover, as the legislative history supports, this portion of the Section 743(b) basis adjustment is intended to put a buyer in the position he would have been in had the seller never received the benefits of the deferral afforded by Section 721. If there is a compelling logic to treating any portion of the basis adjustment as “used” property under Section 167, or “new” property under Section 168, we believe it should only extend to unbooked appreciation the economic benefit of which has not previously been realized by the transferor of the partnership interest.

It therefore appears appropriate that a matching of the booked-in appreciation or depreciation layer of the Section 743(b) adjustment and the Section 704(c) (or reverse 704(c)) gain or loss be achieved by applying a redetermined rate of amortization to such layer of the Section 743(b) adjustment that will amortize that adjustment over the same period that the Section 704(c) (or reverse 704(c)) gain or loss is being amortized.[100] This redetermined rate of amortization is derived from the rate of depreciation or amortization applied to the common basis of the adjusted property. Under this analysis, only the unbooked appreciation component of the Section 743(b) adjustment should be treated as either "used" property under the Section 167 regulations or "new" property under the proposed Section 168 regulations and subjected to whatever amortization rate is prescribed by regulation. This second layer of the adjustment attributable to an interest burdened by a Section 704(c) (or reverse 704(c)) allocation should always equal the entire Section 743(b) adjustment attributable to an interest benefiting from such allocation if both interests were purchased at the same price. Such a "dual approach" in depreciating the Section 743(b) basis adjustment should always result in equivalent depreciation or amortization on interests purchased at the same price, thereby providing tax identity to interests that are otherwise identical as an economic matter.[101]

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[100] Notably, this is presumably the identical result that would ensue under the deferred sale approach since, under that approach, common basis would be stepped up to fair market value at the time the booked-in appreciation is realized as an economic matter.

[101] This approach will result in tax identity of interests when applied to a property with booked-in appreciation which has subsequently declined in value, or with respect to a property with booked-in depreciation which has subsequently increased in value.

The dual approach to depreciating basis adjustments may be attacked on the grounds that it provides an opportunity for a purchaser of an interest to take an inordinate amount of depreciation over the potentially shorter cycle attributable to common basis. It would not appear, however that such opportunity is unwarranted since the redetermined rate derived from the depreciation rate applied to common basis would only be applied to the booked-in appreciation layer of the adjustment. If it is assumed that the contributed property produces income reflecting an amortization of its initial book value at the same rate as such property is depreciated for book and tax purposes, the application of the dual approach will merely provide the transferee with depreciation coverage to offset the Section 704(c) amortization of the seller's deferred gain.[102] Thus, it would provide the buyer with no net benefit; merely protection from an unwarranted income recognition.

If the contributed (or revaluation) property does not produce income reflecting its book value at the same rate as it is depreciated, the transferee partner under the dual approach is still getting no more than a tax deduction for the economic loss such partner is actually incurring (through the charge to his capital account). The transferee of an interest burdened by the section 704(c) (or reverse 704(c)) allocation is, thus, put in the same position he would have been in had he acquired an interest benefitting from such allocation, and yet not allow the Section 743(b) adjustment to provide the same benefit to a buyer from a partner bearing the burden of such allocation. Moreover,

[102] It would appear that § 704(c) contains an implicit assumption that an appreciated property will produce income equal to its book value at the same rate as such property is depreciated for tax purposes, since § 704(c) relies on allocations of depreciation, rather than gross income, to amortize the booked-in appreciation out of operating revenue. Of course, what was § 704(c)(2) predated tax subsidized depreciation under ACRS.

the significance attributed to the alignment of economic and tax consequences under the Section 704(b) regulations through the utilization of Section 704(c) principles may compel an application of Section 743 (which section in many respects is a counterpart to Section 704(c)) in a consistent manner.

The policy of Proposed Regulation Section 1.168-2(n) appears to be to prohibit a buyer from receiving an inordinately large depreciation deduction by acquiring an interest in a partnership with a property of substantial value in the final years of its depreciation cycle. It should be emphasized that the dual approach we suggest does not provide that opportunity to a buyer. Because the booked-in appreciation is being amortized at the same rate as the property is being depreciated for book and tax purposes, the component of the Section 743(b) adjustment attributable to such booked-in appreciation should not be substantial. To the extent the property's actual economic life proves significantly longer than its book and tax life, the residual value in such property would constitute unbooked appreciation and the corresponding component of the basis adjustment would be subjected to the rates prescribed by regulations.

If a revaluation of such property occurred so that the unbooked appreciation became booked-in appreciation, it is true that the basis adjustment of the purchaser of an interest "burdened" by the reverse 704(c) allocation applied upon such revaluation would contain an inordinately large booked-in appreciation component.[103] In that case, however, a ceiling

[103] If such revaluation occurred after tax basis had been fully depreciated, presumably a new depreciation cycle would commence for book purposes. That depreciation cycle would be determined by the depreciation method that would otherwise have applied for tax purposes.

limitation would result from the lack of adequate common basis in the property and the purchaser of this “burdened” interest would be subjected to a curative allocation of gross income (or expense) at the same rate he would depreciating the booked-in appreciation layer of his basis adjustment. Thus, the depreciation on this layer of the basis adjustment would merely offset the impact of the curative allocation, with no net depreciation benefit derived by the buyer.

This analysis does point up the possible need, however, to limit the use of the dual method to only those cases in which (1) a curative allocation, whether through gross income or expense, has been utilized to reverse distortions from ceiling limited depreciation, (2) such curative allocation is being amortized at the same rate that the ceiling limited property is depreciated for book and tax purposes and (3) there are adequate items of either gross income or expense to facilitate such curative allocation.

One justifiable criticism of the dual approach to depreciating Section 743 (b) adjustments is that such approach allows a taxpayer to avoid, for purposes of depreciating a portion of a basis adjustment, adverse legislative changes in depreciation rates that have occurred since the revaluation event (but that do not apply to common basis under the applicable transitional rule). Thus, the buyer of a partnership interest could obtain depreciation advantages not otherwise available upon a purchase of an undivided interest in the properties held by the partnership.[104] This opportunity is especially apparent in the

[104] The dual approach can cut the other way in subjecting a purchaser of an interest to lesser favorable rates than he would otherwise be entitled to upon the purchase of an undivided interest if legislation has effectively accelerated the rates.

context of the 1986 Act with its move away from the highly subsidized tax depreciation rates of ACRS.

There appears to be somewhat of a conflict between the objective of the dual approach in achieving an alignment of a buyer's tax consequences with his economic consequences (as presumed to be reflected by adjustments to book capital) and the objective of Section 743(b) in placing such purchasers in the position they would have been in had they acquired a direct interest in the underlying properties. In fact, such conflict arises from the larger conflict between the aggregate theory of Section 743(b) and the application of the entity theory that results in depreciation on common basis being unaffected by changes in the ownership of partnership interests.

