REPORT #896

TAX SECTION

New York State Bar Association

COMMENTS ON PROPOSED REGULATIONS RELATING TO
DEFINITION OF LIMITED PARTNER
FOR SELF-EMPLOYMENT TAX PURPOSES

March 11, 1997

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March 17, 1997

Hon. Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Regulations on Definition of Limited Partner Under Section 1402

Dear Secretary Lubick and Commissioner Richardson:

I am pleased to enclose a report prepared by the Committee on Pass-Through Entities of the Tax Section of the New York State Bar Association that comments on proposed regulations relating to the definition of "limited partner" for self-employment tax purposes. The principal drafter of the report was Kimberly S. Blanchard.

We congratulate you for continuing to work on these difficult issues, especially in the face of statutory language that could be described as anachronistic. While we continue to believe, as stated in our prior reports on this subject, that legislative change is needed, in the present context the current proposals represent a major step toward rationalizing and simplifying the rules in this area.

As the enclosed report explains in detail, the Tax Section is generally supportive of the proposals' efforts to simplify the rules that apply the self-employment tax regime to all individuals owning interests in pass-through entities, regardless of whether the entities are formed as partnerships, limited liability companies or limited liability partnerships under state law. However, the report generally takes the view that the proposals could have gone further in the direction of eliminating state-law distinctions between individuals which, like personal liability for the entity's debts or the power to bind the entity, do not necessarily bear any relationship to the performance of services. As the Tax Section has stated in prior reports on this subject, we believe that the Treasury Department has the authority to promulgate regulations that would treat owners of pass-through entities, without regard to their labels or their authority, as deriving net earnings from self-employment ("NESE") to the extent their distributive shares of pass-through income represent compensation for services.

The report favors, therefore, the elimination of two of the three definitional criteria that the proposals use to exclude individual owners from limited partner status: the personal liability and the power to bind tests. With some modifications and clarifications, the report supports the use of the third test, which looks to participation in the entity's business, and urges that it should be adopted as the sole criterion for determining whether an owner is or is not a limited partner (within the meaning of Section 1402(a)(13) of the Code) entitled to exclude his or her distributive share income from NESE.

If, however, you believe that the statutory language limits the Treasury's authority to adopt our suggestion, the report suggests in the alternative that the personal liability and power to bind tests be combined into a single criterion based on state law.

The report questions the portion of these proposals that excludes all "service partners" of "service partnerships," as defined, from limited partner status. Given the functional approach of the proposals and the even more functional approach we have suggested, any such per ££ rule should be unnecessary.

Finally, while the report agrees with the apparent rationale underlying the proposals' bifurcation exceptions, and congratulates the Treasury for its willingness to incorporate such exceptions into the regulations, we believe that the exceptions as proposed are too restrictive to accomplish their desired objectives. The report contains several specific suggestions for the liberalization of these exceptions.

Please let me know if we can be of further assistance in the finalizing of the proposed regulations.

Very truly yours,

Richard O. Loengard, Jr.
Chair

CC: Kenneth J. Krupsky
Deputy Assistant Secretary
(Tax Policy)
United States Treasury

Jonathan Talisman
Tax Legislative Counsel
United States Treasury

Hon. Stuart L. Brown
Chief Counsel
Internal Revenue Service

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMENTS ON PROPOSED REGULATIONS RELATING TO DEFINITION OF LIMITED PARTNER FOR SELF-EMPLOYMENT TAX PURPOSES[1]

March 11, 1997

Proposed Treasury Regulations issued pursuant to Section 1402(a)(13) of the Code on January 13, 1997 (the “Proposed Regulations”) replace a previous notice of proposed rulemaking published on December 29, 1994 (the “1994 Proposals”). We commented on the 1994 Proposals (“Comments on Proposed Regulations Relating to Self-Employment Tax Treatment of LLC Members,” November 16, 1995; hereafter, the “1995 Report”), and offer our comments on the Proposed Regulations here.

