Subchapter K: Origin & Developments

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Origin of Partnerships and Dawn of Subchapter K

An organic extension of contract, agency, and family law principles

- Code of Hammurabi [1]
- Jewish Shutafut [2]
- Roman Law [3]
- Manusmriti (Laws of Manu in ancient India) [4]
- Islamic Musharakah (capital + capital) and Mudarabah (capital + services) [5]
- Europe & UK [6]
  - Lex Mercatoria (Law of Merchants)
  - Common law culminates in UK Partnership Act of 1890
- United States
  - Uniform Partnership Act (1914)
  - Uniform Limited Partnership Act (1916)
  - Aggregate v. entity under state law at the dawn of subchapter K [7]
  - 1939 Code §§ 181-188 [8]

[1] *The Code of Hammurabi*, translated by L. W. King, available at http://avalon.law.yale.edu/ancient/hamframe.asp .

[2] Jessica Goldberg, *Re-considering risk and the 'Maghribi' traders: Agency relations, contract enforcement, and the economy of the eleventh-century Islamic Mediterranean* (Draft), available at http://people.hss.caltech.edu/~jlr/events/Goldberg-EMGV.pdf .

[3] Salvo Randazzo, *The Nature of Partnership in Roman Law*, 9 Australian Journal of Legal History 119 (2005), available at http://www.academia.edu/3632426/The_Nature_of_Partnership_in_Roman_Law .

[4] "Manusmriti," WIKIPEDIA (Sep. 4, 2017), https://en.wikipedia.org/wiki/Manusmriti .

[5] "Profit and Loss Sharing," WIKIPEDIA (Sep. 18, 2017), https://en.wikipedia.org/wiki/Profit_and_loss_sharing ; "Sharika," INVESTMENT & FINANCE (Sep. 18, 2017), http://www.investment-and-finance.net/islamic-finance/s/sharika.html .

[6] "Lex Mercatoria," WIKIPEDIA (May 3, 2017), https://en.wikipedia.org/wiki/Lex_mercatoria .

[7] Darrell L. Peck, *Partnerships: The Nature of the Partnership Before the Law*, 37 MARQ. L. REV. 65 (1953), available at http://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=3118&context=mulr ; Michael J. Broyde and Steven H. Resnicoff, *Jewish Law and Modern Business Structures: The Corporate Paradigm*, 43 WAYNE L. REV. 1685 (1997), available at http://www.jlaw.com/Articles/corporations.html ; David J. Hoare, "Aggregate and Entity Theories of Partnership," BUSINESS ECONOMICS (Dec. 28, 2016), http://businessecon.org/2016/12/aggregate-and-entity-theories-of-partnership/ .

[8] INTERNAL REVENUE CODE OF 1939, available at http://constitution.org/uslaw/sal/053_itax.pdf ; Joint Committee on Taxation, *Derivations of Code Sections of the Internal Revenue Codes of 1939 and 1954* (Jan. 21, 1992), available at http://www.jct.gov/s-1-92.pdf .

Some Milestones for U.S. Taxation of Partnerships

1913:	Sixteenth Amendment
1914:	Uniform Partnership Act
1916:	Uniform Limited Partnership Act
1918:	Revenue Act of 1918 contains rudiments of “hybrid” approach
1939:	Expands “hybrid” approach from prior Revenue Acts
1954:	Dawn of subchapter K
1976:	Revised Uniform Limited Partnership Act
1977:	First LLC statute in Wyoming
1984:	Section 704(c) becomes mandatory
1986:	Tax Reform Act of 1986 / Repeal of General Utilities / Passive activity losses
1988:	IRS rules that Wyoming LLC is taxed under subchapter K
1997:	Check-the-box regulations

Partnership Overlap and Boundary with Other Arrangements

- Marriage & family
- Provision of services
- Lease of property
- Loan of money
- Insurance

Modern IRC definition: a commercial venture (including, but not limited to, a business entity) that is not taxable as a corporation. [9]