An alternative to the dual approach of depreciating basis adjustments would entail an elimination of the entity rule by requiring every purchaser of a partnership interest, whether from the partnership or any partner, to commence a new depreciation cycle with respect to his full inside basis, whether such inside basis is attributable to common basis or Section 743(b) basis, just as if he had acquired a direct interest in the property. Under such approach, no transferee would be entitled to "step into" the existing cycle of depreciation applied to common basis of the partnership's' property. Although administratively complex in that different partners could be using different methods of depreciation over different periods with respect to the same property, it would avoid the unfairness inherent in the existing Section 167 and 168 regulations of treating transferees of partnership interests, with identical economic characteristics, very differently for tax purposes. In treating all buyers of interests equally, whatever their source of inside basis, this aggregate approach achieves identity of interests as to all

partners. Moreover, such approach would also avoid the opportunity inherent in the dual approach for a buyer of a partnership interest to avoid adverse changes in the depreciation rates that he would otherwise be subjected to as the buyer of a direct interest in the underlying properties.[105]

c. Section 755

Section 755 and the regulations thereunder establish rules for allocating Section 743(b) basis adjustments among the particular partnership properties. Such regulations require that the basis adjustments be made in a manner which reduces the difference between the fair market value and the adjusted basis of partnership properties. If applied literally, such regulations can create a lack of uniformity in the tax consequences attributable to partnership interests. Principally, the sources of nonuniformity which arise from a literal application of the Section 755 regulations are derived from (1) the fact that such regulations do not allow both positive and negative basis adjustments to be made within a class of assets and (2) the regulations do not take into account the effect of Section 704(c), reverse 704(c) or any other disproportionate allocations in determining a transferee partner's share of the unrealized appreciation or depreciation in a property.[106]

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105 Of course, if more favorable depreciation rates were enacted this pure aggregate approach would allow a buyer of a partnership interest to avail himself of those rates sooner than under the dual approach (but no sooner than he would had he acquired a direct interest in the properties).

106 This latter source of nonuniformity would not exist if the deferred sale approach to S 704(c) (and reverse 704(c)) allocations were allowed.

The Section 755 regulations provide that the net basis adjustment will be allocated between ordinary income assets and capital gain or Section 1231 assets based on the difference between the portion of the amount paid by the buying partner for the partnership interest with respect to such class of property, and the selling partner's share of the partnership's basis for that property.[107] The adjustment is then allocated among the assets of a particular class on the basis of the difference between the partnership's fair market value and the adjusted basis of the properties within such class. Thus, the allocation between classes of assets is apparently a partner level determination, while the allocation among the assets of a particular class is apparently a partnership level determination. The regulations provide that increases and decreases in basis can only be made to properties whose value is in excess of, or is less than, the partnership's basis in such properties.[108]

The effect of the Section 755 regulations is to limit the allocation of basis adjustments to either a net positive adjustment or a net negative adjustment with respect to a particular class of assets, and, in addition, to allocate such net adjustment only to those assets within the particular class that have appreciated or depreciated, depending on whether the net adjustment is positive or negative. If a partnership has certain assets within a class which have appreciated and others within the class which have depreciated, application of the Section 755 regulations results in a transferee partner not receiving a full-cost inside basis in the partnership's assets, as he would had he acquired an undivided interest in such assets. Thus, the underlying rationale of Section 743(b) in placing the

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[107] Treas. Reg. § 1.755-1(b)(2).

[108] Treas. Reg. § 1.755-1(a)(1).

transferee of a partnership interest in the position he would have been in had he purchased a pro rata portion of the underlying assets is not achieved.

If, for example, netting the appreciation in certain assets against the depreciation in other assets within a class results in a net positive adjustment with respect to that class of assets, it will not give the transferee a full cost basis in the appreciated assets, because such positive adjustment has been reduced by the amount of depreciation attributable to other assets within the class. Furthermore, the buyer's share of the basis of the depreciated assets within that class will not be adjusted to cost, as the basis of such depreciated assets will be unaffected by the basis adjustment. In addition, if some of the assets in the class are subject to Section 704(c) (or reverse 704(c)) allocations, the resulting disparity from the closed class allocation under Section 755 is not shared evenly by the partners and can create intrinsic tax differences between an interest acquired from a contributing (or revaluation) partner and an interest acquired from a noncontributing (or newly admitted) partner.

The following example illustrates how such distortions arise.

> Example 14: Assume that A and B form an equal partnership, AB. A contributes a tract of land ("X") with a tax basis of $500 that is valued at $1,000. B contributes another tract of land ("Y") with both a tax basis and value of $1,000. If property Y declines in value to $800 and A sells his interest to C for $900, C's Section 743(b) adjustment will equal $400 ($900 purchase price less $500 tax capital). Since properties X and Y are in the same asset class there is no need to allocate this adjustment between asset classes. Once having narrowed the adjustment to an asset class, it can only be allocated to appreciated assets in the class. Thus, all of C's $400 adjustment would be allocable to property X. Following that adjustment, C still does not have a full-cost inside basis in either asset. C has an economic cost in property X of $500, but a tax basis of $400 (with a deferred Section 704(c) gain of $500). C's uncovered $100 deferred gain is theoretically offset by his $100 inherent loss in property Y. However,

> significant timing and character distortions may be incurred by C. Had C bought B's interest for $900, he would have had a negative Section 743(b) adjustment, along with the Section 704(c) allocation applicable to property X, which would give C a full-cost inside basis in each asset. Thus although the Section 743(b) adjustment is intended to treat C as if he had acquired a direct interest in AB's properties, that result is not achieved and C will be better off, from a tax standpoint, acquiring B's interest rather than A's interest, even though such interests are identical from an economic standpoint.

The Section 755 regulations do provide a possibility for relief from such distortions by allowing the taxpayer to make both positive and negative adjustments within a class of assets if the consent of the district director is obtained. The net amount of all such adjustments must equal the total Section 743(b) adjustment, and permission will only be granted upon a satisfactory showing of the values for partnership assets.[109] Although such procedure is available, successfully obtaining the district director's consent within the time period prescribed by the regulations may be difficult.

Although it is not clear from the legislative history of Section 755 why positive and negative basis adjustments within a class of assets are prohibited, there may have been a concern that permitting such adjustments might increase the opportunity for abuse in artificially valuing assets to result in allocations of basis adjustments that would maximize tax benefits to buying partners. As in the case of the ceiling rule, this concern over valuation led to the adoption of an entity approach under which an allocation of basis adjustments could not be made to reflect the basis a partner would have had in each asset had he acquired a direct interest in such assets. For the same reasons discussed in the context of the ceiling rule, such valuation concerns no longer seem to provide a sufficient justification for prohibiting positive and negative adjustments within a particular class of

[109] Treas. Reg. § 1.755-1(a)(2).

assets when allocating basis adjustments under Section 755. In addition, even under the Section 755 regulations as currently applied, there is some potential for valuation misstatements. Such potential arises when the determination is made as to how to allocate the overall basis adjustment between capital gain or Section 1231 assets and ordinary income assets. Permitting positive and negative adjustments within a class of assets would not appear to expand significantly the possibilities for valuation misstatements which already exist.