BACKGROUND

Under Section 1402(a), an individual's net earnings from self-employment (“NESE”) subject to SECA generally include his distributive share of bottom-line income (or loss) from any trade or business carried on by a partnership of which he is a partner. An exception to that rule, contained in Section 1402(a)(13), excludes from NESE the distributive share of a limited partner as such (other than guaranteed payments for services).

[1] This report was prepared by the Committee on Pass-Through Entities. The principal drafter of this report was Kimberly S. Blanchard. Substantial contributions were made by Richard Loengard and Marc Silberberg. Helpful comments were received from Donald Alexander, Karl Connell, Carolyn Joy Lee, Lawrence Witdorchic and Alyssa Wolpin.

Section 1402(a)(13) was enacted in 1977 and reversed the result in Estate of Ellsasser, 61 T.C. 241 (1973), where the Tax Court held that a limited, inactive partner of a brokerage partnership was subject to SECA on his distributive share of the partnership's bottom-line income. As noted in the Ellsasser decision, when Section 1402(a) was originally added to the Code in 1949, Congress specifically stated its intent that SECA should apply to "limited or inactive" partners.[2] In 1977, Congress changed its mind, exempting limited partners from the scope of Section 1402(a)'s general rule.

The Section 1402(a) (13) exception was enacted at a time when state partnership laws required limited partners to be almost entirely passive investors. Despite some suggestion by the Tax Court to the contrary,[3] it seems fairly clear that when Congress originally referred to "limited or inactive" partners, it believed that these two adjectives were simply different ways of expressing the same thought. In the 1977 legislative history, Congress stated its concern that purely passive limited partners were attempting to come within the Social Security system by virtue of Section 1402(a)'s general aggregate rule. Congress made clear that the provision was intended to distinguish "income from an investment" and "earnings from work."[4]

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[2] H. Rep. 1300, 81st Cong., 1st Sess. 136-137 (1949).

[3] See Frances Cokes, 91 T.C. 222, 233 n. 11 (1988)("It appears that, in the words of the 194 9 committee report, petitioner may fairly be described as an 'inactive member,' rather than a limited partner.").

[4] "Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits. In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work." H.R. Rep. No. 702, Part I, 95th Cong., 1st Sess. 40-41 (1977).

In the ensuing years, the states increasingly adopted RULPA, pursuant to which limited partners can take on somewhat more active roles without losing limited liability. More recently, all fifty states have adopted LLC legislation (and many have adopted LLP legislation) creating entities in which no member is a "limited partner, as such." Finally, the "check-the-box" entity classification rules promulgated last year undercut the income tax significance of state-law distinctions between general partners, limited partners, LLC managers and LLC members. All of these developments have put great pressure on the statutory language and its underlying assumptions.[5] The basic problem presented by the statute is that the character of income as NESE is determined at the partnership, rather than at the partner, level. Thus, unless a partner can qualify as a "limited partner as such," it appears to be irrelevant that the partner performs no services; the only apparently relevant fact being whether the partnership conducts a trade or business.

On December 9, 1994 we filed with, inter alia, the Assistant Secretary (Tax Policy) and the Commissioner comments on the appropriate treatment of owners in pass-through entities for purposes of the self-employment tax, an issue which had been considered in connection with the Health Care bills presented

[5] Similar definitional problems are encountered in other provisions of the Code and/or Regulations that refer specifically to limited partners or general partners, although in each case the underlying policy considerations may be unique. For example, Section 469(h)(2) provides that, "[e]xcept as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates." The temporary regulations promulgated pursuant to that paragraph approached the definitional problem traditionally, relying generally on state law to determine whether a partner's liability is limited. Temp. Reg. § 1.469-5T(e)(3).

