Identifying Partners’ Interests in Profits and Capital: Uncertainties, Opportunities and Traps

By Sheldon I. Banoff*

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### The Problem

A large and increasing number of Code provisions, regulations and rulings (both inside and outside Subchapter K) refer to the ownership percentages of a partner’s interest in partnership profits (PIPP) and/or a partner’s interest in partnership capital (PIPC). The operative consequences of meeting (or failing to meet) the requisite percentage interest in profits and/or capital can have profound favorable or unfavorable tax consequences, affecting all types of partners and partnerships.

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A large and increasing number of Code provisions, regulations and rulings (both inside and outside Subchapter K) refer to the ownership percentages of a partner’s interest in partnership profits (PIPP) and/or a partner’s interest in partnership capital (PIPC). The operative consequences of meeting (or failing to meet) the requisite percentage interest in profits and/or capital can have profound favorable or unfavorable tax consequences, affecting all types of partners and partnerships. 

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1. The Problem

A large and increasing number of Code provisions, regulations and rulings (both inside and outside Subchapter K) refer to the ownership percentages of a partner’s interest in partnership profits (PIPP) and/or a partner’s interest in partnership capital (PIPC). The operative consequences of meeting (or failing to meet) the requisite percentage interest in profits and/or capital can have profound favorable or unfavorable tax consequences, affecting all types of partners and partnerships. 

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A large and increasing number of Code provisions, regulations and rulings (both inside and outside Subchapter K) refer to the ownership percentages of a partner’s interest in partnership profits (PIPP) and/or a partner’s interest in partnership capital (PIPC). The operative consequences of meeting (or failing to meet) the requisite percentage interest in profits and/or capital can have profound favorable or unfavorable tax consequences, affecting all types of partners and partnerships.
Historically, the most frequently cited situations referring to PIPP and PIPC (dating back to the 1954 Code) involved consequences arising from operation of the partnership termination, merger and division rules under Code Sec. 708(b). Of the same vintage is Code Sec. 707(b), which relates to certain sales or exchanges of property that result in disallowance of losses (pursuant to Code Sec. 707(b)(1)) and treatment of certain gains as ordinary income (pursuant to Code Sec. 707(b)(2)) involving partnerships and/or partners, which also are triggered by reference to PIPP and PIPC standards. Planning techniques to avoid (or, as not infrequently occurs in the case of Code Sec. 708(b)(1)(B), to intentionally trigger) such thresholds in partnership profits or capital interests have periodically been discussed by commentators. Other examples illustrate the effects on corporations, individuals, partnerships with foreign-source income, and partnerships with taxable and tax-exempt partners.

Presumably, the general goal of the delineations that use PIPP and/or PIPC is to distinguish between the ownership of economic interests in the pass-through entity that meet or fail to meet some policy of “relatedness” underlying the applicable Code provision. To illustrate, let us look at the policies underlying Code Sec. 707(b), which has several operative provisions that turn on “relatedness.” Buying and selling property generates tax consequences which, in the absence of restrictions, could be manipulated by a person having control over the other party to the transaction. (In contrast, in most transactions, unrelated parties deal at arm’s length.) Manipulation may take the form of realizing a tax deductible loss not otherwise allocable or by converting ordinary income into capital gain. Congress enacted Code Sec. 707(b) “to prevent tax avoidance through the realization of fictitious losses or increasing the basis of property for purposes of depreciation.” The provisions of Code Sec. 707(b) provide for the nonrecognition of certain losses and treatment of certain gains as ordinary income when the transaction generating the loss or gain is between a partner and a controlled partnership or between certain “related” partnerships. The restrictions involving such partner/partnership transactions are akin to provisions applicable in the corporate and individual area under Code Secs. 267 and 1239, which are also concerned with “relatedness.” It is no coincidence that the vast majority of provisions involving “relatedness” are designed to restrict favorable tax consequences that taxpayers might otherwise enjoy.

Concerns as to “control” have led to the widespread usage of PIPP and PIPC as measuring sticks. Stated simply, when a partner has a specified ownership interest in a partnership, certain tax consequences may arise. When a partner does not have the specified ownership interest, different tax consequences may arise. The specified ownership interest is typically measured with respect to PIPP and/or PIPC. Whether PIPP and/or PIPC are the optimal tools for identifying situations where partners “control” their partnership is a valid question, discussed later in this article.

The level of ownership that establishes “relatedness” varies from provision to provision. In some cases, a threshold as high as 80 percent of PIPP or 90 percent of PIPC must be reached for the relevant Code provision to cause relatedness to occur. At the other extreme, some Code sections provide that any ownership interest in the partnership technically causes sufficient “relatedness” to trigger operative tax consequences. Several hundred other Code and regulations provisions delineate “relatedness” based upon any of a number of percentages that fall somewhere in between. In some cases, only PIPP is the relevant measurement stick; in others, only PIPC is relevant. In most cases, the presence of a sufficient percentage interest in either PIPP or PIPC triggers the operative Code provision. In some cases, the requisite percentage of both PIPP and PIPC must be met to cause the operative provision to apply. Appendix III reflects your author’s attempt to delineate the differing categories of percentage interest thresholds for operative Code provisions and regulations. (As discussed herein, we were quite surprised to see the multitude of categories that have found their way into the Code and regulations.)

There is a lack of uniformity as to the meanings of the terms “partnership profits interest” and “partnership capital interest.” In addition, there is a lack of guidance as to the measurement of PIPP and PIPC. What little guidance exists is not always consistent. In a tax system where numerous significant operative tax consequences (favorable or unfavorable) may arise, this potentially raises serious problems of administration and compliance with the relevant tax rules. A “straight up” or “vertical slice” ownership interest in the partnership seems to be the norm that Congress (in legislation dating back to 1954) and the Treasury and the IRS (in regulations and rulings) had in mind.

As recently as 20 years ago, one of my esteemed commentators (Professor Philip Postlewaite) and his co-authors observed that in most partnerships, the parties have simple agreements in which their share of capital, profits and losses are the same. (Oh, to hearken back to simpler times!) However, a number
of long-outstanding regulations contain illustrations in which the Treasury and the IRS acknowledge a difference in percent in the partners’ respective capital and profits interests. In today’s sophisticated world, taxpayers continue to design (i.e., “slice and dice”) their cash flow, profits and loss arrangements so as to meet their respective business and investment objectives, and the partnership with “straight up” ownership interests (e.g., 60 percent to Partner A and 40 percent to Partner B of all items of capital, profits and losses) is the rare exception, not the rule.

We are unaware of a comprehensive analysis of “relatedness” in identifying PIPP and PIPC. We also are unaware of a thorough discussion as to whether the measurement of a partner’s profits and/or capital interest is the best way to identify ownership in the partnership context. Indeed, we were unaware of many matters involving PIPP and PIPC prior to this undertaking, and having begun the journey we remain unaware of explanations, answers and solutions to most of those matters.

Overview

Part I of this paper contains a survey of operative Code provisions and regulations involving PIPP and/or PIPC. Part I illustrates the importance of measuring profits and capital interests in areas both inside and outside of Subchapter K.

Parts II and III of this paper identify definitional and measurement issues arising from a partner’s “profits interest” and “capital interest,” respectively. A thoughtful set of proposals to measure PIPP was prepared by the American Law Institute (ALI) some 25 years ago, but they apparently did not gain traction with Congress or the Treasury. Through use of several discussion models, we analyze in Part II a variety of methods (each having some merit) that can be utilized in measuring PIPP. Part II also identifies additional issues in defining PIPP with respect to the inclusion or exclusion of items such as guaranteed payments, built-in gains under Code Sec. 704(c), mandatory minimum gain and partner minimum gain chargebacks, qualified income offsets, curative allocations of income and gain, and other “mechanical” gain or income allocations mandated by the complex Regulations under Code Sec. 704. Should any of these items be included in determining PIPP? If so, which, when, how, and to what extent? Other definitional issues are also identified.

Part III attempts to measure PIPC for purposes of the numerous operative Code provisions, regulations and rulings that utilize that concept as a measuring stick for purposes of identifying “relatedness.” The ALI Project also attempted to define PIPC and made a recommendation which, like its PIPP proposals, has not been accepted by Congress or the Treasury.

Part IV deals with practical and administrative aspects of identifying PIPP and PIPC. How do valid retroactive allocations of profits affect the measurement of PIPP and PIPC during the year? If methods used to determine PIPP result in different profits interests among the partners during the year or in different years, what are the operative tax consequences of changes or shifts in profits interests? If the partnership owns more than one property and the partners share profits and losses (or have capital contribution obligations) differently for each property, are PIPP and PIPC determined on a property-by-property basis or a unitary (or “overall”) basis? More basically, can the partnership and its partners validly take different positions as to the measurement of PIPP and PIPC?

Part V identifies planning opportunities (and traps for the unwary) in dealing with various operative Code provisions, with respect to the meaning of PIPP and PIPC.

Part VI identifies and explores conceptual issues, having relevance both inside and outside of Subchapter K, with respect to “relatedness.” Some of the relevant conceptual issues include the following:

- **Should there be uniform definitions of PIPP and PIPC, respectively, for all purposes of the Code, or should they evolve on an operative Code section–by–Code section basis?** If a uniform definition is appropriate, is it within the domain of Congress, the Treasury or the IRS to provide same?

- **Why is the line of percentage demarcation drawn in various operative Code sections and Treasury regulations where it is? Why is “50 percent” used in some places, while zero, one, two, five, 10, 20, 25, 30, 35, 70, 80, 90 percent or something else is used in others?** If the underlying theme is to identify when a partnership is “related” or “unrelated” to one or more of its partners, why are there any—much less so many—differing standards? Should the percentage be made uniform?

- **From an administrative viewpoint, how does the system currently deal with this problem? In drafting statutes and regulations, it appears that Congress, the Treasury and the IRS typically “punt” on the issue, making no attempt to define the standard against that the operative Code provision is to be measured. Have the drafters of statutory and regulatory provisions concluded it is preferable for the IRS and taxpayers to resolve the issues as they arise on
a case-by-case basis (i.e., upon request for private ruling, during an audit, or in litigation), rather than attempt to establish bright-line rules? How can or does the IRS administer the system?

In the absence of guidance, are tax practitioners required to follow the “lowest common denominator” approach, i.e., certainty exists only if any and all interpretations of what constitutes the measurement of partnership profits or capital are met (or failed)? Is the “lowest common denominator” approach what Congress, the Treasury and the IRS have in mind when they use the undefined terms? How are the courts likely to respond?

In defining PIPP and PIPC, should anything turn on the partner’s interest in partnership losses? Is “relatedness” only relevant based on one’s share of partnership profits or capital?

The concept of “ownership of the partnership” recently arose in the Instructions to Schedule M-3. Is this a new, different method of determining “relatedness,” or is it merely shorthand for identifying the partner’s interest in partnership profits and/or capital?

In Part VII, we analyze whether the concepts of “relatedness” contained in the Code with respect to corporate stock ownership provide any useful analysis or benchmarks in thinking about this topic. Are the methodologies or the measuring sticks used in determining corporate “relatedness” (in comparison to those used for PIPP and PIPC) different but good, different but bad, or just plain “different”? A discussion model, involving a state law LLC that is initially taxed as a partnership but in a later year simply elects to be taxable as a corporation (with no change in ownership) could illustrate the different regime that applies to the same owners of the same state law unincorporated entity in determining whether “relatedness” exists for tax purposes.

Part VIII considers alternative approaches to “relatedness” for partnerships and partners. If PIPP and PIPC were not the measuring rod for most “relatedness” purposes, what alternative or supplemental approaches can be provided that are viable and administrable? Is the presence or absence of voting power relevant for determining relatedness? Should the value of each partner’s interest be the sole arbiter of whether relatedness exists in the partner/partnership context? Are there other approaches? Stated succinctly, should there be a uniform alternative approach, which takes the place of PIPP and PIPC throughout the Code, regulations and other governmental guidance? What are the advantages and disadvantages of each alternative?

Finally, in Part IX your author provides certain observations, conclusions and remaining concerns as to the concept of “relatedness.”

Before we begin our analysis, a few words as to what is not covered herein. This article does not address other concepts of partnership ownership that appear in the Code or regulations. Thus, there is no extensive discussion of the meaning of a “partner’s interest in the partnership,” which appears, inter alia, in Reg. §1.704-1(b). (A thoughtful analysis and proposed definition of that amorphous concept were presented at this Tax Conference by our esteemed colleagues Howard Krane and Jeffrey Sheffield almost 25 years ago.) Nor do we deal directly with the meaning or measurement of “the ownership interest in the entity,” which is of significance for certain purposes under the check-the-box regulations. This article does not delve into the meaning or measurement of each partner’s “proportionate share” of ownership of the partnership, which is of significance in applying the partnership-to-partner attribution rule in Code Sec. 318(a)(2)(A). This article also does not cover the meaning and measurement of a “proportional interest in a partnership,” which is relevant for purposes of determining whether a U.S. person is required to file a tax return with respect to his or her interest in a foreign partnership. Although “attribution” and “relatedness” (the latter being the linchpin of this article) are somewhat related and sometimes confused with each other, this paper does not plunge into the broader questions of the scope, meaning and inconsistencies of the Code’s attribution rules.

One further prelude to the analysis. I wish to express my gratitude to my fellow author and co-commentator, Philip Postlewaite, for both his assistance in shaping my thinking on this topic and in going beyond the call of duty to prepare a thoughtful and far-reaching paper many degrees past that of a mere Monday morning quarterback commenting on my Sunday shenanigans. As a practitioner who wrestles with the vagaries of PIPP and PIPC in practice, I am inclined to get caught in the thicket of a dense forest of a topic where no sunshine has been seen for at least 52 years (i.e., since the 1954 Code) on such questions as, “what is the meaning and measurement of PIPP and PIPC, with respect to these myriad references throughout the Code and Regs, and how do I apply it to the unlimited permutations of partnership arrangements that my clients generate?” It is easy to get lost in those trees.

In contrast, Phillip, bringing the academic’s viewpoint to the jungle, need not be greatly bothered by the practical; he swings lithely and blithely,
from tree to tree, from his high perch, able to see the entire forest (swooping down on occasion to touch ground, machete in sheath) and focusing on the higher questions of “what should the measurement of PIPP and PIPC be, and which governmental institution has proper standing to bring sense to the senseless?” A comparison of our papers (mine, the quantity; his, the quality) shows the checks and balances that the University of Chicago Tax Conference format forces us to adopt. Stated simply, in the pending case of Forest v. Trees, Phillip sees the forest, whilst I wander through the trees.

Inclusion of Phillip in this panel was not without some modest concerns. Having an inkling that the measurement of PIPP and PIPC could ultimately be a potential morass, did I want to make Phillip a first-hand witness of still another perceived failing of Subchapter K? After all, this is the man who had the chutzpah to write an article (not that long ago) entitled, I Come to Bury Subchapter K, Not to Praise It. Why add fuel to the fire?

Nonetheless, I do not in the slightest rue our invitation to him to participate and contribute substantially to this topic.

Phillip is unique in many senses of the word; his strong interest in Subchapter K and his willingness to swing his imaginary machete through the dense underbrush of PIPP and PIPC truly marks him as “The Hemingway of Subchapter K.” (A nickname that rhymes!) One must read his introductory discussion about “The Hemingway Play” and its profound effects on the four phases of Phil’s fabulous career to appreciate both the moniker hereby bestowed on him as well as the schizophrenic dilemma Phillip graciously faced in taking on, with his typical good nature, a self-examination of his own thinking and positions on PIPP and PIPC published 20 years earlier! I continue to enjoy the stimulating discussions we have had in editorially commenting on each other’s papers, just as was the case two years ago, and this time around we shared the joy and wonderment of two grizzled veterans of Sub K—having about 60 years’ combined experience traipsing in Code Secs. 701 et seq.—who have discovered that many of our presumptions, predilections and premonitions about PIPP and PIPC were unfounded, inappropriate and/or straight out wrong! I commend Phil’s paper to all readers on this topic, and tip my French beret to him as the only human being to seriously tackle this topic twice—and exhibiting even greater perception the second time around.

I. Survey of Operative Provisions Involving PIPP and/or PIPC

As reflected in Appendices I and II, there are over 250 provisions in the Code and Treasury regulations that we have identified as potentially having significant tax consequences depending upon whether a partner owns a specified percentage of partnership profits and/or capital. A fair number of these provisions (almost 100) listed in Appendix I expressly establish the requisite ownership in the partnership; far more (in excess of 160, at last count, listed in Appendix II) incorporate the “relatedness” tests found in Code provisions such as Code Secs. 267(b) and 707(b)(1) to determine whether certain transactions among a partner and another person have desirable or undesirable tax consequences.

The listings in Appendices I and II identify the operative tax consequences arising from the measurement of PIPP or PIPC. As one might expect, some provisions involving PIPP and/or PIPC have substantial impact as to transactions governed by Subchapter K, including termination of the partnership’s tax year; disallowance of losses on sales involving a partner and his partnership (or two partnerships); elections out of Subchapter K, determining the tax year of the partnership; and determining whether the broad scope of information on the new Schedule M-3 to the U.S. Form 1065 partnership tax return is required. However, the references to PIPP and PIPC found in Subchapter K (and regulations thereunder) are shockingly few, i.e., we have identified less than 25.

The measurement of PIPP and/or PIPC can have substantial impact outside of Subchapter K. Indeed, the vast majority of provisions that incorporate PIPP or PIPC measurement tests are found outside of Subchapter K—well over 200 at last count. Matters as diverse as constructive ownership under the consolidated return rules, REIT qualification, prohibited transactions, taxes on excess business holdings of private foundations, qualified retirement plan matters involving owner-employees, a partner’s apportionment of his or his partner’s interest expense and computation of the percentage depletion allowance, to name a few, can be affected by PIPP and PIPC standards.

Perusal of Appendices I and II evidences how PIPP and PIPC measurement tests have become embedded in all crevices of the Code. Your author and those commenting on this manuscript have uniformly been amazed to learn of statutes and regulations that rarely if ever arise in one’s tax practice but which have implemented PIPP or PIPC standards, either explicitly or indirectly through...
references to Code Secs. 267(b) and 707(b), which themselves incorporate PIPP and PIPC measurement rules. PIPP and PIPC measurement issues are not unique to federal income tax matters; they cut across many states’ tax rules, which piggy back off the computations of taxable income and loss under the Internal Revenue Code (with adjustments). In addition, tax matters not directly based on the Code, such as aggregation of multiple LLCs formed to avoid state fees and multi-state apportionment of income, can raise issues of PIPP and PIPC at the state and local level. For example, draft amendments relating to regulations involving the taxation of corporate partners under New York Tax Law Article 9-A provide that under the aggregate method a corporate partner’s proportionate part of partnership assets and liabilities “generally is based on the partner’s capital interest in the partnership.” In commenting on this, the New York State Bar Association Tax Section noted that “ascertaining a partner’s overall capital interest in a partnership” (i.e., PIPC) is “not always a clear-cut exercise, as a partner’s capital interest percentage may change during the course of the tax year for any number of reasons,” and identified this as an area that will likely require further study.

II. Partner’s Interest in Partnership Profits: Measurement Issues

As Part I and Appendices II and III illustrate, there are numerous operative provisions that turn upon the presence or absence of a specified percentage interest of ownership of a partnership’s profits and/or capital. In a situation involving partners who have the identical proportionate interest in all items of partnership income, gain, loss and capital, this test is relatively straightforward. Example 1 provides the benchmark (a “proportionate” or “straight-up” ownership of partnership interests in profits and capital) for purposes of launching our analysis.

Before we can contemplate and calibrate the measurement of partners’ interests in “profits” and “capital,” we must first come up with working definitions of those terms. Neither term is defined in the Code; if they were, some of the “fun to come” might never be encountered. The Code’s failure to define what constitutes either a capital or a profits interest in a partnership has been identified as being in part “a result of the elusive nature of the tax partnership and the unusual accounting that often attends the partnership’s variable form and procedure.”