As stated, tax dissimilarities among otherwise identical partnership interests can also result from the failure of the Section 755 regulations to take into account Section 704(c) (or reverse 704(c)) allocations when allocating basis adjustments. Such allocation, as well as other disproportionate allocations, would be taken into account in allocating the Section 743(b) adjustments. As discussed, the substantive impact of the Section 704(c) (and reverse 704(c)) allocations is to give each original partner and his buyer a unique share of an asset’s inside basis (reflecting that portion of the asset’s book/tax disparity that is inherent in the capital accounts of that partner). The Section 743 regulations specifically take into account the basis impact of the Section 704(c) allocation in the computation of the adjustment and have generally been interpreted to take into account the basis impact of the reverse 704(c) allocation. It would not only be inconsistent to allocate the adjustment among the assets without regard to this inside basis impact, but the appropriate interface between Section 704(c) (and reverse 704(c)) allocations and the Section 743(b) adjustments would not be preserved. Assuming such allocations must be taken into account under Section 755, and the failure of the regulations to do so is merely a drafting oversight, the relationship between the Section 704(c) (and reverse 704(c)) allocations and the Section 743(b)

adjustment must be respected in taking such allocations into account.

As discussed, Section 704(c) insures that a buyer acquiring an interest which was originally issued to a noncontributing (or newly admitted) partner will not be allocated any of the tax consequences of the property's booked-in appreciation or depreciation. Section 704(c) will have no impact, however, with respect to the unbooked appreciation or depreciation in such property. Consequently, in order for the buyer from such noncontributing (or newly admitted) partner to offset fully the tax consequences attributable to this unbooked appreciation or depreciation, the buyer must rely on Section 743(b) adjustments. Alternatively, if the interest is acquired from a contributing (or revaluation) partner, or a buyer from such a partner, the buyer partner will have to rely solely on Section 743(b) adjustments to provide a full offset against the tax consequences attributable to both the booked-in appreciation or depreciation and the unbooked appreciation or depreciation attributable to the partnership's properties in which he has indirectly acquired an interest.

The relationship between Section 704(c) (and reverse 704(c)) allocations and Section 743 will be maintained if a partner's unique share of (rather than the partnership's total amount of) both the booked-in appreciation or depreciation and the unbooked appreciation or depreciation are taken into account in allocating basis adjustments under a pure aggregate approach. Notably, if the property reflects booked-in appreciation and unbooked depreciation (or reflects booked-in depreciation and unbooked appreciation), such an aggregate approach to Section 755 can give effect to both layers. The two layers should always net to the net appreciation or depreciation inherent in the property. The

aggregate method would focus on each partner’s unique share (taking into account the Section 704(c), reverse 704(c) and curative allocations) of each of these two layers in arriving at that portion of the total Section 743(b) adjustment allocable to a particular property. Once the difference between the fair market value and the basis of each property is divided into these two layers, and each buying partner’s distributive share of each layer is determined, the total amount of each property’s value/basis differential allocated to each partner should equal that partner’s net Section 743(b) adjustment allocable to a particular property. Basis adjustments would be made to each property to reflect such buying partner’s share of the value/basis differential in each such property, the sum of such adjustments netting to the net Section 743(b) adjustment.

As discussed, the Section 743(b) adjustment is not subject to a different computation with respect to property as to which the ceiling limitation has disrupted the alignment book and tax Consequences under Section 704(c) principles. Thus, ceiling-limited properties should not be treated differently when applying the Section 755 allocation rules. For example, in determining a contributing partner’s share of booked-in appreciation of a contributed property all of the booked-in appreciation in such property would be attributed to such partner even though some portion of it would be shifted to the noncontributing partners due to the application of the ceiling rule, as discussed previously.

Example 15: Assume that A and B form an equal partnership, AB. A contributes land ("X") with a tax basis of $600 that is valued at $1,000 on the contribution date. B contributes another tract of land ("Y") with a tax basis of $700 that is valued at $1,000 on the contribution date. One year later both tracts of land are valued at $1,500. If A sold his interest to C for $1,500, C would be entitled to a $900 Section 743 (b) adjustment (purchase price of $1,500 less tax capital of $600). In addition, if B sold his interest to D for $1,500, D would be entitled to an $800 Section 743(b) adjustment (purchase price of $1,500 less tax capital of $700). Under the aggregate method of applying Section 755, C's Section 743(b) adjustment would be allocated $650 to property X and $250 to property Y. D's adjustment would be allocated $250 to property X and $550 to property Y.

The aggregate allocation method is likely to result in the allocation of a Section 743(b) adjustment to a ceiling limited property even if the difference between its fair market value and basis was less than the amount of such adjustment. If this situation were occur with respect to a partnership which was not utilizing curative allocations to reverse ceiling rule distortions, the Section 755 regulations would likely suspend such Section 743(b) adjustment. That result is unjustified. Where the partners have provided, however, for curative allocations to eliminate ceiling disparities, the prohibitions in the Section 755 regulations against al1ocating a positive adjustment to a property whose basis exceeds its value or a negative adjustment to a property whose basis is less than its value should not be violated (assuming the adequacy of residual items of income or expense to support the curative allocations).

Example 16: Assume that A and B form an equal partnership AB. A contributes land with a tax basis of $500 that is valued at $1,000 on the contribution date. B contributes cash of $1,000 which is used to construct a building on the land. The land immediately declines in value to $500, at which time contributing partner A sells his interest to C for $750. C would have a Section 743 (b) adjustment of $250 (purchase price of $750 less tax capital of $500). It is unclear under a literal application of Section 755 whether such adjustment would be suspended or, instead, would be allocated to the land. Under the aggregate method, the value/basis differential would be fragmented into two components: (1) the booked-in appreciation component of $500 (book value of $1,000 less tax basis of $500), 100% of which would be attributed to C (as the transferee of contributing partner A) and (2) the unbooked depreciation component of $500 (fair market value of $500 less

book value of $1,000), 50% of which would be attributed to C, which results in the need for an allocation of a net positive adjustment of $250 to the land. Since the value of the building contributed by B has not changed, there is no need to consider it in the allocation. Such aggregate method results in C allocating his entire $250 adjustment to the land, which has not net value/basis differential to the partnership. Even under the aggregate method, the aggregate approach would only appear to support the allocation to the land if a curative allocation were in place to eliminate the ceiling limitation on gain from sale of the land. Without such curative allocation, the utilization of the $250 adjustment should either be suspended or subject to strict limitations to prevent C from realizing a unwarranted $250 tax loss.

Example 17: Assume the same facts as set forth in Example 16 except that in the same year that C acquires A's interest, the land is sold for $500 and the building produces $500 of income (of the same character that results from the sale of the land). For book purposes, the $500 of building income is allocated $250 to C and $250 to B, but for tax purposes the entire $500 of building income is allocated to C (as a curative allocation to eliminate the $250 ceiling disparity arising on the sale of the land). The $500 book loss on the sale of the land is allocated $250 to C and $250 to B (there is no tax corollary to such book loss). The effect of the curative allocation is to allocate an additional $250, of income to C so that B will receive the equivalent of a $2-50 tax loss to match the $250 economic loss he suffered on the sale of the land. Because C has a full cost investment in the partnership, he should not incur additional tax liability for this curative allocation of additional income. Consequently, the Section 743(b) adjustment of $250 should be currently available to him to utilize as an offset against the $250 curative allocation. Thus, as long as a curative allocation is in place (and sufficient residual items of income and expense exist to support such allocation) the aggregate method seems to provide the appropriate basis adjustment.