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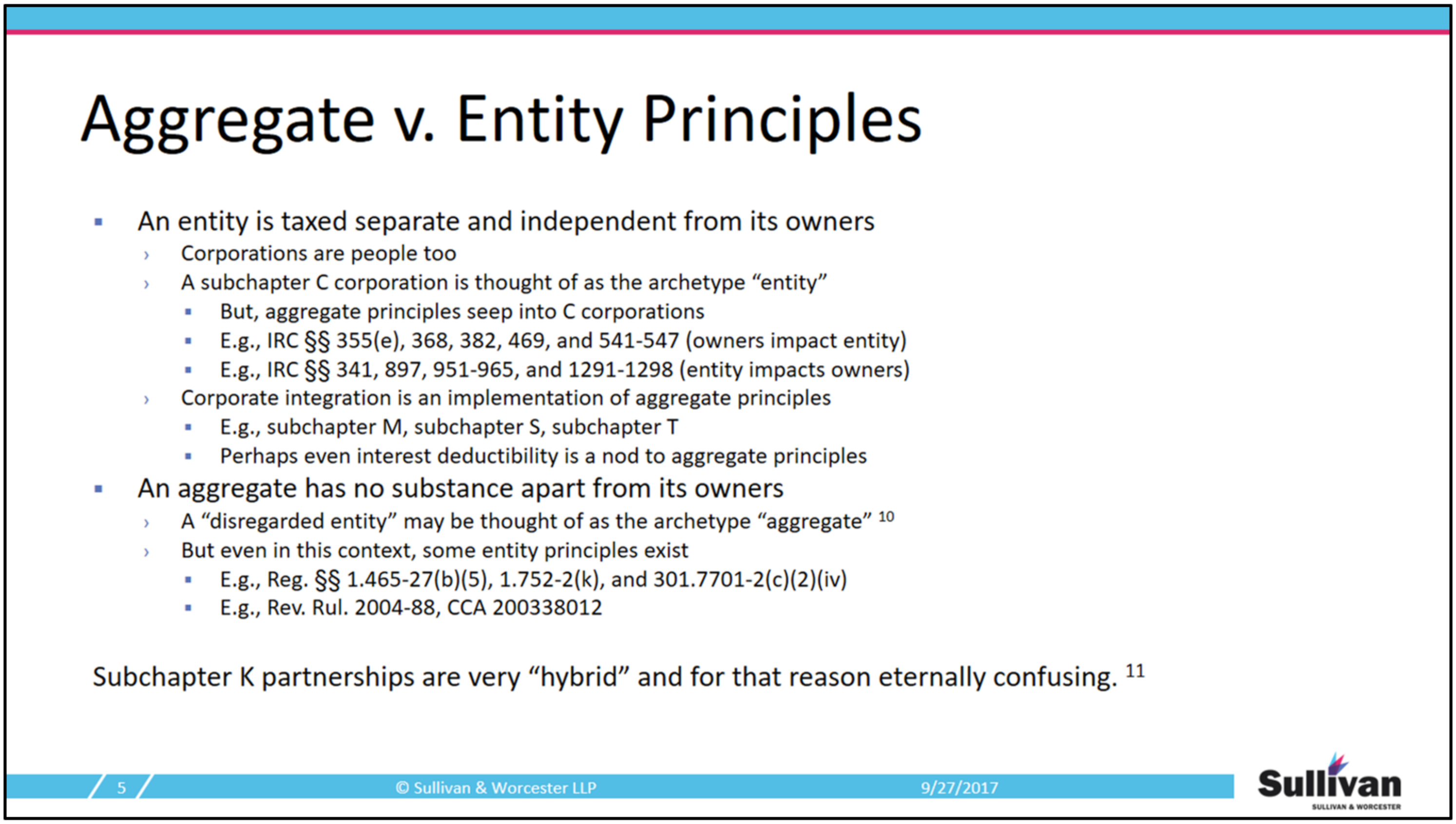
[9] IRC §§ 7701(a)(2) and 7704; Reg. §§ 301.7701-1 through -4.



[10] Reg. §§ 301.7701-2(a), -2(c)(2) and -3.

[11] Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 THE TAX LAWYER 451 (2001), abtract available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=285821.

Gergen, The Story of Subchapter K: Mark H. Johnson's Quest

- Is it outsiders or insiders that innovate?
  - Two outsiders: Mark Johnson & Carolyn Tenen
  - Like Michael Lewis' Moneyball, In Nature's Casino, Big Short, Flash Boys
  - Thomas Kuhn, The Structure of Scientific Revolutions, Paradigm Shifts
  - But Stanley Surrey (then of HLS) is very much an insider
  - Eventually the iconoclasts become the icons
- Ideas matter
  - Tax reform & simplification require thought and debate
  - Collaboration of academics and practitioners
  - Untying versus cutting the Gordian Knot
- Mark Johnson argued that aggregate theory should have a greater role
  - 704(c) and reverse 704(c) are now mandatory
  - The "trend" in the IRC has been toward aggregate theory [12]
  - Profits interests and carried interests are now entrenched
  - Mark Johnson was prescient
- Collective blind spots
  - Partnerships would be small (e.g., Scrooge & Marley)
  - Partners would generally be taxable and in the same tax bracket

[12] Monte A. Jackel, *Summaries of Aggregate and Entity Authorities*, 2017 TNT 142-2 (Jul. 25, 2017), available at http://pdfs.taxnotes.com/2017/2017-63474_TNT-Docs_release.pdf.