In absence of guidance as to the meaning of the terms “profits interest” and “capital interest” the states are not uniform in their partnership acts, but if Illinois statutes are typical, state statutes are not particularly illuminating. The prior version of the Illinois Uniform Partnership Act (relating to general partnerships) provided simply that the property rights of a partner are (1) his rights in specific partnership property; (2) his interest in the partnership; and (3) his right to participate in the management. In turn, the old Act defined the “partner’s interest in the partnership” to be “his share of the profits and surplus.” Illinois’ revised general partnership statute, officially cited as the Illinois Uniform Partnership Act (1997), defines a “partner’s interest in the partnership” to mean “all of a partner’s interest in the partnership, including the partner’s transferable interest and all management and other rights.” The 1997 Act provides rules that apply, except as otherwise provided to the contrary in the partnership agreement, as to each partner’s rights. Each partner is deemed to have “an account” (that effectively is a capital account), an equal share of the partnership profits (and losses), and management rights. On winding up of the partnership’s business, the partners’ shares of profits and losses and their ending (capital) “account” are relevant, but profits remain undefined.

The limited partnership statutes in Illinois also do not advance our quest for a definition of each partner’s share of profits. The prior version of the Illinois Revised Uniform Limited Partnership Act defined a “partnership interest” to be a partner’s share of the profits and losses of a limited partnership and the right to receive distributions of partnership assets. The current statute (the Illinois Uniform Limited Partnership Act (2001)) no longer defines a “partnership interest.” It provides that the only interest of a partner that is transferable is the partner’s “transferable interest”; provides that (in the absence of a partnership agreement to the contrary) a partner has no right to any distribution before the dissolution and winding up of the limited partnership (unless the limited partnership decides to make an interim distribution); requires (in the absence of an agreement to the contrary) that a distribution by a limited partnership must be shared among the partners on the basis of the value of the contributions the limited partnership has received from each partner; and a transferee of a limited partner only has a right to receive, in accordance with the transfer, distributions to which the transferee would otherwise be entitled. The concept of a profits interest, a capital account, and a capital interest no longer are relevant under the Illinois ULPA (except to...
the extent the partners so provide in the partnership agreement). In conclusion, state general and limited partnership statutes in Illinois do not provide useful insight into the definition and measurement of PIPP (or PIPC) for federal tax purposes.

This is not to suggest that there is no connection whatsoever between state partnership law definitions and federal tax law measurement of PIPP and PIPC. In discussing the 1954 Code and its legislative history (particularly with respect to Code Sec. 741), the Tax Court in Evans observed that Congress gave recognition to cases that clearly established that a partner’s interest in the partnership is his share of the profits and surplus (which is the same meaning under the Uniform Partnership Acts). The Tax Court said, “We therefore think it reasonable to conclude that Congress, in enacting the 1954 Code, used the term “partnership interest” in that sense, namely, that a partnership interest is a partner’s interest in profits and surplus.” Thus, when the taxpayer (Evans) assigned his entire partnership interest to his wholly owned corporation, Evans “transferred all the interest he owned,” and thus effectuated a “transfer of the total interest in the partnership capital and profits” that he owned.

In the absence of meaningful guidance as to “profits” and “capital” in either the Code or state law applicable to partnerships, would reference to partnership (financial) accounting principles be illuminating? I combed through my dusty and musty (but still trusty) advanced accounting textbook from college for help, and learned (or should I say “after 36 years, re-learned”) the following:

**Interest in Capital and Share in Profits**—a partner’s interest in a firm should be distinguished from his share in firm profits. A partner’s interest is summarized in his capital account and consists of his original investment, subsequent investments and withdrawals, and his share of firm profits and losses. A partner’s profit share determines the extent to which his interest will go up or down as a result of profits and losses. Partners may agree to share profits and losses in any manner, irrespective of capital interests. In the absence of an express agreement, partnership law provides that profits and losses shall be divided equally; when there is an express agreement as to profits but none as to losses, losses are divided in the same ratio as profits.

Those well-respected accounting authors also identified six ways in which partnership profits and losses are generally divided. Under the heading “Distribution of Profits and Losses,” the textbook lists the following:

1. Equally.
2. In an arbitrary ratio.
3. In the ratio of “partners’ capitals.”
4. First, interest to be allowed on “partners’ capitals,” the balance to be divided on some arbitrary basis as agreed.
5. First, salaries or bonus to be allowed for “partners’ services,” with the balance to be divided on some arbitrary basis as agreed.
6. First, interest to be allowed on “partners’ capitals,” salaries to be allowed for partners’ services, and the balance to be divided on some arbitrary basis as agreed.

Although the accountants’ list does not involve the measurement of PIPP and PIPC directly, items 4, 5 and 6 above are direct evidence that payments of interest on capital and payments of salaries to partners for services - the epitome of guaranteed payments for the use of capital and services under Code Sec. 707(c)—were recognized (at least as far back as 1968) for non-tax, financial accounting purposes as being part of the partnership’s “Distribution of Profits and Losses.” This is the earliest implicit (albeit strong) indication your author has come across as to whether partnership profits include or exclude guaranteed payments; in the nontax (pure accounting) context, they apparently did, at least as far back as 1968 (and, one can speculate, as far back as 1954, when Code Sec. 707(c) was first enacted).

As Phillip observes, the issue has been most frequently encountered with regard to compensatory transfers involving the grant of a capital or profits interest in return for services upon a service provider’s entry into a partnership. Substantial litigation and administrative pronouncements have addressed the issue, resulting in apparent certainty that a capital interest and a profits interest are mutually exclusive.

Borrowing from the regulations under Code Sec. 704(e), which is entitled “Family Partnerships,” a capital interest is defined generally as an interest “in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership.” That definition was embraced by Rev. Proc. 93-27 (dealing with compensatory profits interests), which defined the term capital interest as “an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.” The recently issued
proposed regulations under Code Secs. 721 and 83 (dealing with partnership interests for services) follow accordingly, albeit utilizing a safe harbor procedure employing liquidation value for valuation purposes.

A profits interest in this area is anything that is not a capital interest. As stated in Reg. §1.704-1(e)(v), the mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership. The Eighth Circuit in Mark IV Pictures involving a compensatory partnership interest for services, has stated that the effect of a hypothetical winding up of the partnership determines whether a partner’s interest is in capital or merely in profits; “to determine whether an interest is a capital one, we examine the effects of a hypothetical liquidation occurring immediately after the partners received their interests.”

The aforementioned definition of “capital interest” found in the regulations under Code Sec. 704(e) has been extended to noncompensatory situations as well. In Evans, supra, the Tax Court observed that although Code Sec. 704(e) is directed primarily toward “family partnerships,” that Code section is broad in its scope and covers a situation such as at hand in Evans, which does not involve a “family partnership.” The Tax Court then quoted the definition of “capital interest” contained in Reg. §1.704-1(e) to conclude that the transferee corporation, rather than the transferor partner, was, after the assignment of the partnership interest pursuant to applicable state law, the partner for Federal income tax purposes.

The relationship of profits interests and distributive shares of partnership income also is worth brief comment. A long-standing difficulty in measuring PIPP is uncertainty whether the term “interest in profits” is synonymous with the concept of the partners’ “distributive shares.”

We now proceed to numerous examples that illustrate the difficulty in measuring PIPP.

**Example 1—Proportionate Ownership of Profits and Capital**

On January 1, 2006, A and B, who are unrelated, each contributed $100,000 cash to AB, an LLC taxable as a partnership for federal income tax purposes. A and B are calendar year taxpayers, and AB’s fiscal year ends December 31. Neither A nor B is itself an LLC. The two partners share profits and losses equally. None of AB’s (recourse or nonrecourse) obligations are owed to, guaranteed by or recourse to any of the members of AB (or any affiliates or parties related to A or B). The AB Operating Agreement does not contain any changes in profits, losses or capital contributions in the future. The AB Agreement provides that no member shall be required to contribute additional capital or guarantee any liability or obligation of AB. The AB Agreement complies with the “substantial economic effect” requirements in Reg. §1.704-1(b), and AB maintains capital account balances in accordance therewith. If AB were to liquidate on December 31, 2006, each member would receive one-half of the distributable proceeds, pursuant to the dissolution provisions of the AB Agreement.

During calendar year 2006 (its initial year) AB has net income (for book and tax purposes) of $20,000 and cash from operations of $20,000. AB’s net income is allocated $10,000 to each of A and B pursuant to the AB Agreement. The cash is distributed to the members ($10,000 each) on December 31, 2006.

Example 1 illustrates a “straight up” partnership in which each member (A and B) has an equal 50 percent partnership interest, i.e., each has a 50 percent PIPP. (Note the number of variables in Example 1, all of which need be present in order to have a truly “straight up” arrangement.) Their interests should be so characterized under all of the Code and regulations provisions enumerated in Part I, above.

If the partners have truly “straight up” interests, then they may be able to navigate those Code and regulations provisions that establish exact percentage requirements, by coming up to (but not crossing) the percentage threshold. For example, in FSA 003297, a partnership sold property at a loss to a partner owning exactly 50 percent of PIPP and PIPC. Code Sec. 707(b)(1)(A) provides that no deduction shall be allowed in respect of losses from sales or exchanges of property, directly or indirectly, between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership. Chief Counsel’s Office ruled that because Code Sec. 707(b)(1) only applies to transactions between partnerships and partners that own more than a 50-percent interest in PIPP or PIPC, Code Sec. 707(b)(1) may not apply to disallow a loss arising from such a transaction where the partner owns only, but not more than, 50 percent of the capital and profits of the partnership.

Our journey to this point has been a smooth one. As subsequent examples will illustrate, the ride (like the road to Hana) will get bumpier.

**Example 2—Changes in Profits and Losses Mandated by Form of Passthrough Entity**

The facts are the same as in Example 1, except AB is a limited partnership rather than an LLC and A is the sole general partner. B is the sole limited partner.
Identifying Partners’ Interests in Profits and Capital

having no obligation to contribute additional capital or indemnify general partner A for his losses, and having no economic risk of loss other than B’s initial capital contribution. There are no facts and circumstances that indicate a plan to circumvent or avoid A’s payment obligation on AB’s recourse debts. Cumulative net losses (in excess of any prior net profits) recognized by AB that exceed the partners’ $200,000 aggregate capital contributions and for which A bears the economic risk of loss will be specially allocated solely to A, the general partner. The AB Partnership Agreement provides that income shall be allocated first to A, to the extent of any losses previously specially allocated to A, and thereafter equally among the partners (50 percent to A and 50 percent to B). Upon liquidation, distributions will be timely paid in accordance with ending capital account balances.

At first glance Example 2 appears virtually identical to Example 1 as to sharing of profits and losses (at least to the extent of the first $200,000 of losses in excess of profits), i.e., everything is shared equally among A and B. Thus, A and B each appear to have a 50-percent PIPP and a 50-percent PIPC—at least initially. Assuming that (as in Example 1) AB has net income (for book and tax purposes) of $20,000 and available cash from operations of $20,000, which are both allocated and distributed (in 2006) $10,000 to each of A and B pursuant to the AB Partnership Agreement, one might conclude that A and B should be characterized under all operative Code and regulations provisions as each having a 50-percent interest in PIPP and PIPC.

However, Example 2 involves a limited partnership, unlike the LLC in Example 1. Thus, as a matter of limited partnership law, the general partner, A, has unlimited liability. Therefore, in the absence of any further agreements to the contrary, AB’s aggregate net losses in excess of the $200,000 capital contributed by A and B attributable to recourse obligations and for which A bears the economic risk of loss (without indemnification from B) will solely be borne economically by A. In such case, 100 percent of such excess losses should be allocated to A. Assume that in 2006 AB suffered a book (and tax) loss of $250,000 (rather than recognizing net income of $20,000, as in Example 1), with $200,000 of the loss being attributable to the partners’ aggregate capital contributions and $50,000 being attributable to third-party recourse debt for which A (as general partner) has personal liability and solely bears the economic risk of loss. Assume further than in 2007 AB recognizes $50,000 of net (book and tax) income, which is used to repay the third-party debt.

Focusing first on 2006, after allocation of the first $200,000 of loss equally to A and B (in accordance with their capital contributions), all of the remaining $50,000 net loss (attributable to the recourse debt) should be allocated to A pursuant to Code Sec. 704(b). In summary, in 2006 A will be allocated $150,000 of net loss and B will be allocated $100,000 of net loss.

For 2006, the issue is, how are PIPP and PIPC computed when there is a net loss in that year, particularly one that is in excess of the members’ respective capital contributions? This question is analyzed in Example 10, below.

For purposes of Example 2 (and in comparison to Example 1), let us focus on the profits allocation in 2007 of AB’s net income of $50,000, and its potential effect on PIPP. Under the principles of Reg. §1.704-1(b), A should be allocated all $50,000 of income in 2007, because it eliminates A’s economic risk of loss when measured on December 31, 2007. In effect, the allocation of $50,000 of net losses to A in 2006 that were attributable to third-party recourse debt will be reversed in 2007. (Proper capital account maintenance computations under Reg. §1.704-1(b) confirm this result.)

What is the effect of this allocation of 100 percent of AB’s 2007 income to B? In determining A’s and B’s share of PIPP for 2007, the actual allocation of net income was 100 percent to A. Does that mandate the computation of A’s PIPP to be 100 percent and B’s PIPP to be zero percent for 2007? It would if the proper measurement of PIPP is the book or tax income solely for the year being measured.

Should the focus for PIPP purposes instead be solely on the parties’ overall economic agreement and sharing of income? As described in Example 1 and incorporated by reference in Example 2, A and B have the same amounts of capital at risk and will equally share all income above breakeven (i.e., aggregate income in excess of aggregate loss for all years). If the proper standard were to reflect the “upside” profit sharing, A and B would each have PIPP measured at 50 percent. Should PIPP contemplate a long-term view of the “upside” economics of the partners’ arrangement? Your author is unaware of any guidance directly on point, other than that provided for the expressly limited purposes of Code Sec. 706, discussed herein. However, a number of possible approaches come to mind for the measurement of PIPP using a long-term view, which are worthy of consideration (and perhaps rejection). Might the average future profits (for 2007 and all future years combined) be an alternative way to measure PIPP here? If so, A would have an aver-
age profits amount somewhat greater than 50 percent (since A has 100 percent of the 2007 profits and 50 percent profits for all future years). This approach has a lack of mathematical preciseness and predictability. Might a “facts and circumstances” approach apply, whereby A’s overall profits interest is evaluated (but not by literally “averaging” current and future years’ profits)? Might A only have a PIPP of 50 percent under this approach—or perhaps a little more? What about a “most likely allocation of marginal profits” approach, which looks to the last dollar of reasonably expected profits in a partnership’s multiple tiers of profits? In Example 2, A would have exactly a 50 percent PIPP in that scenario.

It should be recognized that a slight variation in the facts in Example 2 again brings unanticipated results. Assume that AB has the same ($250,000) loss in 2006, and in 2007 AB’s net income is $100,000, not $50,000. Under AB’s partnership agreement, and in accordance with Code Sec. 704(b) principles, A will be allocated the first $50,000 (as described above) of AB’s 2007 income, to reverse the allocation of the $50,000 of 2006 losses attributable to A’s economic risk of loss on the third party recourse indebtedness. In addition, A and B will each be allocated $25,000, i.e., 50 percent of AB’s remaining ($50,000) net income for 2007, in accordance with their sharing of income and proceeds in liquidation. In this variation, as required by Code Sec. 704(b), A will be allocated 75 percent (i.e., $50,000 plus $25,000) of AB’s net income for 2007, and B will be allocated 25 percent (i.e., $25,000) of AB’s 2007 net income. If the current year’s actual income allocation is determinative of PIPP, then for the year ending and as of December 31, 2007, A’s PIPP will be 75 percent and B’s PIPP will be 25 percent in AB. In 2008 and subsequent years, assuming that (only) net income is generated, A’s and B’s PIPP will each be 50 percent. This variant of Example 2 with respect to 2007 could be tested under several other approaches to measuring PIPP, with differing percentages being generated. As was seen, this variant reflects a two-level allocation: the first $50,000 of AB’s net income of $100,000 in 2007 is allocated solely to A, and the remaining $50,000 is allocated 50 percent to A and 50 percent to B. If PIPP is to be measured by the bottom-line profits, we arrive at 75 percent for A and 25 percent for B in 2007 as computed in the preceding paragraph. If PIPP is measured by the initial tier of profits in 2007, PIPP would be 100 percent for A, and zero percent for B. If we focus on the last tier of significant profits in 2007, we would compute PIPP to be 50 percent for A, 50 percent for B. Still another approach (that might lead to still another computation of PIPP) could reflect the manner in which the partnership “expects” to allocate its net income for the year. Under this approach, the estimate would be based on all the facts and circumstances known to the partnership as of the first day of tax year 2007. Thus, if AB’s best estimate of 2007 profits on January 1, 2007, was $80,000, then A could be “expected” to be allocated $65,000 (i.e., the first $50,000, as described above, plus 50 percent of the remaining $30,000 of income) and B would be “expected” to be allocated $15,000 (i.e., the other 50 percent of the $30,000 remaining income). As a result, A’s PIPP percentage for 2007 would be 81.25 percent (i.e., $65,000/$80,000) and B’s PIPP percentage would be 18.75 percent (i.e., $15,000/$80,000).

The approaches described in the preceding paragraph all focus on the current year’s income for purposes of measuring PIPP, under the variant to Example 2. Again, a number of other approaches can be identified that also take into consideration profits from subsequent years. What can we conclude from Example 2 and its variant with respect to the alternative approaches to measuring PIPP? Even in a situation that at first glance strongly resembles the “straight-up” partnership in Example 1, there are many approaches to computing PIPP—some that analyze only the current year’s profits, some that look solely (or in substantial part) to future profits. Your author has identified at least 25 potential approaches to measuring PIPP, which are discussed in Part VI, below; the facts in Example 2 illustrate several of them, but many other listed approaches are more relevant, or produce more varied results, in other fact patterns.

Example 3—Disproportionate Profits and Capital due to Additional Profits Interest for Services

The facts are the same as Example 1, except A provides services (as well as capital) to AB and it is agreed that, after A and B each receive aggregate distributions equal to their capital contributions, distributions will be paid 75 percent to A, and 25 percent to B. Example 3 illustrates the receipt by one member (A) of a disproportionately large interest in partnership profits, which occurs because that member also contributes services to the LLC.

How do we measure A’s and B’s respective PIPP percentages? As stated in Example 1, each contributed 50 percent (i.e., $100,000) of AB’s capital. Nonetheless, for purposes of compliance with the allocation rules under
Section 704(b), the $20,000 of profits recognized by AB in the initial year (2006) would be allocated 75 percent (i.e., $15,000) to A and 25 percent (i.e., $5,000) to B. Under those approaches that focus on the current year’s profits and those that focus on future years’ anticipated marginal or residual profits, PIPP could remain 75 percent for A and 25 percent for B. The only approach that might mandate a different measurement of PIPP would be a “facts and circumstances” approach that takes into consideration B’s disproportionate capital contribution (50 percent) in comparison to B’s ongoing profits interest of 25 percent. Reflecting the capital contribution in the mix presumably would result in B having a PIPP percentage that is somewhat greater than 25 percent (but in no event approaching 50 percent). It is submitted that in this Example 3 a “facts and circumstances” approach should not result in PIPP being anything other than the partners’ stated profits percentages; the capital contribution “factor” will automatically be reflected in the members’ computation of PIPC, and to include it in the PIPP computation appears to be double counting that single factor.

As a variant, assume the same facts as in Example 3 except the initial year (2006) generates a loss of $100,000, which under principles of Reg. §1.704-1(b) would be allocated equally to A and B. In 2007, assume AB generates income of $200,000. Under Reg. §1.704-1(b) principles, the first $100,000 of income in 2007 would be allocated 50 percent (i.e., $50,000) to A and 50 percent (i.e., $50,000) to B, to effectively restore the partners’ capital accounts back to their original capital contributions. All additional income (here, $100,000 more in 2007) would be allocated 75 percent (i.e., $75,000) to A and 25 percent (i.e., $25,000) to B. Thus, A’s total income in 2007 would be $125,000 ($50,000 plus $75,000) and B’s income would be $75,000 (i.e., $50,000 plus $25,000).