This aggregate approach to allocating basis adjustments under Section 755 does not strictly comply with the existing Section 755 regulations, because this method allows positive and negative adjustments to the basis of partnership assets within a single class and takes Section 704(c), reverse 704(c) and other disproportionate allocations (such as curative allocations of gross income or expense) into account. To the extent, however, that the total inside basis of all partnership assets (including Section 743(b) adjustments) equals the total outside basis of all partners, this approach should not create any material tax distortions. In addition, the aggregate approach is to be

recommended on the basis that, unlike a strict application of the Section 755 regulations, it achieves the purposes of Section 743(b) adjustments in providing a transferee of a partnership interest with a full-cost inside basis in his interest, which would be the result had the transferee acquired an undivided interest in the partnership's assets. In achieving this full-cost basis, the aggregate approach also serves to alleviate the distortions which otherwise arise between the intrinsic tax characteristics of various partnership interests, thereby providing fungible interests. Finally, this approach is straightforward in its application.

d. Conclusions Regarding Fungibility Issues and the Rules of Sections 704, 743 and 755

Differences in the intrinsic tax characteristics of partners' interests in a partnership generally can be attributed, directly or indirectly, to the disproportionate sharing of inside basis that results from the now mandatory Section 704(c) and reverse 704(c) allocations. Such differences generally result under (i) the ceiling limitation, (ii) regulation Section 1.167(c)-l(a)(6) and proposed regulation Section 1.168-2(n), (iii) the Section 755 prohibition against allocating positive and negative basis adjustments within a designated class of assets and (iv) the application of the Section 755 rules at the partnership level, rather than the partner level.

When Congress made Section 704(c) mandatory, and Treasury followed suit with respect to reverse 704(c) allocations upon a revaluation of partnership properties in the regulations under Section 704(b), it became apparent that the current regulations under Sections 167, 168, 704(~), 743, and 755, just to name a few, were in substantial need of revision. The proposals set out herein provide at least a frame of reference for commencing that

process. It should be noted, however, that much of the need for such revisions can be eliminated through adoption of the deferred sale approach.

As stated, the restoration of tax uniformity among partnership interests that are otherwise identical, as an economic manner, would be of significant benefit to all partnerships, whether or not their interests are publicly traded.

(ii) MLP Compliance With the Constructive Termination Rule of Section 708(b)(1)(B)

Section 708(b)(1)(B) of the Code provides that a partnership terminates if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Because MLP units are held in street name, MLPs have not been able effectively to monitor unit transfers so as to determine with certainty whether a constructive Section 708 termination has occurred. If an MLP was unaware of the occurrence of a constructive termination, it would be difficult (or even impossible) for the MLP to be in compliance with Section 708 and the regulations thereunder as to the tax consequences of a constructive termination.

The inability to identify a constructive termination when it occurs has not been of great practical significance because either the trading volume of MLP Units in any 12-month period typically has been sufficiently low for most MLPs to be certain that a constructive termination has not occurred, or MLP sponsors have retained a sufficiently large percentage of units to insure that no constructive termination can occur. Moreover, it appears that the problems in identifying a constructive termination can be remedied under present law. Once the nominee reporting systems necessary to comply with the nominee reporting requirements in

Section 6031(c) are in place, MLPs will be able to determine if and when a constructive termination of the MLP has occurred. Nominee reporting will enable MLPs at any particular date to identify both their current unitholders and their unitholders as of the same date in the previous year. Accordingly, MLPs will be able to identify those holders who held units at both dates and the number of units held by this group on each date. If a group of holders held more than 50% of the total units at both dates, the MLP can be certain that there was no constructive termination.[110]

Consideration should perhaps be given to modifying Section 708(b)(1)(B) as it applies to MLPs. The Congressional purpose for enacting Section 708(b)(1)(B) is not at all clear from the legislative history. It has been suggested that the provision was primarily designed to by purchasing and selling prevent manipulation of taxable years partners as a means of tax deferral.[111]

This rationale for Section 708(b)(1)(B) is generally inapplicable to MLPs because, particularly after the amendments to Section

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110 The MLP will need to make sure that it eliminates from the group holders who have sold their units and subsequently repurchased units. If the group holds less than 50% of the units at either date, the MLP will only be able to avoid a constructive termination by identifying transfers of units which are not sales, such as gifts and testamentary transfers, which are sufficient, when added to the units held by members of the group, to bring the holdings of the group on both dates to more than 50%.

111 See Jackson, Johnson, Surrey, Tenen & Warren, The Internal Revenue Code of 1954: Partnerships, 54 Colum. L. Rev. 1183, 1198 (1954); Birkeland and Postlewaite, The Uncertain Tax Ramifications of a Terminating Disposition of a Partnership Interest - the Constructive Termination of a Partnership, 30 Tax Lawyer 335, 339 (1977). The manipulation contemplated was for one partner, before the close of the partnership fiscal year, to sell to another partner on a different tax year, Section 708(b)(1)(B) prevents this abuse in the case of transfers of 50% or more of the partnership interests by forcing the partnership tax year to close.

706(b) made by the 1986 Act, individual unitholders and MLPs will almost invariably have the calendar year as their tax year.

However, when the ownership of a partnership has substantially changed, it does appear to be justifiable as a matter of policy (i) to subject the partnership to legislation enacted prior to the termination which was not previously applicable to the partnership because of effective dates and (ii) to require that the partnership's assets be depreciated under any new depreciation system if this produces slower depreciation than the rules in force when the property was originally placed in service. If these or similar points justify retention of the constructive termination concept, it may nevertheless be appropriate to reconsider the point at which constructive termination occurs. In the MLP context, there seems to be no potential for abuse in the case of transfers of small minority parcels of units. It may, therefore, be appropriate for purposes of determining whether a constructive termination occurs to include only transfers of units by any unitholder transferring a block that exceeds a certain minimum threshold, say 5%.

(iii) Accounting Convention for Allocation of Income

Pursuant to Section 706 (d), each partner's distributive share of MLP? income, gain, loss, deduction or credit of a partnership must be determined by taking into account his varying interest in the partnership during the partnership's taxable year. This provision was enacted to prevent retroactive allocations of partnership losses for a tax year to partners entering the partnership near the end of its tax year. [112]

[112] See Conf. Rep. to H.R. 10612, 34th Cong., 2d Sess. 421.

Section 706(d)(1) provides for regulations to prescribe methods for taking into account the varying interests of partners in a partnership during the taxable year. Such methods generally need to establish both a method for allocating tax items for a tax year to the months of the year and a method for determining whether the transferor or transferee of a unit is to be recognized as the owner of a unit for a period to which income is allocated.

The IRS has announced that it will allow the use of semimonthly conventions for partnerships using the interim closing of the books method, but that partnerships using the proration method would be required to use a daily convention.[113] The IRS announcement appears to be overruled by the Joint Committee Report to the 1984 Act, to the effect that any reasonable convention may be used until regulations are promulgated (expressly referring to a mid-monthly convention).[114]

In the MLP context, the concerns that led to the enactment of Section 706(d) are less significant because most MLPs are formed to conduct profitable businesses, rather than to operate as tax shelters. Moreover, for all partnerships, any tax benefits that might otherwise have been obtained by incoming partners from retroactive loss allocations have been severely restricted as a result of enactment of the passive loss limitation rules by the 1986 Act.