Similarly, Section 736(b)(3), enacted as recently as 1993, contains a special rule for general partners of service partnerships, leaving open what is to be done if the partnership in question is a state-law LLC.

to Congress in that year (the “Health Care Report”). In that report we recommended (1) that no distinction should be made in the treatment of owners of the various types of pass-through entities, (2) that any NESE treatment should apply to, and only to, owners who rendered substantial services to the entity and (3) in appropriate cases the interest of an owner should be bifurcated between that attributable to services and that attributable to capital. While none of these bills was enacted into law, we congratulate Treasury and the Internal Revenue Service for continuing to address these issues in the present context.

The 1994 Proposals attempted to address only the issues posed by applying the literal language of Section 1402(a)(13) to members of LLCs. Proceeding from the assumption that LLC members who are also “managers” act in a capacity similar to that of a general partner, the 1994 Proposals excluded managers from limited partner status. The 1994 Proposals also conditioned limited partner status upon a showing that the LLC “could have been formed as a limited partnership ... in the same jurisdiction, and the member could have qualified as a limited partner in that same partnership.”

Our 1995 Report expressed our continuing dissatisfaction with the use of state-law criteria to determine which members of pass-through entities must treat their distributive share income as NESE. Nevertheless, we supported the 1994 Proposals' “manager rule,” because it generally equated managing members of LLCs with general partners of partnerships and nonmanaging members of LLCs with limited partners of partnerships. We noted that “[t]he treatment of a managing member essentially as a general partner and a nonmanaging member essentially as a limited partner for employment tax purposes is consistent with the approach used by the Service in the entity classification area.” This, of course, is no longer the case.

INTRODUCTION

We commend Treasury and the Service for continuing to work on this difficult set of issues in the context of an outdated and anachronistic statute. We are particularly pleased that the Proposed Regulations reflect, to a significant extent, the general approach we suggested in our Health Care Report.

As stated in both our Health Care Report and our 1995 report, we continue to believe that the relevant statutory provisions relating to the SECA status of all individual interest holders in pass-through entities (including partnerships, S corporations and sole proprietorships) should be reexamined and revised to treat similarly-situated individuals in a similar manner. We understand that further rationalization of the SECA regime for pass-through entities not treated as partnerships may require legislation. However, the Proposed Regulations go a long way toward rationalizing the rules applicable to partnerships, and might have gone even further.

We believe that the Proposed Regulations continue to reflect an overly restrictive approach to the problem presented by the statutory language in that they attempt to distinguish between general and limited partners based on traditional state-law notions of personal liability and agency. The Proposed Regulations contain three tests, in the negative disjunctive, for determining whether an individual is a limited partner. Under the first test, a partner is treated as a limited partner unless she has personal liability for the debts of and claims against the partnership (the “personal liability test”). Under the second test, a partner is excluded from limited partner status if she has the authority under state law to contract on behalf of the partnership (the “power to bind test”). The third test disqualifies a person from limited partner status if she participates in the partnership's business over 500 hours in a given year (the “material participation test”).

The first two tests are based on traditional notions of what it means to be a general, as opposed to a limited, partner of a state-law limited partnership (the second test may also have application to state-law “managers,” or members having management rights, in LLCs). Neither of these two tests is relevant to the underlying inquiry for NESE purposes, which should be the extent to which the partner's distributive share represents earnings from work. Rather, these tests seem designed solely to define the term “limited partner” as anachronistically used in Section 1402(a) (13).

In our Health Care Report, written in the context of proposed legislation, we unequivocally supported an approach that would have eliminated the existing “per se” interpretation that treated the entire distributive share of a partnership's bottom line income as NESE to a general partner as traditionally defined. Specifically, we rejected the notion that personal liability should be the touchstone for characterizing a partner's distributive share income as NESE.