Polsky, A Compendium of Private Equity Tax Games [13]

- Preferential rates on risky pay
- Management fee waivers
- Misallocation of expenses
- Monitoring fee deductions

Section 704(c) stuffing is omitted because it is not in the private equity landscape

Has there been too little IRS guidance / enforcement under subchapter K?

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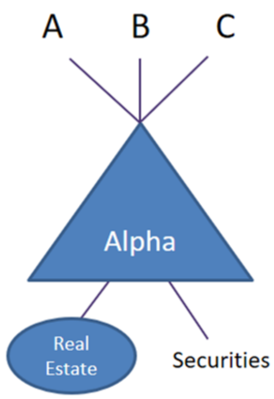
[13] Gregg D. Polsky, *A Compendium of Private Equity Tax Games*, 146 TAX NOTES 615 (Feb. 2 2015), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2524593 .

704(c) Basic Principles:

Partnership Formation and Contribution of Appreciated Property

In Year 1, A, B, and C form partnership Alpha and agree to split all items evenly three ways. A and B each contribute $100 in cash, while C contributes real estate worth $100 with a tax basis of $40. The real estate has a built-in gain of $60. Alpha uses the contributed cash to purchase securities. At the end of Year 1, Alpha looks like the following:



Alpha Partnership: Year 1

Alpha Asset	Tax Basis	FMV
Securities	200	200
Real Estate	40	100

Capital Accounts

Partner	Tax	Book
A	100	100
B	100	100
C	40	100

704(c) Basic Principles:

Asset Appreciation and Sale

In Year 2, each of Alpha's assets appreciates by 30%. Alpha's balance sheet stands as follows:

Alpha Asset	Tax Basis (inside)	FMV
Securities	200	260
Real Estate	40	130

After the appreciation Alpha sells the real estate contributed by C for its fair market value of $130. Alpha realizes $130 - $40 = $90 of tax gain from the sale. Note that the book value of the real estate was $100, so Alpha only has $30 of book gain from the sale.

Without 704(c): If the gain were allocated evenly among the partners, then C would only be allocated $30 of gain, as opposed to the $60 that C would have realized had C sold the real estate directly and contributed the proceeds. The presence of Alpha would have effectively shifted the remainder of the gain to A and B.

704(c) Basic Principles:

Allocation of the Built-in Gain

Application of 704(c).

- In order to prevent this shifting, 704(c) acts to reduce the book/tax disparity in the partners' capital accounts.
- If an asset contributed to a partnership is sold by the partnership, the contributing partner is allocated any built-in gain or loss existing at the time of the contribution of such property to the partnership. Any remaining gain or loss is allocated normally.
- At the time C contributed the real estate to Alpha, the real estate had a built-in gain of $60. Thus, 704(c) allocates this $60 to C alone. The remaining $30 of the gain is allocated evenly among the three partners, so that the $90 of gain is allocated**: $70 to C**, **$10 to A**, and **$10 to B**.
- After the 704(c) allocation, C's book/tax disparity has been eliminated.

After the $90 of tax gain and $30 of book gain are allocated appropriately, the capital accounts of the Alpha partners are as follows:

Partner	Tax	Book
A	110	110
B	110	110
C	110	110

704(c) Basic Principles:

Admission of New Partners; "Reverse 704(c)"

In Year 1, X and Y each contribute $100 to form partnership Beta and agree to split all items evenly. Beta purchases Property L for $100, Property M for $40, and Property N for $60. In Year 2, the properties have appreciated 20% (as these properties are purchased by Beta, they were not contributed by X or Y and 704(c) as described above will not apply to them).

At the end of the year, new partner Z contributes $120 to Beta in exchange for a one-third interest. Beta uses the $120 to Purchase Property O. Beta's property is flat for the next two years. At the beginning of Year 5, Beta's books are as follows:

Beta Partnership: Year 5

Beta Asset	Tax Basis	FMV
Property L	100	120
Property M	40	48
Property N	60	72
Property O	120	120

Partner	Tax	Book
X	100	120
Y	100	120
Z	120	120

704(c) Basic Principles:

Admission of New Partners; "Reverse 704(c)"

Redemption of Partner X. In Year 5, X redeems from Beta. Beta sells Property L for its fair market value of $120 and uses the proceeds to buy out X's capital account in full.