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[113] The interim closing of the books method actually traces partnership income, expenditure, and other items to the particular segment of the partnership taxable year during which each such item was derived or incurred. The proration method allocates income and expenditure to segments of the partnership taxable year by prorating the entire taxable year's income and expenditures regardless of the part of the year in which derived or incurred.

[114] See & Joint Corn. Rep. to H.R. 4170, 98th Cong., 2d Sess. 222.

There is an obvious need under Section 706(d) to balance the government's legitimate concern over the retroactive allocation of losses against the taxpayer's desire to avoid needless complexity. Enactment of the passive loss limitations should greatly reduce the pressure to require daily allocations under Section 706 (d).[115] Nevertheless, taxpayers with excess passive income should not be able to buy passive losses that were incurred in prior periods. Resolution of this issue necessarily involves an artificial drawing of lines, and is by no means limited to MLPs. Indeed, MLPs are probably better able, if necessary, to meet a daily allocation requirement than are smaller partnerships. In drawing that line, a monthly accounting convention seems reasonable. Any shifting of one month's income or loss does not seem to be the flagrant abuse at which Section 706(d) was aimed. Given the spirit of the Joint Committee Report position noted above and the new passive loss limitations, permitting monthly allocations seems reasonable. If, for whatever reason, Treasury concludes that shorter allocation periods are necessary to prevent the artificial shifting of losses, consideration should be given to making such shorter allocation period requirement applicable only for taxable years in which the partnership reports a loss.

(b) MLP Information Reporting to the IRS and Unitholders

Congress has taken extraordinary steps in recent years to improve taxpayer compliance through expanded information reporting obligations. In the partnership area, Congress added partnership reporting obligations to partners (Sections 6031(b) and 6050K); broker reporting obligations with respect to transfers of partnership interests (Section 6045); and, most

[115] Our recommendations with respect to the passive loss limitations are discussed in Section II.B. infra.

recently and importantly for MLPs, nominee reporting obligations (Section 6031(c)).[116]

Information reporting requirements are intended to achieve increased compliance by taxpayers with their income tax obligations by increasing awareness of tax obligations and by increasing the ability of the IRS to police non-compliance, which in turn, provides an additional incentive for taxpayer compliance. With the exception perhaps of Section 6031(c), the legislative changes noted above were not directed specifically at MLPs, but rather were enacted to enhance compliance procedures with respect to partnerships generally. They will, however, have a significant effect on MLPs and their partners. We strongly endorse those provisions and believe that once they are fully implemented, all partnerships, including MLPs, as well as their partners, will be better able to comply with the income tax laws. As is noted below, the enactment of Section 6031(c) will have a very major effect on MLPs, and should enable MLPs and their unitholders to achieve a high rate of compliance. The enactment of Section 6031(c), however, came in a vacuum and we recommend that Sections 6045 and 6050K be reconsidered in its light.

(i) Section 6031

Section 6031 and the proposed regulations thereunder require partnerships to file information returns and to notify each partner on Schedule K-1 of that partner's share of partnership income, loss, deductions, and credits. Where partnership interests are held by nominees (which includes interests held in street-name), the nominees are now required by Section 6031(c)(2)

[116] See Appendix: Comparison of Reporting Requirements.

to furnish to the beneficial owners the Schedule K-1s that the nominees of the partnership interests receive from the MLP.[117]

This appears to contemplate a process pursuant to which partnerships continue to forward a Schedule K-1 to each nominee, with the nominee then having the responsibility to forward separate K-1s to each beneficial owner of the partnership interests he holds (or held, in the case of transfers during the year) on their behalf. If the partnership receives proper nominee information pursuant to Section 6031(c)(1), as described below, we strongly believe it would be more efficient for the partnership to send the information directly to the beneficial owners.

Effective for partnership taxable years beginning after October 22, 1986, Section 6031(c)(1) requires that any person who holds an interest in a partnership as a nominee for another person shall furnish to the partnership the name and address of such other person and any other information required by regulations. Notice 87-10, 1987-3 requires a nominee to provide the following information to a partnership:

(a) the name, address and taxpayer identification number of the nominee and the beneficial owner of the partnership interests;

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[117] Some nominees may permit short the purchaser of the unit sold sales of MLP units. If SO, short should be treated as the partner for federal tax purposes, but the tax treatment of distribution substitute payments to the “lender” of the unit (who is no longer a partner) is not entirely clear. Dividend substitute payments received by the lender of stock sold short are fully taxable as rent. See Prop. Treas. Reg. § 1.1058-1(d). If substitute payments received by a lender of MLP units are fully taxable instead of partially tax sheltered partnership distributions, the lender may object rather vigorously to nominees using their units in short sales. For this reason, several major brokerage houses will not “lend” MLP units to cover short sales.

(b) the number of Units and a description thereof (including CUSIP number) held by the nominee for the beneficial owner on the first day of the taxable year;

(c) the number of partnership interests transferred to and by the beneficial owner and the dates of such transfers.

Section 6031(c) was enacted to meet the concern that a significant number of beneficial owners holding partnership interests through nominees do not receive Schedule K-1s. As a result, some may not have reported their distributive shares of partnership income producing a direct loss of revenue. Once the necessary tracking systems are established, Section 6031(c) should significantly improve the reporting of partnership income. Unfortunately, no penalty has been imposed for failure to comply with Section 6031(c), and without a penalty, implementation of proper tracking systems may be slow. We strongly suggest implementation of some form of penalty for non-compliance with Section 6031(c).

Notwithstanding the lack of an effective enforcement mechanism, two companies (Wall Street Concepts and IECA) are developing systems that will enable them to serve as clearinghouses between the brokers and MLPs. The brokers would report information on MLP transactions to the clearing house which would collate the information and send it to the MLPs. The clearinghouse system most likely will be a transaction based system that picks up every purchase, sale, name, taxpayer ID number and transaction date and would provide to the MLP the information required by Notice 87-10.

Employing either of these clearinghouses will entail considerable expense. It is unlikely that all brokers will comply

with Section 6031(c) and implement appropriate tracking systems until a penalty for noncompliance is imposed. Nominee reporting is extremely important, and we strongly urge that Congress impose an appropriate penalty on the failure to file the Section 6031(c) information.

Notice 87-10 allows nominees to furnish the required information annually, quarterly, monthly or on any other basis provided that all statements are furnished to the partnership before January 31 following the close of the partnership's taxable year (in the case of calendar year partnerships). In order to give partnerships (and MLPs in particular) sufficient time to prepare Schedule K-1s for delivery to all beneficial owners of units, we suggest that the regulations to be promulgated under Section 6031(c) should require nominees to provide the information no less frequently than quarterly, and perhaps on a monthly basis.[118]

(ii) Section 6045

Regulation Section 1.6045-1(c) generally requires stockbrokers to file information returns on Form 1099-B with respect to sales of securities (including partnership interests) made on behalf of their customers. Subject to certain exceptions,[119] this reporting requirement would apply to all sales of MLP Units that are held in street-name. The information required to be reported on Form 1099-B includes the name, address and taxpayer identification number of the customer, the security

[118] We understand that the accounting systems of most brokerage houses are designed to process statements on a monthly basis, with the result that monthly reporting should be manageable for most brokerage houses.