What are A’s and B’s PIPP percentages in 2007 under this variant? As was illustrated in our variant to Example 2, there can be a range of potentially applicable PIPP computations; in our variant to Example 3, A’s PIPP might be 50 percent (i.e., A’s initial tier profit share); 62.5 percent (i.e., A’s actual share of 2007 income); 75 percent (i.e., A’s residual share of 2007 income, which also is A’s share of future years’ income in AB, assuming no further losses), or any percentage in between 50 percent and 75 percent (if PIPP may be calculated based on approaches such as “average future profits”; “facts and circumstances,” or “expected net profits” (based on the best profits estimate made on the first day of the 2007 tax year)).

The variants in Example 2 and 3 raise another conceptual question; should each partner’s PIPP percentage be subject to redetermination annually, with differing amounts based on differing operational results, including the impact of prior years’ losses (with corresponding income chargebacks), or no prior losses (and no income chargebacks), as the case may be? The answer is unclear, and ultimately may vary from Code section to Code section.

**Example 4—Disproportionate Profits and Capital due to Service Partner’s Profits Interest**

The facts are the same as in Example 1, except A provides services to AB and makes no capital contributions, and it is agreed that, after B receives aggregate distributions equal to B’s capital contribution, distributions will be paid 50 percent to A, and 50 percent to B.

Example 4 involves a traditional service partner (A) who is a profits partner only. A most likely will take the position that A’s receipt of the profits interest for services was a nontaxable event. A byproduct of that position is that A obtains no tax basis capital account, and presumably no book capital account, either, in AB.

The analysis in Example 4 should be quite comparable to that in Example 3. For purposes of compliance with Code Sec. 704(b), the $20,000 of profits recognized by AB in the initial year (2006) would be allocated 50 percent (i.e., $10,000) to each of A and B. Under those approaches that focus on current profits and those that focus on future years’ anticipated, marginal or residual profits, PIPP percentages would remain 50 percent for A and 50 percent for B. One approach that might indicate a different measurement of PIPP would be a facts-and-circumstances approach that takes into consideration the disproportionate capital contributed by B. As discussed in Example 3, although such disproportionate capital contribution will be reflected in the members’ computation of PIPC, inclusion of the factor in the PIPP computation would appear to be an inappropriate double counting of that factor.

Should AB initially have a loss for 2006 and then income in 2007, the discussion and analysis applied to the factually similar variant in Example 3 would also apply to this Example 4, and (thankfully for the reader) we do not repeat it here.

**Example 5—Guaranteed Payments**

The facts are the same as Example 1, except A provides services to AB and receives current payment of $20,000 per year as a guaranteed payment for services under Code Sec. 707(c), before any other distributions to partners.
The question raised in Example 5 is, “Is A’s receipt of a guaranteed payment described under Code Sec. 707(c) included in the computation of As PIPP?” If it is, then A has more than 50 percent of PIPP for the year in which A is taxable with respect to the guaranteed payment. Stated in terms of aggregate/entity analysis, should the guaranteed payment to A be treated under an aggregate approach (as an interest in partnership profits) for purposes of the 250-plus provisions listed in Appendices I and II, or should it instead be characterized under an entity approach and thus effectively ignored?26

As stated elsewhere herein, a literal reading of Reg. §1.707-1(c) provides that guaranteed payments do not represent an interest in profits (i.e., are excluded in computing PIPP) for purposes of Code Secs. 706(b)(3), 707(b) and 708(b). However, for the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner’s distributive share of ordinary (partnership) income.87

This seemingly definitive dichotomy in Reg. §1.707-1(c) does not seem to be universally accepted. One commentator suggests that this dichotomy should apply for PIPP purposes, “absent contrary guidances.”99 However, he contends there are good policy reasons to use an entity approach as the general approach for purposes of those Code and regulatory provisions that turn on the extent of PIPP and exclude guaranteed payments in general. A leading treatise states that the specific elimination of guaranteed payments from the concept of PIPP in the three specified Code Sections “indicates that the guaranteed payments may be a share of partnership profits for most, but not necessarily all, other purposes.”91

In a few cases, the applicable regulation or statutory provision generates an explicit rule for dealing with guaranteed payments as included or excluded in PIPP. However, as a general matter the treatment of guaranteed payments remains substantially unclear.92

This uncertainty can have dramatic effects. Returning to Example 5, the $20,000 guaranteed payment to A will reduce AB’s net income to zero for the partnership’s tax year. Therefore, if the guaranteed payment constitutes a portion of partners’ profits, A will have 100 percent (i.e., $20,000) and B will have zero percent (i.e., $0) of PIPP. If the guaranteed payment is excluded from the computation of PIPP, then AB will either have $20,000 of income (if A’s receipt of the guaranteed payment is totally disregarded) or $0 income (if the Code Sec. 707(c) payment is nonetheless deductible for this purpose). Again, a wide range of PIPP percentages hangs in the balance, with no guidance in sight.

So what is this writer’s conclusion? After examining statutory language and legislative history, the partnership and partners may have flexibility as to including or excluding guaranteed payments from the computation of PIPP. Philip concludes that guaranteed payments should be ignored generally from the computation of PIPP, while contending there is already support in Reg 1.707-1(c) for this conclusion.93

Example 6—Code Sec. 707(a) Payments

The facts are the same as Example 1, except A provides property management services and receives, before any other distributions to partners, five percent of the gross revenues (or gross income) of AB of a nature that is characterized as a Code Sec. 707(a) payment.

Example 6 provides a straightforward illustration of whether a payment described in Code Sec. 707(a) constitutes an interest in profits for purposes of measuring PIPP. Clearly such payments, which are treated by the Code and regulations as though made to third parties, should be excluded from any determination of partners’ profits. No commentator champions the inclusion of Code Sec. 707(a) payments in the computation of PIPP.

Example 7—Profits Interest for Services by Partner’s Affiliate

The facts are the same as Example 3, except the services are provided by Parent, which owns 90 percent of A (but A is not treated as a disregarded entity with respect to Parent), and Parent receives a 20 percent profits interest for services (leaving A and B each with 40 percent profits interests). A and Parent together have 60 percent of the profits interests of AB.

The first issue to be analyzed is whether Parent is a true profits partner for tax purposes, or merely a service provider who is receiving compensation in the form of a profits interest. If Parent is not a tax partner, then its compensation (while being measured as an amount equal to a profits share) would be disregarded in determining PIPP, and the remaining partners would be deemed to own 100 percent of the profits interests of AB. Thus, A and B would each be deemed to own 50 percent of the profits interests (i.e., each owning 40 percent of the 80 percent, excluding Parent’s share). In such case, the measurement of As and B’s profits interests for tax purposes differs from the stated profits shares in the partnership agreement.
Assuming that Parent is treated as a partner of AB, there is nothing inherent in the definition of PIPP that would cause A to be deemed to have a 60 percent PIPP (i.e., to include Parent’s profits interest), or vice versa. Except where attribution rules specifically so apply and provide to the contrary, PIPP and PIPC should be measured solely with respect to the partner’s own interest.94

Example 8—Differing Profits Interests for Differing Sources of Income
The facts are the same as Example 1, except A provides services (as well as capital) and receives a greater percentage only of operating cash flow (i.e., 75 percent to A, 25 percent to B), while the partners continue to share all net proceeds from the sale or refinancing of the property equally, i.e., 50 percent to A, 50 percent to B.

Example 8 illustrates that partnership agreements may provide for allocations of profits from operations that differ from allocations of gains on sales. One treatise suggests that perhaps the present values of these two interests should be weighed to determine each Partner’s PIPP.95 Obviously, such present valuation of the partners’ future interests requires determination of an appropriate discount rate; reasonable estimates as to likelihood of future income and gains; assumptions as to the likely date of disposition of the property, and numerous other variables that would impact upon the measurement of future profits.96

As an alternative approach, that treatise suggests that (at least for the measurement of PIPP for purposes of Code Sec. 708(b)(1)(B)), in this situation PIPP means simply the selling partner’s interests in Code of Code Sec. 702(a)(8) residual (tax) profits.

Example 9—Disproportionate Capital and Profits Interest Subject to Recharacterization
The facts are the same as Example 1, except the LLC Agreement provides all distributions are to be made 60 percent to A, 40 percent to B.

Example 9 illustrates a capital (and profits) shift. Per Example 1, A and B each contributed 50 percent (i.e., $100,000) of AB’s capital. However, if AB were to liquidate the following day and distribute its cash proceeds to its members, A would receive $120,000 (i.e., 60 percent of $200,000) and B would receive $80,000 (i.e., 40 percent of $200,000).

It appears obvious that A’s PIPP percentage is 60 percent and B’s is 40 percent. The unstated reason97 why B willingly shifted 10 percent of the capital and profits to A should not affect the measurement of PIPP, even though the transfer may have other income or transfer tax consequences to A and/or B.

Example 10—Impact of Recognition of Losses
The facts are the same as in Example 1, except AB has a net loss of $10,000 in 2006.

In a year that a partnership recognizes net losses, how do we measure PIPP? One regulation of relatively ancient vintage states that PIPP will be determined (for purposes of Code Sec. 46) in accordance with the ratio in which partners divide the general (residual) taxable income of the partnership, “regardless of whether the partnership has a profit or loss.”98 In our Example 10 (which is based on the 50/50 straight-up allocations of Example 1), this would result in a 50/50 PIPP computation for Partners A and B in the year of loss.

However, when there are special allocations of income and gain, the Regulation’s reference to “profit” is not straightforward. If, pursuant to the AB Agreement, A is to bear (and be entitled to tax losses corresponding to) the first $100,000 of AB’s losses, and AB recognizes $10,000 of losses in 2006 (i.e., year one) in this Example 10, would the first tier allocation of profits (should there be any in 2007 or future years) of $10,000 solely to A, as required by Code Sec. 704(b), given these facts, be dispositive for purposes of the 2006 computation of A’s and B’s PIPP? In other words, would an income chargeback of 100 percent to A (to the extent of prior losses, i.e., $10,000) mean that A has 100 percent PIPP (and B, zero percent) in loss year 2006? If future profits are relevant, must all future profits (including the $10,000 income chargeback) be included in the computation of PIPP (so that A will have something more than 50 percent, but not 100 percent, of PIPP)? Or do all of the partners have a zero-percent share of PIPP in year one, because there are no year one profits to allocate? There exist other “future profits” approaches to be used for the loss year, as Part VI, below illustrates. What is the best way to compute PIPP in an initial loss year? There is no clear answer.

Example 11—Priority Allocation of Profits
The facts are the same as Example 1, except A will receive a priority allocation of profits equal to five percent of A’s unrepaid capital investment (i.e., $5,000), to the extent there are profits in 2006, and A and B will share any remaining 2006 profits equally. Thus, A will be allocated $12,500 of AB’s $20,000 of profits in 2006: the first $5,000 of profits, pursuant to
its priority allocation, plus $7,500 (i.e., 50 percent of the remaining $15,000 profits). B will be allocated $7,500 of AB's profits in 2006 (i.e., the other 50 percent of the remaining $15,000 profits).

A determination of PIPP involving a priority (i.e., two-tiered) allocation of profits arose 37 years ago in LTR 7003310490A (March 31, 1970), involving a limited partnership ("RP") formed to acquire, own and develop real estate. The sole general partner ("GP") contributed $10,000 capital. The limited partners (who contributed substantially more capital) were investors solicited through a public offering of limited partnership interests. Partnership net profits for any year were to be allocated first, among all the partners, in an amount equal to eight percent of the daily average capital for the year, in proportion to the partners' respective interests as of the end of the year; and the balance of RP's net profit, if any, was to be allocated 25 percent to GP and 75 percent among all the partners in proportion to their respective interests as of year end.

RP would from time to time obtain real estate mortgage loans, or acquire real estate by giving purchase money mortgages as part of the consideration. Some of the mortgages would be nonrecourse (i.e., without personal liability to GP).

RP requested a ruling as to the sharing of such liabilities among its partners under Code Sec. 752. At that time, Reg. §1.752-1(e) provided that a partnership liability with respect to which neither the partnership nor any of the partners have any personal liability will be considered as being shared, under Code Sec. 752, by all of the partners of the partnership, including the limited partners, in the same proportion as the profits of the partnership are shared.

The underlying question in LTR 7003310490A was, what is each partner's share of the "profits of the partnership," when there is a two-tiered profits allocation? RP requested a ruling that the limited and general partners be considered as sharing the nonrecourse liabilities under Code Sec. 752 "in the same proportion as the net profit is allocated to them for the year in which the obligation is incurred." (Emphasis added.) This indicates that (1) the partners would add up their allocable shares of profits from the two tiers for each year in which RP incurred a nonrecourse liability, and (2) the partners' respective profits ratio for the year in which the liability was incurred would determine their liability share under Code Sec. 752 for the entire period that the nonrecourse liability remained outstanding. Thus, if liabilities were incurred in different years, and the partners' respective profit shares differed (given their actual profits under the two-tier profits allocation in effect annually), the partners could have different shares of liability under Code Sec. 752 for different mortgages incurred by the partnership at different times.

The IRS did not rule as to how the partners' respective profit shares should be determined in LTR 7003310490A. The IRS merely stated generically that such nonrecourse liabilities are considered as being shared, under Code Sec. 752(c) and within the limitations of that Code section, by all of the partnership's partners (including the limited partners) "in the same proportion as the profits of the partnership are shared," citing Reg. §1.752-1(e). The IRS had a golden opportunity to provide guidance as to measuring PIPP (at least for purposes of Reg. §1.752-1(e)), but failed to do so. Thus, there is little learning in the letter ruling that can be applied to our Example 11.

The Letter Ruling's significance should not be overstated or overrated—after all, it is now 37 years old, it was issued at a time when such rulings were not reviewed for purposes of release to the public, and it never carried precedential effect. Nonetheless, it is interesting to see that, even in 1970, some partnerships were utilizing multi-tier profits allocations (i.e., an eight-percent return on capital and then a carried interest to the general partner, in the residual profits share) and seeking guidance as to the meaning of the partners' "share of profits," which was—and remains—undefined under former Reg. §1.752-1(e).

Finally, the letter ruling is interesting because the partners requested a single (i.e., first year) determination of the profits share with respect to each newly generated nonrecourse liability, which would be both administratively convenient and, hopefully, not susceptible to shifting annually with ever-changing changes in profits—but the IRS wouldn't so rule.

Returning to our Example 11, what is the correct computation of the partners' PIPP percentages in a year in which there are sufficient profits to permit both priority and residual profits allocations? The answer is unclear, and again depends on which approach to computing PIPP is deemed appropriate. Part VI, supra, analyzes 25 different methods of computing PIPP. The following alternative approaches (as applied to Example 11) are included in that analysis:

If one looks to the total profits allocation in 2006, with A being allocated $12,500 (including A's priority) and B being allocated $7,500, then A's PIPP percentage is 62.5 percent and B's is 37.5 percent. If only the residual tier of profits should count, then A's and B's PIPP percentages are 50/50. If the priority profits...
allocation is dispositive, then A’s percentage of PIPP is 100 percent and B’s is zero percent. If PIPP is measured based on the highest percentage that a partner may ever have of any item over the life of the partnership, then A’s percentage is 100 percent (i.e., if there is only enough future income to cover the preferred return) and B’s percentage is 50 percent (i.e., B’s residual profits share). If PIPP is measured by the average future profits interest that the partners will be allocated, A’s PIPP percentage may be anywhere between 100 percent and 50 percent (with B having the remainder, of course). If PIPP is measured by the partners being able to designate the percentage based on “any significant item,” A could have a PIPP percentage of 100 percent if its preferred return of $5,000 is deemed “significant.” (There is no clear line identifying “significant,” for purposes of PIPP (or elsewhere in Subchapter K) to our knowledge.) Alternatively, A’s 50-percent residual percentage would be significant and could be used if the partners so elected under that approach. If the “bottom-line taxable profits” approach is used, which looks to each partner’s net taxable income under Code Sec. 702(a)(8), a preliminary determination would need to be made as to the amount of AB’s bottom-line taxable income, and included therein, whether A’s preferred return is included in Code Sec. 702(a)(8) (in which case A’s and B’s PIPP percentages will vary annually, as AB’s income in excess of the preferred return varies), or rather in Code Sec. 702(a)(7) (in which case the “bottom-line taxable profits” approach would always give each of A and B a 50 percent PIPP percentage). (Are we ready to cry “Uncle!” yet?)

The analysis further changes if AB’s income for the year is only sufficient to cover all or a portion of A’s preferred return (i.e., net income between $1 and $5,000 in AB’s initial year), with no income pertaining to the residual allocation tier. Code Sec. 704(b) would require 100 percent of AB’s income to be allocated to A in that initial year, and thus A’s PIPP would appear to be 100 percent in 2006, under the current year’s actual profits approach. However, alternative approaches could support other PIPP percentages, again ranging for A between 100 percent and 50 percent (and anything in between) and for B, in general, the inverse.

Readers should keep in mind, in this Example 11 and elsewhere, that our examples focus primarily on the initial year or two of the partnership’s operations. In the real world, the operative Code or regulations provision may require a measurement of PIPP (or PIPC) when there is several years’ history (or “hair”) to be dealt with. To illustrate, in Example 11 if there had not been income in 2006 (the initial year) or 2007, while A’s priority return continued to accrue, and in 2008 AB had substantial income, would A be allocated the first $15,000 of taxable income (i.e., A’s $5,000 annual preference times three years) under Code Sec. 704(b), to cover the three years 2006 to 2008, and if so, how might that affect the computation of the PIPP percentages under the numerous approaches described earlier in this Example?

**Example 12—Priority Allocation of Gross Income**

The facts are the same as Example 1, except A will receive a priority allocation of gross income equal to five percent of A’s unrepaid capital investment (i.e., $5,000) in 2006, to the extent there is gross income in 2006, and A and B will share equally all net profits (after reduction for the gross income allocation). Thus, in 2006 A will be allocated $5,000 of gross income; AB will have net profits of $15,000 (after reduction for the $5,000 gross income allocation to A), and A and B will each be allocated $7,500 of the residual net profits.

For purposes of computing PIPP, Example 12 is similar in form to Example 11, employing a special allocation of gross income in lieu of the priority allocation of net profits in Example 11 (if and when net profits are recognized). The economic difference is that A is virtually certain to get its gross income priority (even if there is a net loss in any or all years) in Example 12, whereas in Example 11 A gets its priority allocation (and payment) only if net profits are ultimately recognized.

There is also a potential difference in the computation of the partners’ PIPP percentages unrelated to the economic differences between Examples 11 and 12. As stated in Example 1, AB’s net income in 2006 is $20,000. A gross income allocation in Example 12 of $5,000 to A would result in there being residual net income for AB of $15,000. If the computation of PIPP is based on an approach that excludes special allocations of income, gain, loss or deduction from the computation of “profits” or “income,” then the partner receiving the gross income allocation will have a lesser PIPP percentage. For example, A’s exclusion of the ($5,000) gross income allocation from the PIPP calculation in Example 12 would result in A having exactly a 50 percent residual profits share; as a result, A may not be subject to Code Sec. 707(b) or other operative provisions that apply to a partner having “more than 50 percent” of PIPP or PIPC. In contrast, if A’s preferred return (of the same amount) in Example 11 is included in computing PIPP, A would always exceed the 50-percent threshold, and in some years A could
conceivably reach the 100 percent PIPP level under some approaches, as described in Example 11.

Another subtle difference between Examples 11 and 12 in computing PIPP may arise in a year in which AB’s net income is positive but less than A’s preference. In this variant, assume A’s priority is $5,000 in 2006 (year one), but AB’s net income that year (before taking the priority into consideration) is only $3,000. In Example 11, A would be allocated all $3,000 of net income as a priority allocation of profits, and depending on the method selected, A might have a 100 percent PIPP percentage in 2006 because all of AB’s net income was allocated to A.