We took a far more constricted review of this problem in our 1995 Report, where the context was the 1994 Proposals' limited attempt to apply existing principles to the LLC form of entity. However, our 1995 Report was expressly based on certain assumptions that no longer apply. We said:

> In the present context...we are not dealing with a general overhaul of the NESE tax system, but rather with the need for regulations that apply the existing NESE statute to the new LLC form of business entity. Given the original concerns underlying the statute as to whether a partner's distributive share represents earnings from work, we believe that Treasury has the authority to create an LLC NESE rule under which LLC members would, without regard to their labels or their authority, be subject to the NESE regime to the extent their distributive LLC shares represented compensation for services. We recognize, however, that this would introduce yet another set of NESE rules for pass-through entities and would further complicate this area by creating NESE tax disparities between LLCs and limited partnerships. For these reasons, while we continue to believe that this entire area should be reexamined and revised, we also recognize the benefits of adopting, in the interim, an NESE rule for LLCs that generally corresponds to the existing treatment of limited partnerships
> (emphasis added).

In the present context, we are no longer concerned about creating NESE tax disparities between LLCs and partnerships. In fact we congratulate the Treasury for moving beyond the narrow scope of the 1994 Proposals' interim measure and reexamining the NESE treatment of all owners of interests in entities treated as partnerships. We continue to believe that Treasury has the authority to create a general NESE rule under which all partners would, without regard to their labels or their authority, be subject to the NESE regime to the extent their distributive shares represent compensation for services. In light of the radically different state law environment in which partners and members of LLCs now operate, Treasury could issue regulations reflective of the legislative intent to impose SECA taxes on earnings attributable to work, and to exclude from the SECA regime earnings on investment capital.

Accordingly, we believe that the personal liability and the power to bind tests should be eliminated entirely. We favor the adoption of the material participation test with certain modifications and clarifications.[6] This test in effect construes the term “limited partner,” as used in Section 1402(a)(13), in a manner that reflects, in a modern context, “the basic principle of the social security program that benefits are designed to partially replace lost earnings from work.”

We are mindful of the fact that the approach we recommend represents a very significant departure from practices and assumptions that have prevailed for over 45 years. A minority of the Executive Committee believes that there may be some vested interest in maintaining the status quo, pursuant to which an individual is treated as having NESE by the attribution to such individual of the activities of a partnership or of agents rather than by virtue of his/her own activities. The majority believes, however, that only a thorough reexamination of this area will generate any successful long-term solution to the problem presented by the statutory language.

If, despite our view that Treasury has the authority to interpret the statutory language in a functional way, Treasury believes that its authority is constricted by the statutory language and that such language requires that it define who is and is not a “limited partner” by reference to state-law criteria, an alternative approach would be to narrow the application of those state-law criteria as far as possible. This could be done, for example, by eliminating the power to bind

[6] An alternative approach would be to adopt a single, neutral principle that treats so much of any business owner's distributive share income that equals reasonable compensation for services as NESE, and everything over and above that amount as income from investment of capital. (This is basically the test that applies to shareholders of S corporations who act as officers and perform substantial services.) We supported this approach in our Health Care Report and in our 1995 Report, but recognized that while such a formulation is easy to state and to understand, it may be difficult to apply in concrete cases. In the present context, we believe that the adoption of our suggestions herein would come close to achieving this result for partners of partnerships.

test or by combining the power to bind test with the personal liability test. Because both personal liability and the power to bind are hallmarks of general partner status, any attempt to exclude individuals from Section 1402(a) (13) should be limited to excluding individuals who have both of these characteristics.

This alternative would obviously perpetuate artificial distinctions between partners of partnerships (who might have personal liability) and members of LLCs (who will not). It would also perpetuate the ambiguities and difficult interpretational issues inherent in determining who is personally liable, and who has the power to bind, under state laws. There is a wide divergence of opinion among the Executive Committee over whether such an alternative should even be considered, and if so, how it ought to be applied. We emphasize that we are not endorsing this alternative, but mention it only as a means of giving some token acknowledgement to the statutory scheme while in practice (we hope) limiting the rule to very few taxpayers.

DETAILED COMMENTS

1. The Personal Liability Test.

The Proposed Regulations define personal liability by cross-reference to Reg. § 301.7701-3(b)(2)(ii): “a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such.” While it is clear that no member of an LLC would have personal liability under this definition, application of this definition to members of LLPs may lead to confusing and/or contradictory results depending on the vagaries of different states' LLP statutes.