[119] Treas. Reg. § 1.6045-1(c)(2) provides cross-references to a number of exceptions to the reporting requirements for brokers including exceptions for corporations, REITs and exempt foreign persons.

sold, the CUSIP number of the security sold (if known), the gross proceeds from sale and the sale date. Compliance with Section 6045 by brokers is no more difficult with respect to transfers of MLP units than it is with respect to transfers of corporate stock. So as to avoid duplicative reporting, transactions that are required to be reported by brokers under Section 6045 are exempt from the Section 6050K reporting requirements.[120]

(iii) Section 6050K

Section 6050K was enacted to address the concern that partners who sold partnership interests might report the entire gain from such sale as capital gain, ignoring the requirements of Section 751. Section 6050K and the regulations thereunder are thus designed to enable the IRS to police sales or exchanges of partnership interests in partnerships holding Section 751 property so as to ensure that the selling partner reports ordinary income in the amount required by Section 751. Of course, the compliance problem posed by failures to report ordinary income as a result of Section 751 will be greatly diminished after 1987 for so long as capital gains are taxed at the same rate as ordinary income.

MLPs generally are unable to match transferors and transferees, with the result that they cannot complete Form 8308 in the manner prescribed by the regulations. Irrespective of the identity of the buyer, however, a seller can correctly report the amount of ordinary income derived under Section 751 upon a sale or exchange of his units. The general inability of MLPs to match sellers and buyers thus is not a policy concern in this context. This has been recognized by the IRS in Announcement 86-30[121],

[120] Treas. Reg. § 1.6050K-1(a)(2) and (d)(2).

[121] 1986-11 I.R.B. 29.

which announced that for 1985 if a partnership (such as an MLP) cannot match seller and buyer partners but otherwise complied with the regulations to the extent possible, the IRS will not impose penalties.[122] We recommend that Section 6050K and the regulations thereunder be amended to eliminate both the requirement to match sellers and buyers and to report to buyers, in the case of MLPs.

Announcement 86-30 also acknowledges that partnerships may not know the identity of a seller or buyer where units are held in street name and a seller fails to report the transfer. This problem should be eliminated once the nominee reporting systems necessary to comply with Section 6031(c) are in place.

There are other problems under Section 6050K that are not MLP specific. These are noted here in the hope that they too can be taken up in any overall revision of the partnership compliance provisions.

Under Section 6050Kf a partnership only has to report Section 751 sales of which it has notice. Until enactment of Section 6031(c), the primary source of notice was notice of a sale given by the seller. Once the nominee reporting systems necessary to comply with Section 6031(c) are in place, an MLP should have notice of every sale or exchange by reason of the information provided to it both by its transfer agent (in the case of sales that are registered) and by nominee reporting pursuant to Section 6031(c). The requirement that sellers report

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[122] The exemption from S 6050K reporting for transactions required to be reported by brokers under § 6045 implicitly recognizes that information with respect to the buyer is not necessary to achieve the purpose of § 6050K - no information with respect to the buyer is required under § 6045.

sales to the MLP pursuant to Section 605OK(c) then will be superfluous and should be repealed.[123]

Another problem with Section 6050K is that, although a copy of Form 8308 is required to be sent by the partnership to each seller in a Section 751 exchange, Form 8308 does not tell the transferor the amount of his sales proceeds that is reportable as ordinary income. Form 8308 only gives the transferor notice of his reporting obligations under Regulation Section 1.751-1(a)(3) and informs him that he is required to treat a portion of the gain as ordinary income. The unitholder generally will not know how much ordinary income he must report; the only source of this information is the partnership itself. If Section 6050K is considered important notwithstanding the 1986 Act, consideration could be given to requiring more complete reporting by MLPs. The minimal reporting required by Section 6050K presumably reflects concerns over the administrative burdens that would be imposed upon partnerships by detailed reporting requirements. This may be of less concern in the case of MLPs, particularly where a Section 754 election is in effect because such MLPs typically undertake recurrent valuations of partnership properties. It should also be noted that, as a result of such valuations, MLPs are generally better able to determine when they have Section 751 assets (and thus better able to comply with Section 6050K) than many smaller partnerships that are less aware of their property values.

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[123] Section 6050K and the regulations thereunder seem to be flawed in that they only require the seller to give notice of a § 751 exchange, which requires the seller to make a judgment as to whether the partnership has § 751 assets. The seller may not have the information necessary to make that judgment. If seller reporting is to be retained, consideration should be given to requiring the seller to give the MLP notice of every sale or exchange, leaving the partnership to determine whether it has § 751 assets and whether it should file Form 8308.

The regulations under Section 6050K contain an exemption for transactions reported under Section 6045. A partnership presumably observes when the reporting requirements of Section 6045 apply and omits these transactions from its Section 6050K reporting.[124] Although this avoids some duplication, Section 6045 does not achieve the result desired under Section 6050K because no notice is given to the partnership under Section 6045 and no notice of the requirement to report ordinary income is given to the unitholder under Section 6045. This could be corrected by deleting the Section 6045 exemption with respect to the partnership's obligation to file Form 8308.[125]

Regulation Section 1.6050K-1(c) requires that the statements to sellers and buyers be sent on or before January 31 of the calendar year following the calendar year in which the Section 751 exchange occurs (or, if later, 30 days after notification of the exchange). In the interests of administrative we recommend that this regulation be amended so as convenience, to allow these statements to be forwarded to partners at the same time as the partnership sends out its Schedule K-ls.[126]

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[124] MLPs should assume that all foreigners have filed a Form W-8 and are as a result exempt from § 6045 reporting with the result that § 6050K reporting is required. This may result in some duplication, but will ensure that there is no breach of the § 6050K reporting requirements.

[125] If seller reporting is to be retained the exemption from seller reporting for transactions reported under § 6045 should be retained because the partnership will get notice of such transfers via nominee reporting.

[126] We also recommend that the Commissioner authorize, pursuant to Treas. Reg. § 1.6050K-1(a)(3), the use of a single or composite document which would include all transactions which are required to be reported on partnership returns pursuant to § 6050K.

(c) MLP Audit and Collection Issues

Section 6221 requires that the tax treatment of any partnership item generally be determined at the partnership level. In addition, partners must treat partnership items in a manner which is consistent with the partnership return or must notify the IRS of any inconsistent treatment.

The partnership audit provisions of Sections 6223 to 6231 establish a system for the conduct of proceedings for the assessment and collection of tax deficiencies (or for the refund of tax overpayments) arising out of a partner's distributive share of partnership items. Such proceedings must generally be conducted at the partnership level rather than the partner level.[127] Final administrative or judicial determinations obtained under the partnership audit rules are binding on all partners. We believe these rules represent a significant improvement over the law in effect prior to the Tax Equity and Fiscal Responsibility Act of 1982 (the 1982 Act), under which settlement or judicial determinations of disputes with respect to partnership items were only binding on the individual partners to the settlement or action.