Contrast that with Example 12, where the special allocation of $5,000 gross income to A will result in AB reporting a $2,000 net loss under Code Sec. 702(a)(8). As discussed in Example 10, the partners’ PIPP percentage that must be determined for a year in which the partnership has a net loss may be subject to different approaches or calculations than for years in which the partnership has net profits.

**Example 13—Special Allocations of Nonrecourse Deductions**

The facts are the same as Example 3, except AB has acquired a building using 100-percent nonrecourse financing and has nonrecourse deductions for the year of $20,000, which it has specially allocated 75 percent to A and 25 percent to B in accordance with Reg. §1.704-2.

Example 13 reflects the potential impact of a special allocation of depreciation and gains on the computation of the partners’ interest in profits. In Example 13, AB has net income of $20,000 (per Examples 1 and 3), but also has depreciation deductions of $20,000. Absent a special allocation of the deduction, AB would have bottom-line taxable income of zero, and thus those methods that measure PIPP based on the current year’s (positive) net income would not be able to rely on the partners’ respective shares of 2006 income.

By using a special allocation of deductions, AB (as in Examples 1 and 3) will have residual income of $20,000. Thus, those methods that use bottom-line net profits (such as Code Sec. 702(a)(8) general profits) in computing PIPP would look to the latter.

It is unclear whether the particular facts of Example 13 would result in the same measurement of PIPP, regardless of the use of the special allocation of depreciation. If the current year’s income is the proper measurement stick, A will be allocated 75 percent of the ($20,000) residual net income and B will be allocated 25 percent, as the facts in Example 3 (on which this Example 13 is based) would so indicate. If the current year’s income cannot be the standard (because net income is zero, rather than positive), and the default rule for computing PIPP is to look at all facts and circumstances (or some other method) that takes into account the partners’ respective capital contributions (which were contributed equally by A and B, per Examples 1 and 3), it is not clear that A would have a PIPP percentage of 75 percent; rather, it might be somewhat lower (albeit it clearly should still be in excess of 50 percent).

**Example 14—Minimum Gain Chargebacks**

The facts are the same as Example 13, except in the following year there is a reduction in minimum gain and the AB Agreement correctly requires a minimum gain chargeback of 75 percent to A and 25 percent to B.

Example 14 introduces a special allocation of gain or income attributable to a specific item of property (i.e., the depreciable property that generated deductions attributable to nonrecourse indebtedness). The minimum gain chargeback contained in Reg. §1.704-2 will apply to allocations of certain operating income under Code Sec. 704(c). Next, A and B are each allocated $50,000 (i.e., 50 percent) of the $100,000 residual net profit on the sale. Assume AB is not in the trade or business of land sales.
Example 15 introduces the question of whether the measurement of PIPP should be based on taxable income rather than book income. In our 14 prior examples, tax and book income have been assumed to be the same amounts.

The answer is not clear. The most comprehensive regulations dealing with PIPP\textsuperscript{106} (albeit issued expressly for the limited purposes of Code Sec. 706(b)) utilize taxable income, rather than book income.\textsuperscript{107}

If taxable income is the proper measure of PIPP and if Code Sec. 704(c) is not otherwise excluded from the computation, then A will include in its PIPP percentage computation $100,000 (\textit{i.e.}, $50,000 plus $50,000) gain on sale of the land and B will include $50,000 (the remaining portion of A’s taxable gain). If the Code Sec. 704(c) gain of $50,000 is not included in the calculation of PIPP, then A will include only $50,000 (not $100,000) in the computation.

Example 15 also introduces the question of whether the measurement of PIPP should include all sources of income allocated to the partners, or only certain sources. Recollect that in Example 15, we again begin with the facts of Example 1, which reflects AB’s recognition of $20,000 of net income, which is allocated equally ($10,000) to each of A and B.

If PIPP is determined based on each partner’s total income for the current tax year, then A’s and B’s PIPP percentages will include the gain on AB’s sale of land (which, as discussed above, may or may not include the Code Sec. 704(c) element or gain). If, instead, PIPP is computed based solely on the residual profits allocation under Code Sec. 702(a)(8), then A’s and B’s PIPP percentages will each be 50 percent (\textit{i.e.}, the manner in which they share AB’s $20,000 net income), regardless of the allocation of gain on the land sale, as the latter is separately allocated under Code Sec. 702(a)(1), (a)(2) or (a)(3), as the case may be. Once again, your author is unaware of any authority that specifically deals with the inclusion or exclusion of gains on sale (or other disposition of property) in the computation of PIPP.

\textbf{Example 16—Curative Allocations/Qualified Income Offset}

The facts are the same as Example 1, except in 2009 a gross income allocation is made to A arising from a qualified income offset (QIO) made in accordance with Reg. \textsection1.704-1(b).

Example 16 involves a special allocation that arises from attempted compliance with the capital account maintenance rules required under Reg. \textsection1.704-1(b) for allocations of profit and loss to have substantial economic effect. As in Example 15, the issue arises whether a tax-based allocation (here, a QIO) that may result in an allocation of an item of (gross) income, should be taken into account in determining PIPP.

The answer (like almost all of our other examples) is unclear. For the limited purposes of Code Sec. 706(b), the regulations do include QIOs, as they take into account all rules and regulations including, without limitation, Code Sec. 704(b)\textsuperscript{108}, in determining PIPP.

We have completed 16 Examples that illustrate problems that arise in the measurement of PIPP. What guidance have Congress, the IRS, the Treasury and the courts provided to taxpayers, their advisors and IRS field agents on this topic?

\textbf{Measuring PIPP: Congressional Guidance}

As previously observed, there is no definition of PIPP contained in the Code and very little in the way of statutory guidance. Code Sec. 613A(c)(7)(D), dealing with partners’ basis in partnership property, appears to mandate the inclusion of one’s share of Code Sec. 704(c) gain (or loss) in determining PIPP or PIPC\textsuperscript{109} for purposes of that Section, but no further guidance can be derived from that statute.

Code Sec. 988(c) provides limited guidance, applicable solely to that subsection, with respect to one component of partnership profits—a general partner’s incentive compensation. Code Sec. 988(c), which deals with the taxation of certain foreign currency transactions, excludes from the definition of a general partner’s PIPP for purposes of Code Sec. 988(c)(1)(E)(iii)(I) income allocable to that partner as incentive compensation based on profits rather than capital.\textsuperscript{110} The legislative history to Code Sec. 988(c) states that in computing such PIPP, the conferees intend to treat as compensation based on profits only those interests that result in the partner earning amounts disproportionate to its stated profits interest (that is, its interest in profits stated as a simple, fixed percentage of partnership profits). For example, if a general partner has a stated one-percent interest in partnership profits plus an overriding 20-percent interest in “new profits,” defined in such a way that its profits interest in any one year could be as much as 100 percent, and in fact the percentage of profits actually received by the partner in one year can be expected at times to exceed 20 percent (but not on a regular basis), then such an arrangement generally does not disqualify the fund. On the other hand, if
“new profits” are defined in such a way that the partner can be expected to earn, or does earn, over 20 percent of the profits of the fund in most tax years of the partnership, then the conferees generally intend that the partnership not be treated as a qualified fund.111

**Measuring PIPP:**

**Administrative Guidance**

One might assume that the Treasury and the IRS, having drafted and presumably been called upon to interpret PIPP and PIPC, developed some general institutional understanding of the meaning and the measurement of those terms, other than in just a “straight-up” partnership setting. As illustrated in a 1995 Chief Counsel Office Memorandum/Field Assistance document that undoubtedly was not meant for public consumption,112 there may be no institutional understanding, and indeed no readily-available files to shed light on the measurement of PIPP and PIPC.

The most extensive administrative guidance is provided in Reg. §1.706-1(b)(4) and the Preamble to that regulation as proposed.113 All other administrative guidance pales in comparison. However, Reg. §1.706-1(b)(4) by its terms is limited solely to application under Code Sec. 706(b) and, as described below, was a “front-end” methodology of estimating PIPP (and PIPC) on the first day of the partnership’s tax year—an approach that many other “relatedness” provisions likely would not follow. We first discuss the approach under Reg. §1.706-1(b)(4) to compute PIPP, and then identify other administrative guidance.

**Computation of PIPP Under Reg. §1.706-1(b)(4)**

Reg. §1.706-1(b)(4), issued to reflect changes made to Code Sec. 706(b) by the 1986 Tax Reform Act, provides *inter alia* rules that apply in determining the majority interest tax year,114 the principal partners’115 tax year, and the least aggregate deferral tax year.116 With respect to profits interests, the regulations state that PIPP is generally the partner’s percentage share of partnership profits for the current partnership tax year.117 However, the Regulations and Preamble provide much more flesh to that skeleton, specifying rules to determine PIPP for purposes of Code Sec. 706(b):  

- **The test is based on taxable income, not book income.** The Preamble states that the regulations clarify that PIPP is the partner’s share of the partnership’s taxable income, rather than the book income.118

- **PIPP is based on the manner in which the partnership “expects to allocate” income.** The partners’ profits interests are determined on an annual basis based on the manner in which the partnership “expects to allocate” its income for the year.119

- **If the partnership does not expect net income for the current partnership year, future partnership net income must be predicted and used.** If the partnership does not expect to have net income for the current partnership tax year, then the partnership determines PIPP based on the manner in which it expects to allocate its income in the first tax year in which the partnership expects to have income.120 Specifically, if the partnership expects no net taxable income for the current year, PIPP must be the partner’s percentage share of partnership net income for the first tax year in which the partnership expects to have net income.121 The “partner’s share of partnership net income” for a partnership tax year is the ratio of the partner’s distributive share of partnership net income for the tax year, to the partnership’s net income for the year.

- **Preferred returns and special allocations count.** If a “partner’s percentage share of partnership net income for the tax year” depends on the amount or nature of partnership income for that year (due to, for example, preferred returns or special allocations of specific partnership items), then the partnership must make a reasonable estimate of the amount and nature of its income for the tax year.122

- **The “reasonable estimate” is made as of the first day of the current partnership tax year.** This estimate of the amount and nature of the partnership’s income must be based on all facts and circumstances known to the partnership as of the first day of the current partnership tax year. The partnership must then use this estimate in determining PIPP for the tax year.123

- **In determining PIPP for purposes of Code Sec. 706(b), taxable income is inclusively defined.** For purposes of determining PIPP under Reg. §1.706-1(b)(4)(iii), a partner’s distributive share of partnership net income is determined by taking into account “all rules and regulations effecting that determination, including, without limitation, Code Secs. 704(b), (c) and (e), 736 and 743.”124 The Treasury’s and IRS’ attempts to provide guidance under Code Sec. 706(b) are laudable, and reflect the realization (consistent with Code Sec. 706(b)(4)(A)(ii)) that the partnership and its partners can’t wait until December 31, 2006 (or perhaps many months later, when all requisite data, including from subsidiary pass-through entities, is available), to find out that at some
earlier period during the year (say, April 30, 2006) the partners’ respective PIPP (and/or PIPC) percentages were sufficient to cause the partnership’s current tax year to end say eight months earlier (April 30, 2006). In such case, the partnership’s tax returns would be long overdue, with penalties galore for late filings and other potentially extremely adverse consequences.

However, the approach taken under the Code Sec. 706(b) is not without criticism, to wit:

1. **Should the test have been based on book net income, not taxable income?** Inclusion of pre-contribution built-in gain under Code Sec. 704(c), and so-called reverse built-in gain under Code Sec. 704(b), do not have substantial economic effect under Code Sec. 704(b). Is book income a better measurement of partnership net income for purposes of Code Sec. 706(b)?

2. **Is the IRS likely to challenge the partnership’s “expected” projection and allocation of income for the current year, particularly if clearly foreseeable scenarios ultimately arise that result in actual net income for the current year being allocated in a substantially different fashion?** If there is a substantial tax revenue opportunity, will a field agent apply 20-20 hindsight to challenge the partnership’s assumptions and projections?

3. **How do guaranteed payments under Code Sec. 707(c) fit in the equation, i.e., are they included or excluded in predicting net taxable income?** The general rule, as stated in Reg. §1.706-1(b)(4)(ii)(A), is that for purposes of Code Sec. 706(b), PIPP is generally the partner’s percentage share of partnership “profits” for the current partnership tax year, and that for purposes of Reg. §1.706-1(b)(4)(ii), a partner’s distributive share of partnership “net income” is determined by taking into account “all rules and regulations affecting that determination ...” Assuming that the “all rules and regulations” corollary also applies to “profits,” does this mean that guaranteed payments (whether for services or use of capital) under Code Sec. 707(c) are included or excluded? Reg. §1.707-1(c) (which certainly seems to be one of those “rules and regulations affecting that determination” of a partner’s percentage share of partnership profits for the current partnership year) provides that guaranteed payments do not constitute an interest in partnership profits for purposes of Code Secs. 706(b)(3), 707(b) and 708(b), but they are regarded as a partner’s distributive share for purposes of other provisions of the tax law. When Reg. §1.707-1(c) was issued in 1956, Code Sec. 706(b)(3) contained (and continues to contain) solely the “principal partner” definition (i.e., a partner having an interest of five percent or more in PIPP or PIPC). The “majority interest tax year of a partnership” rule is contained in Code Sec. 706(b)(4) (referring to the partners’ aggregate interest in PIPP and PIPC being more than 50 percent). Reg. §1.707-1(c) has not been amended to include Code Sec. 706(b)(4), and thus it appears technically that guaranteed payments are not included in PIPP for purposes of Code Sec. 706(b)(3) but are included in PIPP for purposes of Code Sec. 706(b)(4). Although Reg. §1.706-1(b)(4)(ii) does not address the treatment of guaranteed payments, query whether this technical difference is intended or desirable.

It should be noted that the guidance provided in Reg. §1.706-1(b)(4) is expressly limited by the Preamble to the regulation. The Preamble states that its definition of PIPP and PIPC is designed to be compatible with the provisions of, and policies underlying, Code Sec. 706(b). Observing that many other sections of the Code also contain references to PIPP or PIPC, the Preamble states that those sections address concerns that differ substantially from the concerns addressed by Code Sec. 706(b); therefore, Reg. §1.706-1 should not be read to create any implication as to the meaning of PIPP and PIPC for purposes of those other sections.

**Computation of PIPP: Other Administrative Guidance**

Beyond Reg. §1.706-1(b)(4), there is fragmentary guidance found in disparate provisions of the regulations. In troving through the regulations, one has the same sense of the futility (and much less of the excitement) that African fossil hunters feel in sifting through tons of dirt to find a few disconnected bone fragments. The following is a partial listing of the other regulations’ meager guidance in measuring PIPP, all of which is fragmentary and some of which is inconsistent:

1. PIPP is determined in accordance with the ratio in which the partners divide the general (residual) taxable income of the partnership, regardless of whether the partnership has a profit or loss. (Reg. §1.46-3(f)(2).)

2. PIPP is determined by the partnership agreement. In the absence of any provision regarding the sharing of profits, PIPP will be determined in the same manner as distributive shares of partnership taxable income. However, a Code Sec. 707(c) guaranteed payment is not considered a distributive share of partnership income for this purpose. (Reg. §1.401-10(d).)
3. PIPP is determined by taking into account all facts and circumstances relating to the economic arrangements of the partners. See the factors listed in Reg. §1.704-1(b)(3)(ii). (Reg. §1.613A-3(e)(4).)

4. PIPP must be determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify PIPP for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the Code Sec. 704(b) regulation) of some other significant item of partnership income or gain. (Reg. §1.752-3(a)(3).)

5. PIPP is determined by reference to the partner's interest in partnership income for the year. (Temporary Reg. §1.861-9T(e)(1).)

6. Control of a partnership (for purposes of Code Sec. 2701) means the holding of at least 50 percent of either PIPP or PIPC. Any right to a guaranteed payment under Code Sec. 707(c) of a fixed amount is disregarded in making this determination. (Reg. §25.2701-2(b)(5)(iii).)

7. PIPP is determined in the same manner as the partner's distributive share of partnership taxable income. See Code Sec. 704(b) (relating to the determination of the distributive share by the income or loss ratio) and the regulations thereunder. (Reg. §53.4943-3(c)(2).)

8. For purposes of determining the tax matters partner where no partnership designation has been made, it shall be the general partner with the largest profits interest (i.e., PIPP). For this purpose, the largest PIPP is determined based on the year-end profits interests reported on the Schedules K-1 filed with the partnership income tax return for the tax year for which the determination is being made. (Reg. §301.6231(a)(7)-1(m)(2).)

The IRS has provided meager guidance in letter rulings, technical advice memoranda and revenue procedures as to the meaning of PIPP. In TAM 8931001, the National Office was asked to determine whether the allocations of investment tax credit made by a partnership in 1984 and 1985 were correct. For purposes of that investment credit allocation, Reg. §1.46-3(f)(2) provides that each partner takes into account separately his basis (or cost) in Code Sec. 38 property placed in service by the partnership during such partnership tax year. In turn, each partner's share of the basis (or cost) of any Code Sec. 38 property is determined in accordance with "the ratio in which the partners divide the general profits of the partnership."129

TAM 8931001 involves a limited partnership ("LP") formed in 1984, to establish and operate a medical facility. The limited partners invested $435,000 and the general partners contributed $565,000 as initial capital to LP. LP's partnership agreement provided that in 1984, 90 percent (rounded) of the net income is allocated to the limited partners, and the remainder to the general partners. For 1985 through 1989, the allocation of net income is first to all partners to the extent of net losses previously allocated to them in proportion to such prior net loss allocations, taking into account any net income previously allocated. Thereafter, during the 1985–1989 period, 60 percent of the net income is allocated to the limited partners and the remainder to the general partners. Beginning in 1990, the residual profits interest is 33 percent to the limited partners and the remainder to the general partners. For all tax years, net losses are allocated 90 percent to the limited partners and the remainder to the general partners, until the capital accounts of the limited partners are zero. Thereafter, net losses are allocated 100 percent to the general partners.

LP's agreement provided that investment tax credits are allocated to the partners in the same ratio as net income is allocated (or would be allocated if there were net income for such year) for the year in which the property to which the tax credit relates is placed in service.

The private placement memorandum provided potential inventors with projections of income and loss for the first five tax years, as follows: 1984—$244,000 loss; 1985—$49,000 loss; and 1986 to 1988: income in the range of $135,000 to $173,000. Actual figures for the first three tax years reflected losses.

In 1984 and 1985, LP leased certain equipment that qualified for investment tax credits flowing through to LP and its partners. Pursuant to the terms of LP's partnership agreement, the limited partners were allocated 90 percent of the credit although they contributed only 43.5 percent of the capital and were expected to receive no distributions or income allocations in excess of 60 percent (other than income allocations that merely offset prior loss allocations).

During the years 1984 and 1985, the limited partners were allocated $331,000 of losses. The IRS field agent calculated that the limited partners' tax deductions and credits were worth approximately $27,000 more than their capital contributions, and he concluded that the general partners could not use the investment tax credits at that time. Therefore, he concluded the general partners were trading early tax credits and losses.
Identifying Partners’ Interests in Profits and Capital

(which were of very limited current use to them) for higher percentages of net income in later years.