Case 1: Standard "Reverse 704(c)." Upon a Year 5 sale, Beta realizes tax gain on the sale of Property L of $120 - $100 = $20. The "reverse 704(c)" regulations implement the general principle of 704(c) by reducing book/tax disparities of the partners to the extent possible. Since X and Y each have book/tax disparities of $20 and Z has none, the "reverse 704(c)" regulations allocate the gain solely between X and Y to the extent of the disparity.

X and Y are each allocated $10 of taxable gain, eliminating part of the book/tax disparity. Z is allocated no gain (consistent with Z not being a partner at the time of the appreciation of Property L). X will realize another $10 of gain when the redemption proceeds are paid out (which does not affect the capital accounts of the other partners).

Beta Partnership: Year 5 (after sale of Property L)

Beta Asset	Tax Basis	FMV
Cash	120	120
Property M	40	48
Property N	60	72
Property O	120	120

Partner	Tax	Book
X	110	120
Y	110	120
Z	120	120

704(c) Basic Principles:

Admission of New Partners; "Reverse 704(c)"

Case 2: Beta's partnership agreement has a "stuffing" provision.

After X withdrew from Beta in Case 1, Beta's property had cumulative unrealized gains of $20, but Y and Z (the remaining partners) had a book/tax disparity of only $10. The remaining $10 represents appreciation which would have been allocated to X (had X still been a partner), but which will instead be allocated to Y and Z when the properties are eventually sold or disposed of.

To prevent the remaining partners from being allocated more than their share of built-in gain, some partnership agreements include a provision that aims to allocate the appropriate portion of the built-in gain to X.* Such "stuffing" provisions attempt to apply "reverse 704(c)" to the case of a withdrawing partner by reducing such partner's book/tax disparity to the extent possible. "Stuffing" allocations are allocation of tax items only, and do not affect the partnership's book items.

* If Beta has a 754 election in effect, Beta's assets would get a basis-step up, obviating the need for such a provision. However, most hedge funds do not make a 754 election.

704(c) Basic Principles:

Admission of New Partners; “Reverse 704(c)”

Case 2 continued.

Beta’s only tax item in Year 5 is the $20 gain from the sale of Property L. As discussed above, $10 of this gain is allocated to X by the application of reverse 704(c) principles, reducing X’s book/tax disparity to $10. The “stuffing” provision also allocates the remaining $10 to X instead of Y, completely eliminating X’s book/tax disparity. Y’s book/tax disparity remains and will be reduced in the future upon a sale of Property M or Property N or upon Y’s withdrawal from Beta.

Beta Partnership: Year 5 (after sale of Property L, with stuffing)

Beta Asset	Tax Basis	FMV
Cash	120	120
Property M	40	48
Property N	60	72
Property O	120	120

Partner	Tax	Book
X	120	120
Y	100	120
Z	120	120

The Case for Stuffing [14]

- Only for hedge funds because of special built-in gain aggregation rules
- Interaction with IRC § 734 supports, or does not detract from, merits of stuffing
- The stuffing approach is "reasonable" when "consistently" applied
- The stuffing approach is "not abusive"

Reply brief: Wishful thinking and not correct [15]

Peeling away the sophistry, much here is in the eye of the beholder

[14] Brian E. Ladin, James M. Lowy, and William S. Woods, II, *Hedge Fund Stuffing Allocations: A Path Through the Maze*, 121 TAX NOTES 925 (Nov. 24, 2008).

[15] Andrew W. Needham, *The Problem With Stuffing Allocations*, 141 TAX NOTES 737 (Nov. 18, 2013), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2356461 .

The New Partnership Audit Regime

- Prior TEFRA rules are not working well
- IRS needs less enforcement and collection under an aggregate approach,
- And more enforcement and collection under an entity approach
- IRS wants "one neck to choke": the entity being audited (rather than its partners)
- The partnership can then try to recoup assessed taxes from past and current partners

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About Ameek Ashok Ponda

Ameek Ashok Ponda, JD, LLM, is a partner with Sullivan & Worcester LLP and formerly a member of the firm's management committee. His practice includes domestic and international taxation, with an emphasis on mergers & acquisitions and REIT transactions. Ameek is nationally recognized for his work in REIT conversions and REIT cross-border matters. In addition, Ameek is an adjunct professor with the Boston University School of Law Graduate Tax Program, where he has taught courses in Business Tax Planning, Corporate Reorganizations, International Taxation, RICs & REITs, and Financial Products. He has also served as a Lecturer on Law with Harvard Law School teaching Partnership Taxation, and on the Internal Revenue Service Advisory Council. A frequent speaker on taxation topics, Ameek is the author of numerous articles, including REITs Abroad, PRACTICING LAW INSTITUTE (2006-2008) and Economic Inconsistencies in the Taxation of Currency Swaps, TAX NOTES (1992).

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