(i) Expansion of Tax Matters Partner's Binding Settlement Authority under Section 6224

Under Section 6224, the tax matters partner (the TMP) may enter into a settlement agreement with the IRS that will be binding on most, if not practically all, of the partners in an MLP. Partners having 1 percent or more of the MLP's profits, however, and other partners who join together in a group having

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[127] The Commissioner may, unless appropriately notified of the inconsistency, directly assess a deficiency with respect to any partner whose treatment of an item on his individual return is inconsistent with the treatment of that item in the partnership return.

at least 5% of the MLP's profits, are not bound by a settlement agreed to by the IRS and the TMP. We find it difficult to believe that such a group of MLP unitholders would find it economical to litigate in this circumstance yet current law affords them that privilege. If, as an equitable matter, substantial partners (or a group of partners collectively having a substantial interest) in any partnership should be given the right to reject an audit settlement, as Congress determined when enacting Section 6224, we believe that right should be denied partners in an MLP as a price they pay for the benefit of freely tradeable interests. Therefore, consideration should be given to expanding the settlement power of the TMP of an MLP to cover all partners. Given this authority, under the partnership audit provisions it cannot fairly be said that the audit of a partnership's activities and the resolution of disputes as to the treatment of partnership items would be significantly more difficult than the audit of a corporation.

While the auditing of the activities of an MLP should not be of major concern, the difficulties of collecting any deficiencies that arise as a result of an audit raise more serious issues. Although the treatment of partnership items is determined at the partnership level, the federal income tax relating to partnership items still must be assessed against and collected from each partner. When there are thousands of partners involved and deficiencies against individual partners are quite small, the IRS may not have much of an appetite for pursuing those partners. Indeed, there may be instances in which the administrative cost of pursuing individual partners are prohibitive when compared to the potential taxes recoverable.

There is little experience to date with the partnership audit rules. To our knowledge, only one MLP has been audited. No

deficiencies have been asserted to date against any partners in that MLP. To some extent, therefore, this problem is only a potential problem that may develop in the future as MLPs undergo routine audits. Nevertheless, we believe action should be taken now that would alleviate any problems that do emerge. The MLP and the IRS have a mutual interest in avoiding the assessment and collection of deficiencies from individual partners. The IRS wants to avoid the administrative burden and the MLP wants to avoid the embarrassment, bad public relations, and costs associated with such proceedings. Even with partnership level audits and judicial determination, tax deficiencies arising therefrom must be assessed against, and collected from, individual partners. We are sympathetic to the IRS's concerns that collection of small deficiencies from large numbers of partners scattered over many IRS regions may cost more than the tax to be collected. Although the partnership audit rules do not expressly address the issue, with respect to existing law there appears to be no statutory impediment to the MLP itself paying an agreed upon amount of tax liability on behalf of its partners as a result of an audit. We suggest that serious consideration be given to permit partnership level tax collection by the IRS as a requirement of continued partnership status for MLPs. Such a process would enable the IRS to collect the settlement amount directly from the MLP and to avoid multiple collection actions against the unitholders. There are three patterns of audit adjustments that could arise. First, the audit may determine that all partners' income was understated. Second, it may determine that their income may be overstated. Third, the income of some partners may be overstated and others understated.[128]

[128] This situation could arise, for example, if the allocation of income from the MLP among the partners was adjusted.

With respect to partners who would be entitled to refunds, they might be required to file individual claims reflecting their own tax status in the year of adjustment. With respect to partners owing deficiencies, the MLP would remit an amount on their behalf computed at the maximum tax rate. Any partner in a lower tax bracket could file a claim for refund to the extent his share of the tax paid by the partnership exceeded his actual deficiency.[129]

An additional benefit to this approach would be the inhibiting influence it would have on MLPs and their tax advisors with respect to tax return positions that may be challenged on audit. If it is true that MLPs tend to file returns using conservative factual assumptions and legal interpretations, the specter of partnership level assessment in a later year should reinforce that tendency to the benefit of the fisc. We believe serious consideration should be given to developing and formally implementing such a settlement procedure.[130]

(ii) Foreign Investors

A foreign investor that acquires an interest in a partnership which is engaged in a trade or business in the United States will, under Section 875(1), be considered as being engaged in a trade or business within the United States. As a result, a foreign investor's distributive share of partnership income will

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[129] Given the relatively small investment by the typical limited partner in an MLP, it may be that most partners would find their refunds too small to justify filing a claim. In that case the Treasury would receive a windfall.

[130] Useful guidance may also be gleened from the experience under Section 6232(c) and the regulations thereunder which provide that a partnership "shall be treated as authorized to act for each partner with respect to the determination, assessment, or collection" of the windfall profit tax.

generally constitute “effectively connected income” taxable at the same rates as are applicable to United States persons.[131]

Section 1446 will impose a new 20% withholding tax on distributions made by partnerships to their foreign partners after the earlier of the effective date of forthcoming regulations or December 31, 1987. MLPs pose no particular compliance problems in this context. The obligation to withhold is imposed directly on an MLP in the case of foreign Unitholders which are registered owners of Units and, in the case of foreign Unitholders holding Units through U.S. nominees, on the U.S. nominees. MLPs can discern which of their registered Unitholders are foreign persons by requiring transfer applications to include appropriate certifications of foreign or non-foreign status from all owners seeking registration. With respect to foreign investors holding Units through U.S. nominees, the withholding obligation under current law is appropriately placed on the nominees rather than the MLP because the nominees, and not the MLP, will have the necessary information in time to enable full compliance with their withholding obligations.[132]

The new 20 percent withholding tax does provide an example of the weaknesses of a withholding system as a means of tax

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131 The criteria for determining which income is “effectively connected” to a U.S. trade or business are established in Section 864(c). Effectively connected income derived by a foreign investor is not subject to withholding of tax pursuant to Sections 1441 and 1442.

132 The MLP may receive the necessary information under Section 6031(c)(1), but even if monthly or quarterly nominee reporting is adopted, it is not likely that such information would be received by the MLP in time to enable it to withhold properly. Where withhold from distributions should not be at the flat 20 percent rate as a result of the application of Section 1446(b) or (c), MLPs will have to provide nominees with the information necessary to ensure appropriate withholding.

collection. First, the 20 percent withholding from distributions is clearly a very imprecise measure of partners' ultimate tax liability with respect to their investment and does not attempt to take account of the partners' particular tax positions. Second, the withholding tax is only collected to the extent a partnership makes cash distributions. Thus, if a partnership does not distribute its available cash from operations (or some portion thereof), the foreign partners may well have income tax liabilities in respect of which no amount is withheld. Finally, even if cash distributions match taxable income, if the foreign investor transfers his partnership interest the withholding mechanism may fail to collect an appropriate amount of income tax. For example, assume that a foreign investor is allocated two months of partnership income but sells his partnership interest before receiving the quarterly cash distribution. If a U.S. investor acquires the interest and is the record holder for purposes of the cash distribution, no tax will be withheld with respect to the two months of income allocated to the foreign investor. If another foreign investor acquires the interest and is the record holder for purposes of the cash distribution, there is full 20 percent withholding from the distribution, but the amount withheld will be refunded to the foreign transferee insofar as it relates to the two months of income allocated to the foreign transferor. The result is that no tax is ultimately withheld with respect to the foreign transferee's tax liability.