Reg. §1.704-1(b)(4)(ii) provides in relevant part that allocations of tax credits cannot have “substantial economic effect” under Reg. §1.704-1(b)(2)(ii)(b)(1), and such credits must be allocated in accordance with the partners’ interests in the partnership (under Reg. §1.704-1(b)(3)) as of the time the tax credit arises. With respect to the investment tax credit provided by Code Sec. 38, allocations of cost or qualified investment made in accordance with Reg. §1.46-3(f) are deemed made in accordance with the partners’ interests in the partnership.130

In technical advice, the National Office stated that a basic question presented by this case is whether the rule provided in Reg. §1.46-3(f)(2)(i) was intended to require the use of all bottom-line net income allocations set forth in partnership agreements. The National Office observed that the reference to the “general profits” ratio in that regulation (having been added to the regulations in 1964 “when partnerships were generally not as complex and tax-oriented as they often are today”) was based upon the premise that the ratio would reflect the real economics of the partners’ profit-sharing arrangement. The National Office concluded that where that is not the case the regulation was not intended to, and does not, authorize the use of bottom-line net income allocations for investment tax credit purposes. Therefore, it concluded the rule in Reg. §1.46-3(f)(2)(i) does not support P’s investment tax credit allocations for 1984 and 1985. Accordingly, the National Office concluded that those allocations do not satisfy Reg. §1.704-1(b)(4)(ii), and P’s investment tax credits must be allocated under Reg. §1.46-3(f)(2)(i) in accordance with the general profits ratio that reflects the partners’ interests in the partnership (as defined in Reg. §1.704-1(b)(3)).131 Accordingly, the National Office advised the agent to disregard the rules and instead impose the “partners’ interest in the partnership” measurement of Reg. §1.704-1(b)(3) as being the proper standard leads to uncertainty as to the measurement of the general profits ratio.

In light of the paucity of administrative guidance, Rev. Proc. 94-46 is of some interest notwithstanding its subject matter is the obsolete tax classification regulation that pre-dates the check-the-box regulations. Former Reg. §301.7701-2(b)(1) provided that the corporate characteristic of continuity of life does not exist notwithstanding the fact that a dissolution of the partnership may be avoided, upon certain events of withdrawal of a general partner, by “at least a majority in interest of the remaining partners” agreeing to continue the partnership. The regulation does not define the term “majority in interest.”

Rev. Proc. 94-46 provides a safe harbor to be used to determine a “majority in interest” for this purpose. If remaining partners owning “a majority of the profits interests and a majority of the capital interests” owned by all the remaining partners agree to continue the partnership, continuity of life will not exist. For this purpose, “profits are determined and allocated based on any reasonable estimate of profits from the date of the dissolution event to the projected termination of the partnership, taking into account present and future allocations of profits under the partnership agreement that is in effect as of the date of the dissolution event.”133

Measuring PIPP: Judicial Guidance

There is a dearth of judicial guidance as to the measurement of PIPP and PIPC. A thorough analysis as to the determination of PIPP arose in Hill, Farrer & Burrill,134 a reviewed Tax Court decision containing majority, concurring and dissenting opinions, in the context of Code Sec. 401(c)(3)(B), relating to qualified retirement plan status. As discussed below, the case highlights the risks of searching for the underlying policy objective or Congressional concern relating to each operative Code or regulations provision that incorporates a measurement of PIPP or PIPC.

The taxpayer in Hill, Farrer was a 19-member law partnership that adopted an employees’ profit sharing plan that met all the requirements for qualification except certain ones applicable to plans which covered “owner-employees” as defined in Code Sec. 401(c)(3)(B). The parties conceded that the plan’s qualification turned on whether any one of the firm’s partners was an “owner-employee.”
The law firm’s general partnership agreement provided, *inter alia*, for capital contributions by each partner and for a formula allocation of profits and losses among the partners. Two-thirds of the annual net profit was to be distributed among the partners on the basis that the total profit to the firm “for services rendered” by each partner during the calendar year bears to the firm’s aggregate total profit. The other one-third of the profit was allocated to the partners in proportion to their respective cash capital contributions. Gains and losses on the sale of capital assets, and income from sources other than fees for legal services rendered, also were allocated to the partners in proportion to their cash capital contributions. Losses of the partnership generally were borne in proportion to their cash capital contributions. The firm also had a policy with respect to client origination produced by a partner or associate attorney, which in part provided an allocation of 20 percent (less proportionate overhead) of the fees received for the services rendered to that client. The attorney entitled to the 20 percent allocation could assign all or part of it or any portion of any of his fees to other attorneys (to compensate them for working on the client or for other reasons).

Pursuant to the contract and policy provisions, at least one partner each year actually received a distribution of profits that exceeded 10 percent of the firm’s annual total profits.

The determination of whether, under these contract and policy provisions, any one of the firm’s partners was an “owner-employee” turned on the definition of that term in Code Sec. 401(c)(3)(B), which provided in relevant part that it means “an employee who ... in the case of a partnership, is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership.”

The IRS conceded that none of the firm’s partners owned more than 10 percent of the “capital interest” in the firm. Therefore, the issue was narrowed to whether any one of the partners “owns more than 10 percent of ... the profits interest” in the partnership. The IRS’ position in its determination letter was that the firm’s “proposed plan for division of profits, either through the partnership agreement or in actual operation, has resulted in partners owning and receiving more than 10 percent of the profits interest of the partnership as a result of their productivity. Thus, it is possible for any partner to have distributed to him in any year more than 10 percent of the firm’s profits interest. Such partner has been in the past and would be an owner-employee.”

The Tax Court stated that since, at all relevant times, at least one partner has actually received a distribution of firm profits that exceeded 10 percent of the total firm profits, IRS asks the court to hold that such partner is or has been an “owner-employee” within the meaning of Code Sec. 401(c)(3)(B).

The law firm pinned its case on the precise language of Code Sec. 401(c)(3)(B), which refers to a partner who “owns” more than a 10-percent “interest” in a partnership. The firm argued that the ownership of the profits interest in a partnership is determined by the terms of the partnership agreement, and the firm’s agreement gives none of the partners a contractual right, in advance, to more than a 10-percent profits interest in the partnership. Rather, to a large extent the agreement keys the amount of the profits to which each partner is entitled each year to his productivity during the year. In such circumstances, the firm argued, a partner may *receive* more than 10 percent of the profits in a given year, but this does not mean that he *owns* more than a 10-percent profits interest in the partnership.

The Tax Court’s majority opinion described the issue as “a close one,” but thought that the IRS “has the better side of the argument.” The Court’s majority held the law firm’s profit-sharing plan as not a qualified one under Code Sec. 401(a).

The majority opinion bases its conclusion on an analysis of what it perceived to be Congressional intent, pertaining not only to Code Sec. 401 but also other employee benefit plan provisions that were concurrently enacted. Prior to Congress’s 1962 amendment of Code Sec. 401, self-employed persons, including partners, were not allowed to participate in qualified profit-sharing plans. At that time Congress (1) amended the term “employee” to include self-employed individuals with earned income; (2) defined the term “employer” so as to treat a partnership as an employer and each partner earning income from the partnership as an employee; and (3) created the above-defined category of “owner-employee” in Code Sec. 401(c)(3), while simultaneously imposing a series of additional requirements for qualification with respect to profit-sharing plans that provide contributions or benefits for such owner-employees under various Code sections. In enacting these and other qualification requirements for plans whose participants include owner-employees, Congress anticipated that such plans, being smaller than existing corporate plans, would present “greater opportunities for abuse.”

The court reasoned that additional qualification requirements were designed to prevent abuses in the management of plans covering owner-employees.
The Tax Court majority opinion concluded the definition of “owner-employee” in Code Sec. 401(c)(3)(B) must be read in the light of these restrictive provisions and congressional concerns. These provisions allegedly show that Congress was concerned that a partner who was an owner-employee “would dominate the employer partnership and, through it, the profit-sharing trust.”141 Such domination of the trust could lead to the abuses for which Congress expressed its concern.

The majority opinion states that in a law firm partnership, capital usually is not a controlling consideration and the ownership of capital interests provides no real measure of a partner’s control or domination over the firm’s management decisions. On the other hand, a partner’s stake in his law firm’s annual earnings, ordinarily derived from services, can be a significant gauge over his influence over the firm’s affairs. This is particularly true where, as in Hill, Farrer, two-thirds of the partnership’s net profits are divided among the partners according to their productivity and the firm’s policy, in general terms, calls for a partner to receive 20 percent (less proportionate overhead) of the fees derived from client origination. Of significance to the court was the fact that during the two years (1972 and 1974) for which the firm’s profits are shown in the trial record, the individual partners who received more than 10 percent of the firm’s profits were the same in both of those years.140

In light of the above the majority found itself “compelled to conclude that the partners who receive a distribution of [the partnership’s] profits that exceed 10 percent of the total firm profits are owner-employees within the meaning of Code Sec. 401(c)(3)(B).”

While the percentage of the ownership of the profits may vary annually, the parties agreed “at all relevant times at least one partner actually received a distribution of firm profits” in excess of 10 percent thereof. The majority stated, “In our opinion, that constitutes ownership of more than 10 percent of the profits interest of the partnership.”

The majority opinion did not accept the firm’s focus on the technical words of the statute as aiding its cause. The word “owns” (which appears in both the statute and Reg. §1.401-10(d)) often means having good title in or holding as property. However, it does not contemplate necessarily a “contractual agreement fixing, in advance, the percentages of the partnership profits to be awarded each partner.” Rather, “owns” was viewed by the majority of the Tax Court as having its statutory meaning as being “affected by the context and the legislative purpose of the provision in which it is used.”

Given the aforementioned congressional concern as to potential abuses of the self-employment retirement provisions and the wide variety of partnership arrangements to which those provisions are applied, “we think the term is broad enough to include a partner’s contractual right to percentage interests measured by earnings productivity during the tax year.”143

Judge Tannenwald’s concurring opinion in Hill, Farrer (joined by two other judges) addressed Reg. §1.401-10(d), which in relevant part provides that “In the absence of any provision regarding the sharing of profits, the interest in profits of the partners will be determined in the same manner as their distributive share of income.” (Emphasis added.) The Judge thought it entirely appropriate to interpret the italicized language as meaning that the provision in the partnership agreement must be one in which the sharing of profits is specified in terms of fixed percentages or, at the very least, contains a formula which, on its face, enables the percentage share of any partner in the profits to be readily determined. Absent these, the Hill, Farrer’s PIPP would be determined based on their distributive share of income for the year, and in looking back, there were partners whose distributive share of partnership taxable income exceeded 10 percent. A provision for the division of profits as determined by two of several partners, in their discretion, “certainly ... should not qualify”; even under a formula such as involved in Hill, Farrer, the Judge found “a broad area of discretionary determination” as to who gets credit for business brought in or how much work a person did on a particular matter.144

Judge Tannenwald refused to conclude that it is inappropriate to look at the facts at the end of the year (i.e., the actual distributive share of partnership income) because such an approach might cause a firm not to know in advance of that time whether its retirement plan qualified. Looking back at the end of the year to determine potentially adverse tax consequences is “not unknown” under the Code (e.g., a Subchapter S corporation’s status being invalidated because, at the end of the tax year, its receipts do not meet the necessary requirements).145

In his dissenting opinion in Hill, Farrer (joined by three other judges), Judge Goffe concluded that no partner “owns” a greater-than-10-percent interest in profits, and therefore he would find the plan to be qualified. He emphasized that Reg. §1.401-10(d) states that “a partner’s interest in the profits and the capital shall be determined by the partnership agreement.” Judge Goffe stated the majority looked outside the partnership agreement to see what two partners had
received for two tax years and concluded that because they received more than 10 percent of the net profits, they each “owned” more than a 10-percent interest in the profits and were, therefore, owner-employees within the meaning of Code Sec. 401(c)(3)(B). By doing so, the majority has adopted an interpretation that does not aim at the evil to be corrected by the owner-employee test and that is contrary to the ownership test as contemplated by the regulations.

The partnership agreement involved in Hill, Farrer does not set forth a fixed percentage of the net profits of the partnership that each partner will receive. Instead, the agreement provides that the net profits of the partnership shall be first divided into two categories of one-third and two-thirds. The division of the two-thirds portion of the net profits is distributed upon reflecting each partner’s services rendered. The division of this two-thirds portion is also affected by the firm’s policy to award partners or associates 20 percent of the fees (less overhead) received from client origination by such partner or associate. This incentive, according to the dissent, prevents any partner from owning a fixed percentage of the net profits of the partnership for any given year because each partner’s share of the profits necessarily rests upon three variables, i.e., the new clients brought to the firm by such partner, the total income earned by the partnership and the expenses paid by the partnership for the year involved. Because of these three variables it cannot be said that any one partner in a 19-partner firm owns more than 10 percent of the net profits of the partnership. Until all the fees are received at the end of the year and all expenses are paid, no one can determine the percentage of the net profit each partner will receive. The dissent would contrast that with a partnership agreement that specifies the percentage of the fees to be received by each. In the latter case, no matter what the amount of total fees or expenses of the firm, or the efforts of each partner in securing new clients for the firm, the partners will receive a fixed percentage of the net profits, regardless of the resulting amount of the net profits.

The dissent observed that the majority equates what each partner has received from the firm with what the Code and Reg. §1.401-10(d) require; i.e., what each partner owns in the net income interest of the partnership. The majority looks not to the partnership agreement to see how much each partner owns, as prescribed by the regulations, but instead looks outside the partnership agreement to the final determination of what each has received and relates the receipt back to ownership. The dissent states that “to equate a ‘distributive share’ of profits in any one tax year with ‘profits interest’ in the partnership seems unjustified because of the uncertain fluctuation and variation of such interests.”

The dissent raises a strong policy argument in favor of its forward-looking interpretation of profits. Under the majority’s construction of Code Sec. 401(c)(3)(B), the identity of the owner-employee cannot be made until the close of the tax year; the identity of an owner-employee may vary from year-to-year depending upon the productivity of each partner, the amount of fees earned, and expenses paid by the firm; and in some years, there may be no owner-employee at all. Such a construction would cause a firm not to know whether its plan qualifies from year-to-year because of the variations in the efforts of the partners, the total fees earned, and the expenses paid by the firm. “That is the obvious reason for not looking beyond the terms of the partnership agreement, as the regulations provide, to see if any partner owns more than 10 percent of the net profits of the partnership. Surely the variables of each partner’s productivity, the total fees earned and expenses paid for each year, should not determine qualification of a plan on a year-to-year basis. A determination based upon the partnership agreement applies to all years and provides the certainty that is necessarily required for a viable, functioning, profit-sharing plan ...”

The dissent states that the regulations do not call for an examination of all the facts and circumstances to determine the respective interests in net profits but focus only on the partnership agreement or the absence thereof.

Moreover, the evils described by the majority, which the owner-employee test was designed to thwart, are ongoing throughout the tax year; if the owner-employee cannot be identified until the end of the year when the accounting is completed and such owner-employee may or may not be an owner-employee in the subsequent tax year, how can it be determined who is going to commit the abusive acts that the definition of owner-employee was designed to correct? The dissent concludes that the partnership agreement, the point of reference prescribed by the regulations, does not confer ownership to more than 10-percent interest in the profits of the partnership upon any Hill, Farrer partner “within the intendment of Code Sec. 401(c)(3)(B) and Reg. §1.401-10(d), and, therefore, none of the partners is an ‘owner-employee.’” Thus, one must conclude the plan should be held to have qualified.

The Ninth Circuit Court of Appeals affirmed per curiam “for the reasons stated in the majority opinion,” and shed no further light on the analysis.
What learning can we take from the interpretation of PIPP in *Hill, Farrer*?

First, the majority of the Tax Court (and the Ninth Circuit Court of Appeals, by fact of its *per curium*, one sentence affirmation) knowingly disqualified a retirement plan that otherwise complied with Code Sec. 401 because it perceived strong Congressional concerns about owner-employees. The majority determined the applicable definition in Code Sec. 401(c)(3)(B) of “owner-employee” must be read in the light of the legislative history of Code Sec. 401 and stated Congressional concerns. The majority divined Congressional concern that a partner who was an owner-employee “would dominate the employer partnership and, through it, the profit-sharing trust.”

Second, the majority opinion, by looking at the partner’s actual distributive share (i.e., to see whether a partner received 10 percent of the total firm profits) determined as of the end of the year, effectively equates what each partner has received from the firm with what the partner owns as his PIPP. Code Sec. 401(c)(3)(B) and Reg. §1.401-10(d) explicitly treat as an owner-employee a partner who owns more than 10 percent of either the capital or profits interest. The Tax Court majority opinion resorted to a reading of the word “owns” to be “broad enough to include a partner’s contractual right to percentage interests measured by earnings productivity during the tax year.” The majority effectively acknowledged it was putting a gloss on the common meaning of the word “owns,” because its statutory meaning is “affected by the context and legislative purpose of the provision in which it is used.”

Thus, *Hill, Farrer* suggests that the courts will apply a Code section—by—Code section analysis to ferret out Congressional intent, in deciding whether to put a broad (overreaching?) gloss on the meaning of terms such as whether a partner “owns” a stated percentage interest in PIPP or PIPC.

Third, notwithstanding the “death sentence” to the retirement plan’s qualification that presumably was the result in *Hill, Farrer*, Judge Tannenwald’s concurring opinion refused to conclude that it is inappropriate to look at the facts at the end of the year (i.e., the actual distributive share of partnership income) even though such an approach might cause a firm not to know in advance of that time whether its retirement plan qualified.

Fourth, the dissent in *Hill, Farrer* has the better part of the policy argument; it points out that under the majority’s construction of Code Sec. 401(c)(3)(B), the identity of an owner—employee cannot be determined until the close of the tax year, depending upon a number of variables, and “surely the variables of each partner’s productivity, the total fees earned and expenses paid for each year, should not determine qualification of a plan on a year-to-year basis.” The dissent is correct in stating that certainty “is necessarily required for a viable, functioning, profit-sharing plan.”

The dissent (in our view, correctly) states that the evils described by the majority that the owner-employee test were designed to thwart are ongoing through the year. As the dissent observes, if the owner-employee cannot be identified until the end of the year when the accounting is completed, how can it be determined who is going to commit the abusive acts that the broad definition of owner-employee was designed to correct?

Fifth, *Hill, Farrer* highlights the risks of searching for the underlying policy objective or congressional concern relating to each Code or regulations provision that incorporates a measurement of PIPP or PIPC. The Tax Court majority was heavily swayed by the concern that owner-employees could “dominate the employer partnership and, through it, the profit-sharing trust”; the majority feared the “potential for abuse” to such an extent that it put a strained definition on the common meaning of the word “owns.” The dissent concludes that the policy of providing certainty as to plan qualification status as being required for a viable, functioning, profit-sharing plan must be respected. Moreover, the dissent observes that the majority’s test does not properly implement the policy the majority purports to be serving, because the owner-employee cannot be identified until the end of the year, so how can it be determined who is going to commit the abusive acts during the year that the majority’s broad definition of owner-employee was designed to correct?

Sixth, the Hill, Farrer law firm unfortunately had more than one partner, in each of the two tax years in question for which the firm’s profits are shown in the trial record, who ended up receiving more than 10 percent of the law firm’s profits, and it was the same individual partners in both years. The majority opinion notes the parties’ agreement that “at all relevant times at least one partner actually received a distribution of firm profits” exceeding 10 percent.

Would the majority have imposed the “death sentence” on the law firm’s profit-sharing plan if, for some or all relevant years at issue, no partner in fact had a greater than 10 percent profits (or capital) interest? The Tax Court majority ducked answering that question. It stated in a footnote that, in light of the actual facts, the
court “need not decide whether the mere possibility of this happening [i.e., the potential for any partner obtaining more than a 10 percent PIPP, even though no partner actually received a distribution of more than 10 percent of the firm’s profits] would have rendered one or more partners owner-employees.”¹⁶²

Seventh, when future cases arise outside of Code Sec. 401(c)(3)(B) regarding the interpretation of PIPP or PIPC, will the courts feel constrained to follow Hill, Farrer’s search for legislative intent or “Congressional concern,” and then similarly use that mantra to make a broad (or narrow) computation of PIPP? For example, if the purpose of Code Secs. 707(b)(1) and (b)(2) is to avoid one or more partners obtaining favorable tax treatment while the partner “controls” his or her partnership, will the courts decide any interpretative issue as to the meaning or measurement of PIPP against the taxpayer, taking a cue from Hill, Farrer?