For example, in some states, LLP status protects a member only from the negligence of his or her partners, and not from debts or claims against the LLP itself.

Apart from the irrelevance of the personal liability test to the NESE inquiry, we believe that the personal liability rule will apply only sporadically and arbitrarily. Most pass through entities can be formed as LLCs in all fifty states, and limited partnerships will in the future be unlikely to have individual general partners. Businesses that cannot be formed as LLCs, such as certain service partnerships, may often choose to become LLPs and in most cases avoid personal liability within the meaning of this test.

2. The Power to Bind Test.

Because general partnership laws were predicated on the common-law rule of mutual agency among general partners, a partner who has the legal authority to contract on behalf of a partnership has long been treated as a general rather than as a limited partner. To the layperson, the power to bind rule can easily be confused with the more quotidian role of the day-to-day officer, employee or manager. In fact, the power to bind has nothing to do with the performance of services on a day-to-day basis. Partly for this reason, both the IRS and tax practitioners experienced great difficulty in applying the power to bind rule that formed the basis for the “centralization of management” test in former Reg. § 301.7701-2.

While our 1995 Report supported the addition of a “power to bind” concept to the 1994 Proposals' definition of a “manager,” it did so in the context of treating “managers” consistently with general partners and in the context of the now- withdrawn entity classification rules. Now that these distinctions no longer exist, the reintroduction of the common law concept of agency or power to bind as a separate, stand-alone test is questionable.

Not only is the power to bind test unrelated to the NESE inquiry, the test is confusing and difficult to apply, and may well lead to different federal NESE treatment of similarly-situated individuals based on the vagaries of state laws. For example, section 412 of the New York Limited Liability Company Law provides two general rules, and five exceptions to these general rules, for determining which member (or manager) of an LLC has the authority to contract for the LLC. Moreover, a member or manager may have the authority to contract on behalf of the LLC in some matters but not others. We believe that the attempt to apply a power to bind test in the context of modern and still-evolving state law, when the concept of management no longer has federal significance under the entity classification rules, will lead only to arbitrary and inconsistent results.

3. The Material Participation Test.

The material participation test responds directly to the original legislative intent motivating Section 1402(a)(13), which was to exclude the distributive share income of a limited, inactive partner from NESE. We suggested the adoption of a material participation test, along the lines of that used in Section 469 of the Code, in our Health Care Report.[7]

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[7] In a related context, the material participation test is statutory. See Code Sections 1402(a) (1) (B) (no rental exclusion if there is material participation directly by the owner or tenant with respect to farming), 469(h)(3) (material participation in farming) and 2032A(b)(1)(C)(ii) (estate tax valuation of active farmland).

We continue to support the adoption of the test, with some recommendations.

The Treasury should consider expanding the material participation test along the lines suggested in our Health Care Report. In addition to including participation for more than 500 hours during the year, the test could include participation by an individual that constitutes substantially all of the participation in the entity's trade or business of all individuals during the year. In addition, material participation could include participation for more than 100 hours during the year, if no other individual participates more than the taxpayer.

The material participation test should be clarified insofar as it might apply to employees. SECA does not generally apply to employees. It is becoming increasingly common for businesses taxable as partnerships to provide common-law employees with incentive or “equity” compensation in the form of a restricted or profits interest in the partnership.[8] While the question whether such an employee is a “partner” for tax purposes is beyond the scope of the Proposed Regulations, to avoid confusion the material participation test should be changed to provide that the “participation” in question is in the individual's capacity as a partner. In addition, the Regulations should make clear that an individual cannot be subject to both FICA and SECA taxes on the same income. Thus, while it may be possible to impose FICA taxes on the grant to an employee of a capital interest in a partnership, such compensation should not be NESE.

[8] See Karch, Equity Compensation By Partnership Operating Businesses, 74 Taxes 722, 724-26 (December 1996); Petkun & Shea, Using Partnership Profits Interests to Reward Key Employees of a General Partner, 86 J. Tax. 165 (March 1997).