These examples demonstrate the "rough justice" nature of withholding systems as mechanisms for tax collection. Depending on the level of concern with respect to payment of tax by foreign investors in partnerships there are a number of alternative

approaches with varying levels of complexity, none of which appear to be entirely free of technical problems.[133]

Section 1446 requires tax to be withheld irrespective of whether the partnership is expected to produce taxable income for the tax year in which the distribution is made. Where the amount withheld under Section 1446 exceeds the ultimate tax liability on the foreign partner's distributive share, the foreign partners can file for a refund of the excess tax that was withheld. In tax years in which a partnership anticipates tax losses (or taxable income such that Section 1446 will produce substantial overwithholding) the withholding requirements of Section 1446 would create administrative complexity that cannot be justified by the need to ensure full collection of tax from foreign investors. We recommend that the regulations to be adopted pursuant to Section 1446 should establish an appropriate exception that prevents overwithholding in such cases. For example, a procedure might be established that enables an MLP to certify, based on advice of its investment bankers and tax accountants, that it is highly unlikely/not possible for the MLP to produce taxable income for its investors in a given year.[134]

Gain or loss of foreign investor from the disposition of a U.S. real property interest ("USRPI") is treated as effectively

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[133] We note that with respect to withholding under Section 1445 it appears likely that the complexities created by requiring withhholding by transferees from the proceeds of sales of small parcels of publicly-traded units are considered to exceed the benefits to be derived from such withholding. See discussion of Treas. Reg. § 1.897-1(c)(2)(iv) infra.

[134] An MLP using the closing of the books method might enable a foreign unitholder who sells his units during the taxable year to be allocatd net taxable income even though the MLP had a taxable loss for the entire year. In these circumstances, the proposed exception might result in a foreign investor having a tax liability for which no amount is withheld.

connected with a U.S. trade or business. The resulting tax is generally collected through withhholding required by Section 1445 at the rate of 34% of the portion of the gain realized that is allocable to a foreign prtner.[135] The rules adopted in Temporary Regulations issued on December 18, 1986 provide that in the MLP context withholding is to be made from distributions attributable to the disposition of a USRPI, rather than automatically from the proceeds from the sale of the property that are received by the MLP. In the case of Units held through U.S. nominees, withholding is generally to be made by the nominees, rather than the MLP.

The preamble to Treas. Reg. Section 1.445-8T invited taxpayers to comment on whether MLPs should be required to provide information to withholding agents as to the nature of distributions made. We recommend that MLPs should be required to provide nominees with information as to the amount of a distribution that is attributable to Section 1445(e)(1) transfers within the meaning of Treas. Reg. Section 1.1445-5(c)(3). In the absence of such a requirement, the nominee will be unable to determine the portion of a distribution that is so attributable and will accordingly be compelled to withhold 34% of the total distribution so as to avoid potential liability for failure to withhold. Such a practice would produce substantial overwithholding that cannot be justified by the need to ensure full collection of tax from foreign investors.

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[135] To the extent required by regulations that have not yet been issued, Section 1445(e)(5) will require the transferee of a partnership interest to deduct and withhold a tax equal to 10 percent of the amount realized upon the disposition. Although Final Regulations concerning disposition of interests have been reserved, Treas. Reg. § 1.897-1(c)(2)(iv) provides that a sale of units by a beneficial holder of 5 percent or less of a class of units in an MLP is not treated as a transfer of a USRPI and should provide a safe harbor from withholding when Final Regulations are issued.

An important task that remains is for the Treasury to promulgate regulations coordinating withholding under Sections 1445 and 1446 so that duplicative withholding is avoided.

(d) State [and Local] Tax Compliance Considerations

Concern has been raised by state tax administrators with regard to perceived and actual compliance problems by nonresident MLP who fail to report and pay applicable state and local taxes on their distributive share of MLP income. This concern is not limited to MLPs (and their), but to all partnerships (and their partners) that have significant assets, conduct business, or otherwise become subject to taxation, in more than one state.

Some partnerships, including MLPs, have attempted to ameliorate this compliance concern by entering into agreements with state (and local) governments to pay the appropriate tax directly to the state on behalf of their partners. For example, some major accounting partnerships have adopted an approach whereby they file pro forma returns on behalf of their nonresident partners, a concept similar to that discussed above.

Although any extensions of this concept to MLPs as a class would be up to each state, there is much to be said in favor of it, both from an administrative and compliance standpoint.

B. Concern Regarding Use of MLPs as Passive Income Producing Vehicles to Absorb Deferred Passive Losses

Section 469(h)(2) provides that income or loss from a trade or business conducted by a limited partnership allocated to a limited partner is considered to be passive income or loss. Congress considered this rule to be necessary, since most widely

marketed (and hence the most costly to the fisc) tax shelters were in the form of limited partnerships.

To keep the 1986 Act revenue neutral, Congress classified tax shelter investments as passive activities, despite the fact that taxpayers had invested in them in reliance on prior law. It was this retroactive disallowance of tax benefits from prior investments that was expected to produce substantially all of the revenue from Section 469.

As the 1986 Act emerged from the Senate to be considered by the Conference Committee, it became apparent that promoters could easily take advantage of these provisions. One way would be to organize and market on a wide scale limited partnerships that were virtually certain to produce taxable income rather than losses. This technique would produce “investment yield” type income which could be sheltered with otherwise disallowed passive losses. Properly packaged, such investments could be expected to cause taxpayers to sell (or not invest in) stocks and bonds producing portfolio income and instead invest in passive income generating activities marketed in the same way.

To enforce the spirit of the passive loss rules (to prevent sheltering of positive income sources by losses from unrelated activities) and to protect the revenue estimates upon which the 1986 Act had been based, in Section 469(k)(3) Congress delegated to Treasury extremely broad authority to classify activities as passive.

In the context of limited partnerships engaged in active businesses, there is some debate as to how broad this delegations of authority is. Some believe Treasury may promulgate regulations that would taint all positive income producing activities as not

passive (presumably coming within the portfolio income definition). Others believe that positive income from an active business should constitute passive income to a limited partner without interference by Section 469(k)(3).

On this point we urge that Treasury exercise its authority under Section 469(k) by providing explicitly that if partnership interests are publicly traded, income from such a partnership should be considered portfolio income. We believe such a rule would be within the Treasury’s authority under Section 469(k)(3) and is appropriate. If there is any doubt as to the scope of Treasury’s authority in this area, we urge that Congress itself clarify Section 469 to confirm that income from MLPs is not characterized as passive income.

Appendix: Comparison of Reporting Requirements

	6045	6050 X	6031(c)
Who has reporting obligation?	Broker on Form 1099-B	P/ship of Form 8308 (P/ship only files for sales of which it has notice)	Nominee
To Whom?	IRS	IRS	P/ship
Copies to Whom?	Customer	Transferor/Transferee	None
When?	Broker elects month, quarter, year; file by the end of February following close of calendar year.	With Form 1065 at end of taxable year.	Monthly, quarterly or annually, but before last day of January.
Information	Name, address, TIN of customer, security sold (CUSIP number), gross proceeds from sale, sale date.	Name, address, TIN of transferor/ transferee/ p/ship, Date of Sale.	Name, address, TIN of nominee and beneficial owner.
When does it apply?	Any sale of securities effected by a broker. This will apply to transfers of Units held in street name- (except for foreigners filing w-8; corporations; brokers; certain financial institution; reits).	Any Section 751(a) exchange, excluding transact ions for which returns are required to be filed under 6045.	Any Unit held by nominee and changes in holdings.