Eighth, given that the statutory threshold for owner-employee status is 10 percent (rather than 50 percent or some other number), is Congressional concern as to “the potential for abuse” drawn at too low a number? In other words, can a partner having an 11 percent (or 20 percent or 25 percent) PIPP percentage truly wreak havoc on the qualification and sanctity of an otherwise-compliant qualified plan? Stated another way, if the PIPP percentage standard for “relatedness” under Code Sec. 401(c)(3)(B) is so low, shouldn’t the courts be deciding gray-area questions of interpretation of PIPP measurement in favor of taxpayers, to minimize disqualifications where the owner-employee truly is a noncontrolling member (either by himself or even acting in concert with a small group of other partners)? Note that in a general partnership of nine equal partners (each owning an 11.11 percent interest in PIPP and PIPC), each partner by himself is considered under Code Sec. 401(c)(3)(B) to be an owner-employee who (based on the 10 percent PIPP threshold) could “dominate the employer partnership and, through it, the profit-sharing trust.”¹⁶¹ How can one out of nine equal general partners “dominate the partnership”? Indeed, how can two or three out of the nine “dominate the partnership,” to (figuratively speaking) rape, rob and plunder the profit-sharing trust?

Ninth, is the absence of any decided cases since Hill, Farrer silent testimony to the failure of the IRS to re-litigate a similar case, for fear of reversal? We think not, but it has been 30 years since the Tax Court opinion was issued.

Finally, did the Ninth Circuit’s per curiam affirmation, in the face of a strong dissenting opinion below, signal that the appellate court did not want to respond to the strong arguments in favor of preserving the firm’s qualified plan status? We can’t speculate as to why the Ninth Circuit was so brief, in a case with such vociferous views being voiced by a deeply-divided Tax Court.

### III. Partner’s Interest in Partnership Capital: Measurement Issues

How is PIPC measured for purposes of the numerous operative provisions of the Code, regulations and rulings that utilize that measuring rod? Is there existing authority that provides guidance? What alternative approaches might be used in reaching a working definition of PIPC?¹⁶⁴

As stated above, neither the Code nor regulations set forth a comprehensive definition of PIPC. For purposes of the so-called family partnership rules contained in Reg. §1.704-1(e)(1)(v), PIPC is defined as “an interest in the assets of the partnership, which is distributable to the owner of the capital interests upon his withdrawal from the partnership or upon liquidation of the partnership.”

For the limited purposes of Code Sec. 706(b), the Preamble to Proposed Reg. §1.706-1 provides that “generally, PIPC is determined through reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon the liquidation of the partnership. See e.g., Reg. §1.704-1(e)(iv), Rev. Proc. 93-27, 1993 CB 343. As a practical matter, such a determination will require a valuation of the partnership’s assets.”¹⁶⁵

Recognizing that the determination under Code Sec. 706 must be made on an annual basis, the Preamble observes that the burden associated with actual valuations may make it difficult for partnerships to identify their tax years quickly and easily. Therefore, for partnerships that maintain capital accounts in accordance with Reg. §1.704-1(b)(2)(iv), then for purposes of Code Sec. 706(b), the partnership may assume that PIPC is the ratio of the partner’s capital account to all partners’ capital accounts as of the first day of the partnership tax year.¹⁶⁶ The Preamble notes the IRS and the Treasury are aware that this method (i.e., capital account ratios) will not always be as precise as an actual valuation, but believe that any imprecision is outweighed by the strong interest that partnerships have in being able to easily determine their tax year.

As stated above,¹⁶⁷ the aforementioned definition of PIPC is designed to be compatible with the provisions of, and policies underlying, Code Sec. 706(b). Therefore, Reg. §1.706-1(b)(4) should not be read to
create any implication as to the meaning of PIPC for purposes of the many other sections of the Code that also contain references to PIPC.168

Like PIPP, several measurement issues involving PIPC can be illustrated through examples.

**Example 17—Proportionate Ownership of Profits and Capital**

This Example is based upon Example 1, which is summarized here for the reader's convenience: unrelated partners A and B each contributed $100,000 cash to AB LLC, which is taxable as a partnership. A, B and AB all are calendar year taxpayers. Under the AB Operating Agreement, A and B share profits and losses equally. None of AB’s (recourse or nonrecourse) obligations are owed to, guaranteed by or recourse to any of the members of AB (or any affiliates or persons related to A or B). The AB Agreement does not contain any changes in profits, losses or capital contributions in the future. The AB Agreement complies with the “substantial economic effect” requirements of Reg. §1.704-1(b), and AB maintains capital account balances in accordance therewith. If AB were to liquidate on December 31, 2006, A and B each would receive one-half of the distributable proceeds, pursuant to the dissolution provisions of the AB Agreement.

Example 17 (like Example 1) illustrates a “straight up” partnership in which each member (A and B) has an equal partnership interest, i.e., a 50-percent PIPC (and PIPP). Their interests should be so characterized under all of the Code and regulations provisions enumerated in Part I, above.

As we know from our quest for the proper measurement of PIPP, the “straight up” example is a benchmark that is rarely encountered in today's sophisticated world. Our remaining examples are anything but vanilla.

**Example 18—Disproportionate Allocation of Losses**

The facts are the same as in Example 17, except A will bear (and be entitled to) the first $100,000 of AB’s losses, and B will bear the next $100,000 of AB’s losses. The AB Agreement provides for income chargebacks so that, first, B will be allocated AB income equal to any losses previously allocated to B (and not already offset by this chargeback); second, A will be allocated income, to the extent of any such losses previously allocated to A (not already offset by this chargeback); and thereafter, income is shared equally by A and B. The AB Agreement further provides that liquidation proceeds will be distributed in accordance with ending capital account balances (after giving effect to the income chargeback).

If PIPC is determined under a liquidation value approach, then three steps must be taken to determine A's and B's PIPC. First, the fair market value of AB's property must be accurately determined. Second, AB must compute its unrealized gain or loss on each asset, by subtracting its basis in its assets from the respective liquidation proceeds that would be generated if AB sold each asset for its fair market value. Third, AB must allocate the gain or loss in accordance with the AB Agreement, and the amounts reflected in A's and B's capital accounts, to determine what each member would receive on liquidation.

If, at the moment that PIPC is to be measured, AB's assets have a value of exactly $200,000, then A and B would each receive $100,000 and, coincidentally, A and B would each have a PIPC of 50 percent, as in Example 17. This would be true regardless of the actual allocations of gain and/or loss (for tax or book purposes) that occurred prior to the PIPC measurement date when the hypothetical sale and liquidation are deemed to occur.

But what are the members' PIPC if the value of AB's assets has decreased to $100,000? A deemed sale at that time would result in B receiving all $100,000 of the proceeds, because under the AB Agreement, A suffers the first $100,000 of cumulative losses, and a deemed sale of $100,000 (compared to a basis of $200,000) results in a hypothetical loss of $100,000 to AB. As a result, A would have a $0 capital account at the PIPC measuring date, i.e., A's $100,000 capital contribution minus the $100,000 loss on sale that is specially allocated to A. B, having a $100,000 capital account, would be deemed to have a 100 percent PIPC, and A would have a zero percent PIPC.

Note the sensitivity in the measurement of PIPC corresponding to value changes, as the following variant illustrates. Assume the same facts as in Example 18, except the value of AB's assets on the measurement date is $150,000. A hypothetical sale by AB of its assets would result in a loss of $50,000 (i.e., $150,000 proceeds minus $200,000 basis), all of which is allocated to A. Pursuant to the AB Agreement, B would receive $100,000 and A would receive $50,000 (their respective ending capital account balances). Using that ratio, B's PIPC would be 66.67 percent and A's PIPC would be 33.33 percent.

By comparing the three (substantial) changes in value as of the PIPC measurement moment, we see a potentially wide range in PIPC percentages. Assume AB's property is worth $200,000 on January 1, 2006; $150,000 on July 1, 2006, and $100,000
on December 31, 2006. As computed above, the members’ respective PIPCs will be as follows:

On 1/1/06:  A—50%;  B—50%
On 7/1/06:  A—33.33%;  B—66.67%
On 12/31/06:  A—0%;  B—100%

Although the valuation decrease was extreme, the example reflects the potential importance of (1) when PIPC is being measured, and (2) how accurate AB’s valuation of its properties is. In our example, if AB’s assets are illiquid and subject to a fairly wide range of reasonable/defensible values, note how the measurement of PIPC is affected by the assumptions utilized as to the amount of hypothetical sales proceeds (e.g., $200,000 versus $150,000).

Example 18 also illustrates the potentially critical impact of even one dollar difference in valuation. Assume A has sold its interest in AB to C for $75,000 at a time when the value of AB’s assets (net of liabilities) is approximately $200,000, and A’s share of AB’s net assets (in a liquidation value scenario) would be $100,000. AB needs to determine whether A’s sale triggers a Code Sec. 708(b)(1)(B) termination, which will occur if A has sold 50 percent or more of the PIPP and PIPC of AB. Since A’s interest carries with it a profits interest of (no less than) 50 percent, the key issue for purposes of Code Sec. 708(b)(1)(B) is whether A has also sold a 50-percent-or-greater PIPC.

The answer will not turn on the sales price received by A (i.e., $75,000, which if compared to the approximately $200,000 value of AB’s assets, is only 37.5 percent). Rather, the answer should turn on the three-step test described above, if the liquidation value approach is used. If AB’s assets are deemed to have a value of exactly $200,000, A’s (now C’s) share on AB’s hypothetical sale and liquidation would be exactly $100,000 under the AB Agreement, resulting in A having exactly a 50-percent capital interest. This would result in AB’s termination under Code Sec. 708(b)(1)(B), since A would have sold both a 50-percent PIPP and a 50-percent PIPC.

In contrast, if at the PIPC measurement date AB’s assets have a net value of $199,800, the $200 loss would be allocable to A (who bears up to the first $100,000 of loss) and A would be entitled to only $99,800 (i.e., 49.9 percent) of the hypothetical liquidation proceeds. The IRS has privately ruled that a transfer of 49.9 percent of the PIPP and PIPC within the requisite 12-month period does not by itself trigger a partnership termination under Code Sec. 708(b)(1)(B). Indeed, if there was even a $1 loss (i.e., the correct value of AB’s assets was exactly $199,999), A would have mathematically have less than 50 percent of the proceeds, and thus there would be no tax termination of AB.

Example 19—Disproportionate Contributions and Distributions

The facts are the same as in Example 17, except A, who is in need of cash, withdraws more than his (50 percent) proportionate share of profits, and B leaves in the partnership his (50 percent) share of the partnership’s earnings, to bolster AB’s credit position.

Example 19 highlights the importance of proper characterization of payments between the partnership and its partners, which must be done before a determination of PIPC can be undertaken. A’s withdrawal of cash could constitute a reduction in A’s capital or it may merely constitute a loan transaction (e.g., an advance of cash by AB to A), with or without interest. Similarly, B’s nonwithdrawal of his share of earnings may be a capital contribution by B or merely a loan transaction (e.g., an advance of cash by B to AB), with or without interest. Once the proper characterizations for tax purposes are made, A’s and B’s PIPP will be better subject to measurement.

Example 20—Code Sec. 704(c) Built-in Gain or Loss

The facts are the same as in Example 17, except A contributes land with a basis of $50,000 and fair market value of $100,000 (rather than contributing cash), which constitutes a $50,000 Code Sec. 704(c) built-in gain. (Alternatively, A contributes land with a basis of $200,000, which constitutes a Code Sec. 704(c) built-in loss.) The land is subsequently sold for $150,000.

Example 20 raises the question of whether the computation of PIPC should include or exclude Code Sec. 704(c) built-in gains or losses. The answer is unclear. For example, if PIPC is determined by the ratios of the partners’ respective shares of the adjusted basis of partnership property, Code Sec. 704(c) adjustments presumably would not apply. If PIPC is determined by using a “book capital” approach, the built-in gain or loss under Code Sec. 704(c) could explicitly be included in the computation. If the approach for determining PIPC were to require a revaluation of the partnership’s assets on a current basis (e.g., under the liquidation value methodology of Reg. §1.704-1(e)(1)(v) and Rev.
Proc. 93-27, supra, then the built-in gain or loss in assets that previously were contributed to the partnership is irrelevant—such would be a mere historical footnote, not relevant to the current fair market value of the assets.

There is sparse guidance that we have found as to the inclusion or exclusion of Code Sec. 704(c) built-in gain or loss in determining PIPC. Code Sec. 743(b)(2), relating to basis adjustments when a Code Sec. 754 election has been made, provides that a partner's share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital (PIPC), and in the case of property contributed to the partnership by the partner, Code Sec. 704(c) shall apply in determining such share. A similar rule appears in connection with determining a partner's percentage depletion allowance; Code Sec. 613A(c)(7)(D) states that Code Sec. 704(c) shall apply in determining the partner's proportionate share of the adjusted basis of partnership property. This guidance does not appear to be intended to have broad application, but rather is Code Section—specific.

IV. Practical and Administrative Aspects

In this portion of the paper we attempt to address a number of practical problems faced by practitioners in measuring PIPP and PIPC, and by the IRS in administering the system of over 250 Code and regulations sections that employ PIPP and PIPC. Topics covered herein include (1) the time or date that PIPP and PIPC are to be measured; (2) the effect of valid retroactive allocations of profits and losses in measuring PIPP and PIPC through the year; (3) the potential impact of changes or shifts in current and future profits interests; (4) the types of changes in PIPP or PIPC that should be recognized as requiring a change in the measurement of PIPP or PIPC; (5) the computation of PIPP and PIPC when partners have different allocations of profits and rights to distributions from different properties owned by the partnership; and (6) whether the partnership and its partners can validly take different positions as to the measurement of PIPP and PIPC, without substantial risk of penalty.

1. When Should PIPP and PIPC Be Measured?

This is really a two-part question. The first question is, “should PIPP and PIPC (1) take into account only profits and/or capital events that relate to the current year, or (2) should we also be ‘looking forward,’ and including future years’ anticipated events (e.g., changes in

profits shares)?” The second question is, “How do we measure the current year’s PIPP and PIPC?” Phillip’s article urges us to adopt the approach in (1) above, i.e., make the measurement of PIPP (and PIPC?) wholly determined by the current year’s income, losses and events. For sake of argument, let us first accept Phillip’s proposed solution, and look solely to the current year’s income (and loss), capital and relevant events.

Because interests in PIPP and PIPC may vary at different times during the year, the date of measurement can effect whether the requisite percentage interest in PIPP or PIPC for any particular provision of the Code or regulations is met. For example, a partner’s capital interest can fluctuate during the tax year due to admission of new capital-contributing partners, which may proportionately decrease the existing partners’ PIPC. Conversely, partners’ interests in the partnership could be completely liquidated under Code Sec. 736, thereby increasing the remaining partners’ interest in capital. Disproportionate capital contributions by existing partners and (albeit less frequently encountered) non-pro rata distributions or partial liquidations under Code Sec. 731 can also trigger changes in PIPC for all the partners.

Similarly, changes in PIPP can occur at different times of the year. Fluctuations may be due to several reasons, including varying profits interests during the year, which arise because of admission or withdrawal of partners; disproportionate capital contributions (with corresponding changes in profits interests); reallocations of profits among existing partners, and attainment of various performance levels or cash distribution levels (reflected in different tiers of allocations of profits among partners).

In light of these and other possible variations in PIPP and PIPC, the date and methodology of measurement are relevant. There are several different measurement dates during the year that may be appropriate, depending in part on the operative Code provision and the underlying policy. Assume (1) measurement of PIPP and PIPC is required with respect to a sale or exchange that occurs sometime in 2007 (other than on December 31) for purposes of some operative Code provision, (2) the partnership has a calendar year end for tax purposes, and (3) the partnership does not compute its profits until year end. Examples of different potentially applicable dates include the following:

■ On the last day of the partnership’s preceding tax year (December 31, 2006). There is no authority that supports this approach. However, it is administratively simple and provides greater certainty to the taxpayers and the IRS.
- **On the first day of the partnership’s tax year (January 1, 2007).** In determining the majority interest tax year, the principal partner’s tax year, and the least aggregate deferral tax year for purposes of Code Sec. 706(b), the partnership may assume that each partner’s PIPC is the ratio of the partner’s capital account to all partners’ capital accounts as of the first day of the partnership tax year, if the partnership maintains capital accounts in accordance with Reg. §1.704-1(b)(2)(iv).177

- **On the date that the relevant event (requiring measurement of PIPP or PIPC) occurs.** For many if not most operative Code and regulations provisions, the determinations of PIPP or PIPC is to be made as of the date that the relevant event occurs. For example, in determining whether the loss disallowance rules of Code Secs. 707(b)(1)(A) and (B) apply, the determination should be made as of the date of the sale. Similarly, in determining whether interests that aggregate 50 percent or more of PIPP and PIPC have been sold or exchanged within a 12-month period, the determination is made on the date of the sale or exchange.178

Since the partnership does not compute its profits until year end, one approach would be to estimate (on the date of sale) the partners’ respective profits percentages that are anticipated to occur at the end of the current tax year.

- **Close the partnership’s books on the date of the sale or exchange, and compute the actual profits allocation up to that date (assuming there have been profits for year to date).** Under this alternative, the partnership would have to do a stub period computation of its income, thereby increasing administrative costs to an entity that otherwise only computes its profits annually on December 31.

- **Use the partner’s percentage of profits on the last day of the partnership’s current tax year (December 31, 2007).** This yields an anomalous answer of “zero-percent PIPP and zero-percent PIPC” with respect to the partner who is selling his entire partnership interest during the year (and for whom the requisite PIPP or PIPC computation is relevant). In other contexts measurement of PIPP (or PIPC) on the last day of the partnership’s tax year is appropriate. In determining a partner’s basis, for purposes of allocating a partner’s share of nonrecourse liabilities, PIPP must be determined under Reg. §1.752-3(a)(3). Basis is relevant as of the last day of the partnership’s tax year, as a partner’s distributive share of partnership losses is deductible only to the extent of the partner’s adjusted basis for his partnership interest at the end of the tax year pursuant to Code Sec. 704(d).

As a practical matter, in many partnerships the computation of PIPP cannot be done before the end of the partnership’s tax year. Many personal service partnerships (including accounting and law firms) do not determine the partners’ respective shares of profit until data is available reflecting each service partner’s performance during the entire year. In some other partnerships the profits are shared in one way if certain goals (such as sales quotas or operating income criteria) are met, and in a different way if the goals are not met. Thus, even though Reg. §1.708-1 requires that a determination of the selling partner’s PIPP and PIPC be determined as of the date of sale of the seller’s partnership interest, the seller’s PIPP may not be determinable until year-end or thereafter.179

Another situation in which PIPP is determined on the last day of the partnership’s tax year arises in determining the tax matters partner where no partnership designation has been made. The regulations specify the tax matters partner shall be the general partner having the largest profits interest in the partnership at the close of the tax year.180

- **Compute profits on the date the partner disposes of his entire partnership interest; otherwise, on the last day of the partnership’s tax year.** This approach is mandated for purposes of application of the TEFRA rules involving the existence of so-called one percent and five percent notice groups under Code Secs. 6223(b) and 6231(a)(11). There, the interest of a partner in the profits of a partnership is determined under one of the following rules:

  - In the case of a partner whose entire interest in the partnership is disposed of during such partnership tax year, compute PIPP “as of the moment immediately before such disposition.”181
  - In the case of any other partner, compute PIPP as of the close of the partnership tax year.182

- **On a monthly basis.** In determining whether interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof, for purposes of avoiding publicly traded partnership status under Code Sec. 7704, PIPP and PIPC must be measured monthly. The percentage of PIPP and PIPC, respectively, that is transferred during a tax year of the partnership is equal to
the sum of the percentage interests transferred for such calendar month during the tax year of the partnership in which a transfer of a partnership interest occurs. The percentage interests in capital or profits interests transferred during a calendar month is determined by reference to the partnership interests outstanding during that month.\textsuperscript{183}

- **On every day of the tax year.** In determining the potential applicability of Code Sec. 7704 (publicly traded partnership status), there may arise a need to compute PIPP and PIPC on every day of the tax year of the partnership. As a general rule, for purposes of Reg. \S 1.7704-1, the total interests of PIPP and PIPC are determined by reference to all outstanding interests in the partnership.\textsuperscript{184} One exception occurs if the general partners (and related persons) own, in the aggregate, more than 10 percent of the outstanding PIPP or PIPC at any one time during the tax year of the partnership. In such case, the total percentages of PIPP or PIPC are determined without reference to the interests owned by such persons.\textsuperscript{185}

- **During the course of the tax year.** In determining a partner’s interest expense under Code Sec. 861, Temporary Reg. \S 1.861-9T(e) provides several rules involving partners owning a specified interest in the partnership. For purposes of Temporary Reg. \S 1.861-9T(e), a partner’s percentage interest in a partnership is determined by “reference to the partner’s interest in partnership income for the year.”\textsuperscript{186} This indicates that the partner’s blended PIPP for the entire year is relevant; there is no single measurement date that has significance.