4. Service Partnerships.

We question the rule in Section 1.1402(a)-2(h)(5) of the Proposed Regulations that excludes all “service” partners of enumerated “service” partnerships from limited partner status.[9] We appreciate the fact that other provisions of the Code and regulations enumerate certain businesses that are considered to be so service-intensive that a presumption of material participation is created. However, in no case is the threshold for that presumption as low as the “de minimis” threshold of paragraph (h)(6)(ii) of the Proposed Regulations. Moreover, in most cases the enumerated list of service-intensive businesses includes a catch-all category such as “any other trade or business where capital is not a material income-producing factor.”

A service partner will in most cases be excluded from limited partner status under the material participation test, especially if our suggestions for expanding the definition of material participation, as discussed above, are accepted. In any event, we see no reason to adopt a per se rule that treats only enumerated types of service businesses (apparently imported from the personal service corporation rules) differently from other service businesses.

Like the Proposed Regulations' personal liability and power to bind tests, the service partnership rule appears designed to preserve the status quo. Unlike those tests,

[9] Although our Health Care Report accepted a modified per se rule for service partnerships, that rule had been proposed as legislation and would have defined service partnerships more functionally than the Proposed Regulations do. Moreover, the proposed legislation would have treated only 80% of a service partner's distributive share income as NESE, in effect recognizing that any per se rule is arbitrary.

however, there is no statutory basis for the per se rule for service partners. While the retired partner exception of Section 1402(a)(10) could be construed as a per se rule -- in that the exception only applies where the retired partner provides no services -- the exception is not by its terms limited to service partnerships or service partners. In fact, the Section 1402(a)(10) exception would become statutory surplusage if our approach to the Section 1402(a)(13) exception is adopted, having continuing relevance, if a per se rule is retained, only to retired service partners of service partnerships.

We question the policy basis for a rule that would apply Section 1402 (a) (10) only to service entities (or, if the personal liability and power to bind tests are retained, to individuals who retain those attributes). We also question a rule that would subject many retired service partners to SECA while providing an exclusion for partners of other types of businesses who do not materially participate. Rather than read Section 1402(a)(10) as a limiting rule, we would read that exception as a safe harbor, and as additional evidence that Congress did not intend SECA to apply to inactive partners who derive no earnings from work.[10] It appears that the proposed adoption of a per se rule for service partners, coupled with only a *de minimis* exception, could have the unintended effect of unfairly discriminating against retired partners of service partnerships based solely on the nature of the entity's business

[10] In Joseph Brandschain, 80 T.C. 746 (1983), the Tax Court interpreted Section 1402(a) (10) narrowly, holding that a retired partner who provided only independent services as an arbitrator, and turned over his income to the partnership, was required to treat his entire distributive share of the partnership's income as NESE without regard to the Section 1402(a)(10) exception. While this holding may have been correct under then-existing interpretations and regulations, it is almost impossible to justify as a policy matter. If the retired partner in that case had not been required to turn over his outside income to the partnership, his NESE would have been limited to his own earnings from acting as an arbitrator.

and without regard to the level of participation in such business by the retired person.

5. <u>The Bifurcation Exceptions.</u>

Under Proposed Regulation § 1.1402(a)-2(h) (3), a partner who holds more than one class of interest in a partnership, and who would otherwise be excluded from limited partner status, can be treated as a limited partner with respect to a class of interest if other partners, who are treated as limited partners under the general rule of paragraph (h)(2), hold a substantial interest of the identical class. Under § 1.1402(a)-2 (h) (4), a partner who holds only a single class of interest, but who is excluded from limited partner status solely by reason of the material participation test, can be treated as a limited partner if other partners, who are treated as limited partners under the general rule of paragraph (h)(2), hold a substantial, identical interest in that class. The latter exception is designed to force partnerships to provide for explicit guaranteed payments to participating partners, whose residual interest is thereby relieved from the NESE taint.

The evident purpose of the condition requiring other limited partners to own a substantial, continuing interest of an identical class is to provide an objective benchmark against which to measure the nonlimited partner's distributive share. The underlying rationale for this rule is that, if other partners who are treated as pure “investor” limited partners under the general rule of paragraph (h)(2) are entitled to receive a certain share of the partnership's income on the same terms as the nonlimited partner, what the nonlimited partner receives should not be treated as entirely NESE. Conceptually, we agree with this approach, which avoids the difficult factual inquiry into which portion of the nonlimited partner's interest is attributable to reasonable, arm's-length compensation for services and which portion represents a mere right to share in the partnership's bottom-line income as an investment.

However, we think that the benchmark as proposed is too rigid to be of real practical use. First, the requirement that other partners, not excluded from limited partner status under the general rules of paragraph (h)(2), own a “substantial” interest, and the suggestion that “substantial” means 20% or more, strikes us as an overly-high threshold. If the concern is that interests may be given to passive accommodation parties in order to achieve bifurcation, we think that a 10% interest would be significant enough to avoid such a practice. A 10% rule is used for other purposes under the Code to distinguish between accommodation parties and true investors.

Second, the requirement that the limited partners own their interests “immediately after” the nonlimited partner acquires his interest should be modified to require only that the limited partners own their interests (on other than a transitory basis) at some time during the same taxable year in which the nonlimited partner acquired his interest. For example, the bifurcation exception should be available if the nonlimited partner becomes an initial partner of a partnership in which passive investors are admitted as partners some reasonable period of time after the partnership is formed.

Third, the requirement that the limited partners' benchmark interest be “continuing” should be clarified to provide that such interest be other than transitory. As proposed, the “continuing” requirement could be interpreted to mean that the interests must be permanent, a condition that may be difficult or impossible to ascertain at the time the nonlimited partner receives his interest.

Finally, we question the requirement that the limited partners' benchmark interests be of the same class as, and identical to, the interest of the nonlimited partner. (We note that the test as proposed appears to double up by use of both a same class requirement and an identical requirement.) It appears that even minor, noneconomic differences between the participating partner's rights and obligations and those of the passive limited partners could cause her entire distributive share to be treated as NESE. This all-or-nothing aspect of the bifurcation exceptions should be replaced with a comparative, “to the extent” rule that focuses on the economics of the interests involved. Where the economic interests of a class of purely passive partners are substantially similar to that of a participating partner, the principle that similarly-situated taxpayers be treated in a similar manner should prevail.

To the extent that the Proposed Regulations' requirement of identical interests relates to a concern that nonlimited partners who do not put up capital should not be permitted to rely on the bifurcation rules, we would support an explicit rule to that effect. Specifically, we suggest that a partner who materially participates in the partnership's business, and who receives in exchange for services solely an interests in profits, should not be entitled to rely on the bifurcation exceptions.[11] Where, however, a nonlimited partner

[11] As noted above, we believe that the Proposed Regulations should be clarified such that participation as an employee would be excluded from the material participation test. If that suggestion were not adopted, we would make the opposite recommendation here, i.e., that “employee partners” be permitted to rely on an expanded and liberalized bifurcation rule.

receives a capital interest in a partnership in exchange for services and is subject to income tax on the value of the interest received, the partner should be treated as having invested capital in the partnership and should be entitled to rely on the bifurcation exceptions.

In our Health Care Report, we made several suggestions for ways of approaching the bifurcation, or split interest, problem. These included allowing an owner to prove the extent to which his distributive share is a return on capital invested, with a safe harbor deemed rate of return on contributed capital. For example, if a service partner contributes capital to a partnership, a safe harbor return could be excluded from NESE; if the service partner could show that a passive equity partner realized a higher return on the same amount of capital, the higher return on the service partner's capital would be excluded from NESE. We continue to believe that such an economic approach to the bifurcation issue should be explored as a more workable alternative to the Proposed Regulations' rigid formulations.