- **At a future date.** Partnership audits, and the ensuing application of the TEFRA rules, may occur several years after the year under audit. In Government Arbitrage Trading Company,\textsuperscript{187} the partnership had more than 100 partners in 1983, the year under audit. Therefore, the IRS did not have to provide notice to any partner who had less than a one percent interest in the partnership’s profits pursuant to Code Sec. 6223(b)(1). Such a partner is not a notice partner under Code Sec. 6231(a)(8).

The taxpayer partner had a 0.5-percent PIPP in 1983. However, the taxpayer argued that the appropriate time to determine PIPP is at the time the Tax Court Petition was filed (1992), rather than for 1983.

The Tax Court disagreed. It stated that it considers the PIPP for the year in issue (i.e., the tax year under audit) determines whether the partner qualifies as a notice partner. Thus, the time the petition was filed was irrelevant (even if the taxpayer had a one percent or greater PIPP at that later date).

In summary, there are numerous measurement dates that may be appropriate for computing PIPP and PIPC. The underlying purpose or policy of the operative Code provision can narrow the alternatives to a viable short list. However, there often may be several different dates that may be appropriate, and there is little guidance as to which date must be used in any given situation.

### 2. What Is the Effect of Valid Retroactive Allocations of Profits and Losses in Measuring PIPP and PIPC Through the Year?

If the partners make valid retroactive allocations of profits within the time constraints of Reg. \S 1.761-1(c),\textsuperscript{188} will such be given retroactive effect for purposes of changing the partners’ interests in PIPP or PIPC? The effect of a retroactive allocation of profits among partners is uncertain, in connection with the measurement of PIPP.

In Dyess,\textsuperscript{189} the Tax Court held that an attempt to apply a retroactive allocation accounting method would not be effective to override operation of Code Sec. 707(b). Taxpayer Dyess and his partner (Nace) held a combined 92.5-percent ownership interest in Foxfire Partnership (“Foxfire”), which on the day of its formation (October 4, 1982) bought real property from another partnership (“Equity”) of which Dyess and Nace owned a combined 100 percent. The Foxfire Partnership Agreement then in place in no way suggested that there were undisclosed limited partners in Foxfire as of October 4, 1982. At issue was whether Foxfire’s loss was nondeductible under Code Sec. 707(b)(2)(B).

Dyess argued that, under the “interim closing of the books” method of Code Sec. 706, he was never in violation of Code Sec. 707(b)(2)(B), as he was always deemed to have less than the prohibited percentage of ownership in Foxfire. Dyess asserted that, when the interim closing of the books method is applied to Foxfire, the outside investors (limited partners), who entered that partnership on October 14, 1982, are deemed to have owned their limited partnership interests as of October 4, 1982. (Presumably, that would have reduced Dyess’ and Nace’s interests to be below the percentage interest threshold of Code Sec. 707(b)(2)(B) on October 4, 1982.)

The Tax Court rejected the argument because there was no evidence in the record to suggest that Foxfire ever used or contemplated using the interim closing of the books method.
In dictum, the Tax Court stated that Dyess had misconstrued the purpose of the interim closing of the books accounting method, in any event. After discussing the legislative history of changes to Code Sec. 706, the Court described the interim closing of the books accounting method as requiring a closing of the partnership books as of the date of entry of the new partner and the computation of the various items of partnership income, gain, loss, deduction and credit as of that date. The court stated that the interim closing of the books method would not help Dyess if the books were closed “as of the date of entry of the new partners” (i.e., October 14, 1982). The court observed that Dyess essentially was relying on an accounting convention to avoid the clear terms of Foxfire’s limited partnership agreement and the proscription of Code Sec. 707(b)(2)(B). It stated that the interim closing of the books method and the mid-month convention are accounting methods designed to make the computation of varying partnership interests easier when a partnership interest has been sold or exchanged during the tax year. However, there remains the obligation to use them in a manner that ensures that the tax treatment of various partnership interests reflects economic reality. The determination to be made for Code Sec. 707(b)(2)(B), however, is not a matter of accounting methods or conventions. Code Sec. 707(b)(2)(B) requires that a partner’s percentage ownership of the capital interest or the profits interest be determined on a particular date, i.e., at the time the property is sold or exchanged, to establish the presence or absence of controlled partnerships (i.e., partnerships in which the same persons own more than the specified percentage). The court concluded that nothing in the legislative history of Code Sec. 706(d) suggests that the convention is to be extended beyond distributive share determinations to impute ownership interests for purposes of Code Sec. 707(b)(2)(B).  

Dyess supports the conclusion that retroactive allocations will not be given effect for purposes of Code (and regulations) provisions like Code Sec. 707(b), which appear to require a “snapshot” measurement of PIPP and PIPC at the time the transaction in question occurs. However, the effect of a valid retroactive allocation of profits (or losses) among partners remains uncertain, and is not directly addressed in Dyess.

3. What Is the Potential Impact of Changes or Shifts in Current and Future Profits Interests?

As a general rule, changes in current profits will be relevant in at least two ways. First, such changes may affect the partners’ PIPP (and PIPC, to the extent current profits are not distributed) for measurement events that occur on or after the change in current profits occurs. Second, such changes may affect the computation of PIPP under those approaches that take into consideration future profits, for example, in determining an overall or expected net profit, or determining the highest profit or items of income at any time over the life of the partnership.

It is more difficult to generalize the effect of changes in future profits. Some of the suggested methods of measuring PIPP look solely to meeting the profits thresholds in place for the current event or current year; future years’ profits are irrelevant for such measurement purposes. However, other approaches take into consideration future profits, as described above, and such future profits changes can provide critical changes to the partners’ computations of PIPP and PIPC.

The changes in a partner’s PIPP may have operative tax consequences, which in certain cases may be unforeseen, burdensome and inequitable. A change in PIPP conceivably can cause a deemed distribution or contribution under Code Sec. 752, a change in tax years under Code Sec. 706(b), and many other operative effects, including those catalogued in Appendices I and II.

4. What Types of Changes in PIPP or PIPC Should Be Recognized As Requiring a Change in the Measurement of PIPP or PIPC?

There appears to be no uniform answer to this question; it may depend upon the operative provision of the Code or regulations. As a general rule, it would appear that any event (e.g., a sale; exchange; gift; and partial or complete redemption of a partner’s interest) should be a measuring event, or perhaps a re-determination point (as to approaches such as the partners’ “average future profits interest” alternative). However, in measuring whether there has been a “sale or exchange of 50 percent or more of the total PIPP and PIPC” for purposes of the Code Sec. 708(b)(1)(B) termination rules, a statutory gloss is put on the change in PIPP and PIPC computation, as only “sales and exchanges” are measuring events. Capital contributions in exchange for a partnership interest, and reductions in ownership of partnership interests arising from the partial or complete redemption (liquidation) of the partnership interests, do not constitute “sales or exchanges” for purposes of Code Sec. 708(b)(1)(B). Moreover, for
Code and regulations provisions involving measurement of PIPP and PIPC as of the beginning of the partnership's current tax year, changes in the identities of partners (whether by sale exchange or otherwise) generally are not taken into account.\(^{192}\)

Other Code and regulations provisions are not so limited; any and all changes in PIPP and PIPC apparently are taken into consideration in measuring and re-measuring PIPP and PIPC. For example, in determining for purposes of Code Sec. 6046A whether and when a U.S. person is required to file a tax return with respect to his or her interest in a foreign partnership, the Code looks to acquisitions, dispositions and substantial changes in the person's interest in the partnership. For this purpose, a substantial change may occur for a number of reasons, for example, due to another partner withdrawing from the partnership\(^{193}\) or even by operation of the partnership agreement (for example, if the agreement provides that a partner's interest in profits will change on a set date or when the partnership has earned a specified amount of profits and one of these events occurs).\(^{194}\)

In conclusion, there is no uniform answer as to what types of changes in PIPP or PIPC under current statutes and regulations require a change in the measurement of PIPP and PIPC.

For certain operative purposes there can be potentially adverse, if not ludicrous, results of annual testing for PIPP and PIPC where the applicable threshold is crossed and then in the following year failed. For example, assume the partner exceeds the percentage threshold in year one; dips back down and does not exceed it in year two; and then exceeds it again in year three. This can raise potential problems even when events are beyond the control of the partner who is ping-ponging over the threshold and back.

This problem was pointed out to the Treasury and the IRS several years ago after the issuance of final regulations regarding foreign partnership reporting requirements.\(^{195}\) A Big 4 accounting firm (or were they the Big 5 or 6 or 8, back in 2000?) pointed out that a partner's interest in a partnership is defined in the applicable regulations by reference to the partner's share of partnership capital (PIPC), profits (PIPP), deductions or losses.\(^{196}\) The letter observes that in all but the simplest of partnerships, a partner's share of these measures will vary from year to year depending on partnership operations. For example, a partner with a preferred return could be a “50 percent controlling partner” in bad years (when there are insufficient profits to allocate to other partners) but not satisfy that 50 percent threshold in good years. Similarly, a partner who saw his share of profit, deductions or loss change by more than 10 percentage points in a year because of operations would be required to file under Code Sec. 6046A even though his interest in the partnership has not economically changed, according to the letter.

What other ramifications may arise from change or shifts in the measurement of current and future profits interests? For that portion of the 250-plus Code and regulations provisions that are potentially operative depending on the measurement of a partner's PIPP, the substantive effect can only be measured by reference to each such provision. Sometimes the changes will help taxpayers; many if not most times they will not.

5. How Should PIPP and PIPC Be Computed When Partners Have Different Allocations of Profits and Rights to Distributions from Different Properties Owned by the Partnership?

Once again, we pose a question with no clear answer. If the question arises with respect to a Code or regulations provision that turns on a particular asset, Property X (e.g., qualification for investment credit under Reg. §1.46-3(f), or investment credit recapture under Reg. §1.47-6(a)), then PIPP (or PIPC) with respect to that particular property should control. However, if the question arises with respect to the potential application of Code Sec. 707(b)(1) or 707(b)(2), both referring to PIPP or PIPC without further elaboration, should the focus be on (for example) the measurement of PIPP solely with respect to Property X (the asset that may be subject to the operative effect of Code Sec. 707(b)), or should there instead be a “blended” overall PIPP that is computed by taking into consideration all income from all potential or actual sources of partnership income and gain (and which “blended” PIPP may be more or less than the partners’ agreed-upon special allocations of income and gain with respect to Property X)? Or is some other approach more viable? Once again, we have no “one size fits all” solution to endorse for this measurement scenario.

6. Can Partnerships and Partners Validly Take Different Positions As to the Measurement of PIPP and PIPC, Without Substantial Risk of Penalty?

Your author knows of no authority on point, in the context of PIPP and PIPC computations. However, general principles applicable to the taking of
inconsistent portions by partners and either their partnerships or other partners should apply.

What are the tax consequences of such inconsistent filing positions? Let us first assume that Partner S, a member of ST LLC, sells property in 2007 with a basis of $10,000 to ST for $6,000. S contends that he does not own “more than” 50 percent of the capital or profit interests in ST, and therefore is not precluded by Code Sec. 707(b)(1) from recognizing his $4,000 loss.

ST’s tax return preparer is of the view that S did have a greater than 50 percent PIPP or PIPC percentage, such that Code Sec. 707(b)(1) would apply and S’s $4,000 realized loss should not be recognized. Both S and ST recognize that ST’s basis in the property is its cost ($6,000), regardless of whether Code Sec. 707(b)(1)(A) applies.

In 2007 ST resells the property for $11,000. ST, taking the position that S was subject to nonrecognition of loss pursuant to Code Sec. 707(b)(1), takes the position that ST is entitled to reduce its ($5,000) gain by the ($4,000) loss previously realized but not properly recognized by S, the selling partner. ST consistent therewith, ST reports only a $1,000 taxable gain, which ST allocates among its partners pursuant to Code Sec. 704(b), $500 to S and $500 to T.

S is outraged that ST is taking the position that S did not recognize his $4,000 loss in 2007 due to the alleged application of Code Sec. 707(b)(1). S claims the loss on S’s 2007 Form 1040 tax return, as seller.

On its 2008 Form 1065 (U.S. Partnership Tax Return), ST reports on S’s Schedule K-1 a gain of $500. Because S wants his ($4,000) claimed 2007 loss to be recognized, he takes an inconsistent position, reporting his share of ST’s 2008 gain as being $2,500 (i.e., 50 percent of ST’s gain in 2008, which S contends should be $5,000, not $1,000). If S’s reporting portion is correct, T—the other partner—should also report gain of $2,500 (rather than $500) in 2008 on his 50 percent interest under Code Sec. 704(b).

What are the tax consequences of S, ST and T taking such inconsistent filing positions in 2007 and 2008, arising from their bedrock disagreement as to the measurement of PIPP and PIPC? In light of recent and future IRS efforts to match information on each partner’s Schedule K-1 with the income or losses reported on the partner’s Form 1040 tax return, inconsistent reporting by the partners (whether disclosed or undisclosed) obviously may increase audit risks for all of the partners. Moreover, absent filing a notice of such inconsistent reporting of partnership items, the IRS, as required by Code Sec. 6222(b), may make a “computational adjust-

ment” under Code Sec. 6222(c) and assess the resulting deficiency without the disagreeing partner having an opportunity to contest the issue. Furthermore, inconsistent reporting without providing proper disclosure is subject under Code Sec. 6222(d) to taxpayer penalties under Code Sec. 6662, and possibly to return preparer penalties under Code Sec. 6694. Thus, disclosure of inconsistent reporting positions among partners and partnerships is generally advisable.

V. Opportunities and Traps in Identifying PIPP and PIPC

The previously described uncertainties as to the meaning of PIPP and PIPC provide taxpayers with potential planning opportunities, as well as potential traps for the unwary. In theory, such opportunities and traps exist in each of the aforementioned provisions of the Code and regulations that employ PIPP and/or PIPC to have operative effect. This Part V surveys a few of the significant provisions, to illustrate planning possibilities and potential traps that can arise in practice when dealing with the measurement of PIPP and PIPC.

Before analyzing specific opportunities and traps, we first revisit the categories of relevance. If the operative provision turns on the presence or absence of PIPP only, then the measurement of partnership capital generally is irrelevant. Similarly, if the operative provision turns on the presence or absence of PIPC only, then the measurement of partnership profits is of no direct relevance. Where the operative provision turns on the existence of either partnership profits or capital, then the existence of either sufficient PIPP or PIPC is relevant, and it logically would appear to be unnecessary to measure (or plan for the existence of) the second test so long as the first is met. Finally, if the operative provision turns on the presence or absence of both PIPP and PIPC, it is necessary to measure (or plan for the existence of) both tests, if one is seeking to meet the dual requirement; conversely, if one seeks to fall outside the operative provision, the failure of meeting either the PIPP or PIPC benchmark will suffice, and it is unnecessary to measure (or plan for the absence of) the other.

A. Planning Opportunities

In analyzing potential planning opportunities for PIPP and PIPC, one is both hampered and benefited by uncertainties as to the methodology and measurement of PIPP and PIPC. Some general planning techniques, which may or may not be applicable to a particular Code or regulation provision, include the following:
1. The Use of Guaranteed Payments

To the extent that guaranteed payments for services or the use of capital do not constitute an interest in profits or a distributive share of income, a partner who otherwise would exceed the applicable threshold for PIPP might be compensated in part with guaranteed payments. As provided in Reg. §1.707-1(c), guaranteed payments do not constitute an interest in profits for purposes of Code Secs. 706(b)(3), 707(b) and 708(b). For purposes of determining PIPP under Reg. §1.401-10(d), guaranteed payments are not considered a distributive share of partnership income,202 which would appear to be inconsistent with Reg. §1.707-1(c). In addition, one letter ruling indicates Code Sec. 707(c) payments apparently are not included by the IRS in determining the profits ratio for purposes of computing investment tax credit recapture.204

For purposes of Code Sec. 707(c), a guaranteed payment is defined as one that is determined without regard to partnership income. Thus, the economic arrangement of this planning technique may materially differ from that of receiving a preferred return or priority allocation of gross income under Code Sec. 704(b). It is this economic difference that gives support to this tax-planning technique; the receipt of a guaranteed payment by its nature differs from that of just an allocable share or preferred return.

2. Preferred Returns and Special Allocations

Alternatively, in situations where a partner wishes to increase his or her PIPP, consideration should be given to restructuring a portion of the partner’s economic return as a preferred return or special allocation of gross income, in contrast to a guaranteed payment or merely a residual share of net income. This is most likely to be effective in situations where the operative Code or regulation provision turns on the partner’s residual share of net profits.

In LTR 8651050 (Sept. 22, 1986), two limited partnerships had earlier received a ruling from the IRS to the effect that the investment tax credit on equipment owned and leased by the partnerships to others would be shared among the partners on the basis of their sharing ratios in which the partners divided the general profits of the partnership. In order to comply with the substantial economic effect requirements of Reg. §1.704-1(b), the partnerships proposed to amend section 9.3 of their respective partnership agreements, dealing primarily with income or gain chargebacks. Pursuant to Reg. §1.47-6(a)(2), the investment tax credit allocated under Code Sec. 38 would be subject to recapture if there was a substantial reduction in a partner’s interest in the general profits of the partnerships.

The IRS ruled that the special allocations now being proposed would not result in recapture of previously taken investment tax credits. The letter ruling states that Code Sec. 702(a) enumerates eight classes of items of partnership income, gain, loss, deduction and credit, all of which partners are required to report on their income tax returns. The first six categories, Code Secs. 702(a)(1) through 702(a)(6), are specific items, such as capital gains and losses, and gains and losses attributable to the sale of Code Sec. 1231 property. Code Sec. 702(a)(7) deals with other items not enumerated in the first six subsections but that are provided by regulations. The eighth category, as described in Code Sec. 702(a)(8), is a catch-all or residual provision that includes all taxable income or loss not enumerated under the first seven categories.

The IRS stated that its examination of the partnership agreements reveals that the items of gain provided for and the proposed amendments are items described in Code Secs. 702(a)(1) through 702(a)(7), and therefore are not items described in Code Sec. 702(a)(8). Accordingly, the IRS ruled that any change in the allocation of gain pursuant to section 9.3 of the Partnership Agreement will not result in a reduction of a partner’s interest in the general profits of the partnerships, as that term is defined in Reg. §1.46-3(f)(3). Therefore, since there is no reduction in a partner’s interest in the general profits of the partnerships, pursuant to the partnership agreements, the partnerships’ Code Sec. 38 property will continue to be Code Sec. 38 property, with no resulting recapture of previously taken investment credits, provided that the allocations in the partnership agreement have substantial economic effect.

By holding that the amendments to the allocation of gain will not be considered a change for purposes of Code Sec. 702(a)(8), LTR 8651050 indicates that other changes made by special allocations of income, including the categories described in Code Sec. 702(a)(1) through (7), will not affect each partner’s PIPP if the measurement is in accordance with the general profits interest in the partnership, which is the measurement stick under Reg. §1.46-3(f)(2). On the other hand, where the profits share is determined through some other approach in which allocations of capital gains and/or special allocations of other items of income or gain are included in the computation of PIPP, a change in the partners’ respective shares of special allocations of income versus the residual allocation of income or profit may not have operative effect and thus not be a
useful tax planning tool, depending on what measurement of PIPP ultimately is applied for purposes of that operative Code or regulation provision.

3. Fees to Affiliates

A payment to a partner, other than one described in Code Sec. 707(a), may constitute an interest in partnership profits or net income for purposes of PIPP. For example, assume a partner was to receive a guaranteed payment under Code Sec. 707(c) or a gross income allocation under Code Sec. 704(b) in exchange for services. As described above, a preferred return is likely to be includable for purposes of imputing PIPP, and a guaranteed payment under Code Sec. 707(c) may be includable, particularly for operative Code provisions other than Code Secs. 706(b)(3), 707(b) and 708(b).

If the services instead were rendered by an affiliate of the partner that is not treated as a disregarded entity, the payment by the partnership would be treated as a payment to a nonpartner and, therefore, not includable in PIPP.205

4. Debt in Lieu of Additional Equity

In determining PIPC, the partner's capital interest will reflect the amount the partner would receive upon withdrawal from or liquidation of the partnership. If a partner wishes to have a larger PIPC in comparison to other partners, in order to meet the threshold of one of the operative Code or regulation provisions, the money partner might make an additional capital contribution at an appropriate time, without a matching capital contribution by one or more of the other partners. The disproportionate capital contribution should mathematically increase the PIPC of the contributing partner.

Conversely, if the partnership requires additional funds but the disproportionate capital contribution by one or more of the partners would cause an adverse change in PIPC, the money partner might consider making a loan to the partnership, in lieu of the additional equity contribution. A bona fide loan, payable on demand or on a date certain, should not be treated as capital; traditional debt versus equity principles will apply in determining the status of the partner's payments to the partnership as debt or equity.206

The partner's choice of making a disproportionate capital contribution or instead a loan also may affect the determination of the partner's PIPP. In its simplest form, a capital contribution in exchange for a larger "straight up" (vertical slice) interest in the partnership will, of course, increase the contributing partner's PIPP, however PIPP is measured. More typically, the contribution of additional capital by an existing partner results in a priority return on (and oftentimes, of) that additional capital contribution. The preferred return itself may be included in the computation of PIPP, depending upon the operative Code or regulation provision, as described in paragraph 2, above.

In contrast, if the partner provides additional financing to the partnership in the form of a loan, the interest thereon will not be treated as increasing the lender partner's PIPP, but rather will merely constitute interest income, pursuant to Code Sec. 707(a).207

A hybrid situation may arise in connection with a partner's loan that itself has interest payable in the form of a so-called equity kicker, measured by net sales proceeds and/or net operating income, (although typically subject to a cap or ceiling). The characterization of such a return resembles a partner's receipt of a share of gross income or profits on sale of the partnership's property, and if such were the proper recharacterization of the loan arrangement, could result in unanticipated larger PIPP for the lender-partner. However, such loans with equity kickers have long been respected if the terms and conditions of the financing are characterized as debt rather than equity. The mere fact that the lender happens to be a partner in the partnership should not alone cause the equity kicker to be recharacterized as increasing PIPP.

5. Retroactive Allocations

As discussed elsewhere in this article,208 the effect of a retroactive allocation of profits among partners is uncertain, in connection with the measurement of PIPP. It is possible to agree upon a change in the allocation of profits and losses among partners under Code Sec. 761(c) subsequent to the event that requires measurement of PIPP. Moreover, pursuant to Reg. §1.761-1(c), a partnership agreement may be modified with respect to a particular tax year subsequent to the close of such tax year, but not later than the date (not including any extension of time) prescribed by law for the filing of the partnership return. Thus, for a calendar year partnership, the agreement may be amended as late as April 15 of the year following, and given retroactive effect, subject to application of Code Sec. 706.

One respected treatise concludes that retroactive allocations or profits under Code Sec. 761(c) should be respected in determining whether a sale of 50 percent or more of the interest in partnership profits has occurred for purposes of Code Sec. 708(b)(1)(B).
For example, assume partner X owns a 50-percent interest in PIPP and PIPC, and X sells her entire interest to a third party on November 11, 2006. Can a partnership termination be avoided if the partners agree to retroactively modify X’s profits interest so that she only has a 49 percent interest in the partnership as of the moment of sale? The treatise authors observe that it is unclear what effect, if any, a retroactive allocation of profits under Code Sec. 761(c) has on the determination of a partner’s profits interest as of the date of sale. They conclude that arguably, a post-sale adjustment of the profits attributable to a partnership interest that has been sold should be given effect.209

Of course, this planning technique requires the modification of profits to be respected, and at a minimum, partner X should have a reduced cash distribution from the partnership in connection with her profits interest (and, moreover, the purchaser should have a reduced interest on an ongoing basis in the partnership’s profits), for the retroactive allocation to be given effect.

6. Prospective Changes in Profits Allocations

Assuming arguendo that retroactive allocations to change PIPP are not respected, is it nonetheless possible to make prospective allocations that successfully increase or decrease the partners’ PIPP? For example, if it is known in late 2006 that Partner Q will be selling his or her entire partner interest in Partnership QRS in early 2007, and an operative Code or regulation provision would apply at some time in 2007 to adversely affect Q (or the remaining partners), might it be possible to validly change the partners’ allocations of profits (or profits and losses) prospectively, e.g., commencing January 1, 2007, such that Q does not share in QRS’s 2007 profits? If such is respected as valid under Code Sec. 704(b) and Reg. §1.704-1(b),210 then Q arguably can claim having a zero percent PIPP for 2007, the operative year in question.

Support for the zero percent PIPP planning technique can be inferred from Reg. §301.6231(d)-1, which deals with the time(s) for determining partners’ profits interests for purposes of Code Secs. 6223(b) and 6231(a)(11). That regulation provides in relevant part that if the interest of a partner in a partnership is entirely disposed of before the close of the tax year of the partnership, and no items of the partnership for that tax year are required to be taken into account by the partner, then that partner has no profits interest in the partnership for that tax year.211 The regulation does not specify whether the partnership agreement had long provided that the partner would have no profit share in the year he disposed of his partnership interest, or whether this was a valid (but recent) amendment to the partnership agreement (albeit stipulated as being effective on a prospective basis, for purposes of this analysis). Taken at its face value, Reg. §301.6231(d)-1 supports a valid allocation under Code Sec. 704 as indicating PIPP will go down to zero percent for the purpose of at least two Code provisions—Code Secs. 6223(b) and 6231(a)(11)—and arguably others, as well.

7. Determining PIPP in Loss Years

As described in Example 11, there is uncertainty as to the computation of PIPP in years in which the partnership has a loss. In limited situations (such as under Code Sec. 706(b), for purposes of determining the tax year of the partnership), recognition of a net loss may permit the partners to utilize for purposes of PIPP the expected income that is to be recognized in the first year in which the partnership is expected to generate net income. There may be a number of scenarios or projections that can be justified as reasonable, and thus net losses may provide a range of permissible computations of PIPP, with respect to the loss years. In turn, the partnership may have some flexibility in determining whether it has a “loss” (which, for this purpose, is the opposite of having “income” during the tax year of the partnership, however “income” is defined). For example, if (as in Reg. §1.706-1(b)(4)(ii)) the partnership’s computation of PIPP turns on taxable loss, query whether special allocations of items of income and gain would result in the partnership having a “loss” for purposes of Code Sec. 706(b), rather than “income.” If it would, then an amendment of the partnership agreement to provide for special allocations of income that are respected for tax purposes (e.g., have substantial economic effect under Code Sec. 704(b)) may result in a different calculation of PIPP than if no special allocations occurred, and there was merely a bottom-line net income for the year in question.

8. Partial Redemptions

In certain situations, partners may be able to avoid being at an undesirable threshold by having a portion of their partnership interests redeemed immediately prior to the measurement date or event. For example, assume partner Y has a 51-percent interest in Partnership XYZ’s capital and profits. Y wishes to sell property to XYZ and recognize a substantial loss. Code Sec. 707(b)(1)(A) would disallow loss arising from the sale or exchange of property between a partnership and a person owning more than 50 percent of the capital interest or the profits interest in such partnership.
If XYZ redeemed two percent of Y’s interest in PIPP and PIPC for an arm’s-length price, the redemption should be given effect for tax purposes as a partial liquidation that reduces Y’s interest from 51 percent to 49 percent. If, some time thereafter, Y were to sell the asset to XYZ, then Y should not be precluded from recognizing his loss pursuant to Code Sec. 707(b)(1)(A), assuming that Y is not attributed ownership of a capital or profits interest from another partner.

Another planning technique involving partnership redemptions is of particular potential benefit in avoiding partnership terminations under Code Sec. 708(b)(1)(B). In determining whether there have been sales or exchanges of partnership interests involving, in the aggregate, at least 50-percent PIPP and 50-percent PIPC within a 12-month period, Reg. §1.708-1(b)(2) explicitly excludes liquidations of partnership interests from sale or exchange status for this purpose. Thus, if a partner’s sale of his partnership interest to an existing or new partner would otherwise trigger a tax termination, it may be possible to combine a partial redemption of the selling partner, by the partnership, along with a cross-purchase by the buyer, to avoid a tax termination under Code Sec. 708(b)(1)(B). (Of course, there may be material economic differences between a cross-purchase and a redemption, particularly when there will be more than two partners, which may limit the usefulness of this planning.)

All of these and other potential planning opportunities are subject to differing degrees of uncertainty as to their likelihood of success. As demonstrated in this article, the uncertainties in measurement of PIPP and PIPC may permit more than one reasonable position to be taken, and if applied on a consistent basis, might constitute “substantial authority” for purposes of penalty avoidance under Code Sec. 6662, depending in part on all relevant facts and circumstances. However, as observed by our colleague Steven Schneider at a recent ABA panel program on this topic, it is one thing to meet a “substantial authority” standard to avoid penalties, but it is quite another to reach a “more likely than not” standard in connection with meeting the requirements of recently promulgated FIN 48, with respect to certain measurements of PIPP and PIPC.

B. Traps for the Unwary

As stated above, the massive measurement uncertainties in determining PIPP and PIPC can be a two-edged sword. The vast majority of “relatedness” provisions (as identified narratively in Appendices I and II) are intended to provide unfavorable tax results (or at a minimum, to limit favorable tax results) among related entities, and inadvertent foot-faults over the PIPP and/or PIPC thresholds can be costly and burdensome.

The uncertainty in measurement methodology may permit the IRS to select the approach most unfavorable to taxpayers, who would leave the burden of proof in litigation to prove the IRS wrong. Below are a few of the traps that can arise for unsuspecting taxpayers and their advisors.

1. Improper Reliance on the Provisions in the Partnership Agreement

Assume that Partners L and M are described in the Partnership LM’s partnership agreement as each having a 50-percent share of profits and capital. L sells his entire interest to O, and LM and its partners treat L’s sale as a Code Sec. 708(b)(1)(B) termination, in reliance upon the partnership agreement. If on later examination (say, an audit two years later) it is determined that the allocations do not have “substantial economic effect” under Code Sec. 704(b) and selling partner L’s PIPP was less than 50 percent, the partnership was incorrectly treated as terminated for tax purposes, and retroactive reconstitution of the partnership presumably would be required.

2. The Use of Guaranteed Payments

One potential trap, identified earlier, with respect to the tax year of a partnership, arises from the express exclusion of guaranteed payments from PIPP for purposes of Code Sec. 706(b)(3) but not for purposes of Code Sec. 706(b)(4). As a general rule, a partnership must have as its tax year the “majority interest tax year” (as defined in Code Sec. 706(b)(4)). If there is no majority interest tax year, then the tax year of the partnership shall be that of “all the principal partners” of the partnership as defined in Code Sec. 706(b)(3)). The majority interest tax year uses a measuring stick involving an aggregate interest in PIPP (and PIPC) of more than 50 percent. For purposes of determining whether the more than 50 percent of PIPP requirement is met under Code Sec. 706(b)(4), guaranteed payments presumably are included, as they are not expressly excluded under Reg. §1.707-1(c) or Reg. §1.706-1(b)(4), which defines the computation of PIPP for that purpose in substantial detail.

Code Sec. 706(b)(3) defines a “principal partner” as having an interest of five percent or greater in PIPP or PIPC. Guaranteed payments are not included in PIPP for purposes of that five-percent threshold; Reg. §1.707-1(c) expressly so states. Thus, guaranteed payments are included in the determination of “majority interest tax year” but are not in the “all the principal partners” test in Code Sec. 706(b)(1)(B).
3. Differences in Interpretation of Measurement Methodologies

Although there have been few cases or rulings involving measurement of PIPP or PIPC, taxpayers should not be lulled into complacency in applying measurement methodologies. Even when the statute or regulations authorize or direct a measurement methodology to be used for purposes of a given Code section, the IRS may challenge the taxpayer’s interpretation of that methodology. This occurred in TAM 200436011 (Apr. 30, 2004), involving the audit of X, the member of an LLC who had contributed property, against which the LLC borrowed and made a cash distribution to X. At issue was X’s share of excess nonrecourse liabilities under Reg. §1.752-3(a)(3).218 In exchange for its property contribution, X was issued all of the LLC’s senior preferred membership interests, and was allocated (1) all gross income up to the amount of its preference and (2) a share of the excess nonrecourse liabilities determined with reference to its senior preferred interest. X’s position was that the allocation should be respected for purposes of Regs. §§1.752-3(a)(3) and 1.707-5(b)(1). In TAM 200436011, the IRS National Office advised the field agent that the LLC’s gross income allocation failed to satisfy Reg. §1.752-3(a)(3), with respect to the allocation of excess nonrecourse liabilities in the manner in which they share significant items of partnership income or gain. The IRS reasoned that the Regulation’s reference to “a significant item of partnership income or gain” refers to a significant class of partnership income or gain, such as a gain from the sale of property or tax-exempt income, and not to a tranch of bottom-line gross or net income. As a result, X was unable to include the share of liabilities it desired for purposes of determining whether it avoided recognition of gain under the disguised sale rules.

When troubled by the apparent recognition of a loss on the sale of property by a partnership to its 50 percent “straight up” partner, so as to technically avoid application of Code Sec. 707(b)(1)(A), the IRS may strive to prove that the 50-percent partner in fact has something “more than” 50 percent, and thereby cause the loss to be nondeductible under that Code Section. In FSA 003297,219 the IRS recognized that Code Sec. 707(b) may not apply to disallow a loss arising from a transaction between a partner and a partnership, where a partner owns “only, but not more than,” 50 percent of PIPP and PIPC. However, the National Office gratuitously added that, for purposes of applying the relatedness test of Code Sec. 707(b), all of the facts and circumstances relating to the economic arrangement of the partners must be taken into account, referring to several authorities not directly relating to the measurement of PIPP and PIPC.220

4. Unexpected Losses

As described above,221 there is substantially uncertainty as to the measurement of PIPP when losses occur. It is possible that, at the time a PIPP measurement event occurs (e.g., a sale on July 1, 2006, that is potentially subject to Code Sec. 707(b)), Partnership ABCD is anticipated to have profits for that year, and the partnership has determined that the selling partner will be below the 50-percent threshold for PIPP for purposes of the operative Code provision. Due to losses suffered after the sale but in the same partnership tax year (2006), ABCD ends up with net losses (as measured for PIPP purposes) for 2006. If the computation of PIPP in a loss year would result in different percentage allocations of PIPP among D and the other partners than if ABCD had income for the year, then the events in the second half of 2006—which generates an overall net loss for the year—that occur subsequent to the July 1 measuring date, could potentially result in an allocation to D of PIPP which exceeds the 50-percent threshold. Such could trigger operation of the operative Code provisions (e.g., Code Sec. 707(b)) that D sought to avoid (and thought he avoided, when he sold the property on July 1, 2006, at a time that ABCD had net profits). In this scenario, D might strongly prefer that ABCD forgo losses222 and report at least $1 of income, so that the PIPP (income) measurement stick will be used, rather than the PIPP (loss) measurement mechanism!

VI. Conceptual Issues; Definitional Consistency Throughout the Code, or Section-by-Section Analysis?

As mentioned earlier and reflected in Appendices I and II, there are literally hundreds of provisions in the Code and regulations in which the measurement of PIPP or PIPC is embedded. Can consistent, uniform, one-size-fits-all definitions of PIPP and PIPC, respectively, be promulgated, or should they evolve on a Code section—by—Code section basis? If the latter, will there be different computations of PIPP for different purposes of the Code, even if measured at the same moment in time? If a uniform definition is appropriate, is it within the domain of Congress, Treasury, or IRS to provide the framework and/or details?
A. Principles for Proper Measurement of PIPP

It is submitted that in theory a uniform measurement of PIPP and PIPC, respectively, can be achieved. (Whether such definitions are desirable or administrable is a different question.) It is further submitted that the levels of relatedness—the numeric percentages that establish the thresholds of relatedness—can be consolidated into just a few categories, to meet the needs or objectives of the vast majority of operative provisions of the Code and regulations.

Starting with PIPP, what would be the appropriate measurement method? The answer may depend on what we seek to accomplish. It is submitted that a proper measurement methodology of PIPP would need to meet at least the following objectives:

- It should approximate the partners’ economic sharing of profit or income. Given that relatedness is properly measured by meeting some percentage threshold under the hundreds of operative provisions in Appendices I-III, then PIPP should approximate each partner’s economic share of the partnership’s profits or income. Thus, a purely elective approach that permits partners to specify PIPP in any fashion (e.g., from zero percent to 100 percent for any partner) would obviously be inappropriate and could lead to tax avoidance and game-playing.
- It should not be overly complex. An approach that annually requires partnerships to engage in complicated computations, ever-changing assumptions, and/or redeterminations of appropriate present value discounting of unknown and uncertain future profit streams that require expert computational services likely would bring a level of complexity that would be politically and practicably unacceptable.
- It should be administrable. Complexity is one element of administrability. Cost of compliance is another. And a third is the ability of IRS field agents to audit and verify the reasonableness of the assumptions used and the accuracy of the underlying computations generated in the partnership’s determination of PIPP.
- It should cover the vast majority of situations that arise in partnerships. A “uniform” measurement methodology must be applicable in the vast majority of permutations that arise in a partnership setting. For example, a PIPP measuring stick that looks solely to the partnership’s actual profits for the current year is of no usefulness if the partnership has only losses for the year.

B. Potential Approaches to PIPP

One can identify a number of potentially viable approaches, each having some merit in meeting some of these objectives, but each having its substantial shortfalls. The following are 25 of the approaches that come to mind (in no particular order).

1. The “Bottom-Line Taxable Profits” Approach

Under this approach, the partnership would determine each partner’s net taxable income under Code Sec. 702(a)(8) (i.e., excluding all allocations of income, gain, deduction and loss under Code Sec. 702(a)(1)-(7)). Each partner’s PIPP would be equal to his or her proportionate share of such residual or “bottom-line” net income for the year. Support for the “bottom-line taxable profits” approach is found in Reg. §1.46-3(f)(2).223

One problem with this approach is that it turns solely on taxable income, not book income or profits, which has been viewed as the more appropriate factor for purposes of delineating the economic effect of profit and loss allocations under Code Sec. 704(b). A second
Identifying Partners’ Interests in Profits and Capital

potential problem is that a partnership may have significant items described in Code Sec. 702(a)(1) through (7) (e.g., capital gains, dividend income, and items of income and gain required to be specially allocated to the extent prescribed by Treasury regulations), which by definition will be excluded from the Code Sec. 702(a)(8) bottom-line allocation method.\(^{224}\) Thirdly, the approach will totally disregard all types of tax-exempt income because Code Sec. 702(a)(8) measures only taxable income (and loss). Conversely, this approach generally will include pre-contribution (built-in) gain that is taxable income allocated to a partner under Code Sec. 704(c),\(^ {225}\) which generally will distort the true (post-contribution) gain recognized by the partnership. Additionally, the bottom-line taxable profits approach cannot (at least in some or many situations) be determined with accuracy at the moment the operative event mandates the measurement of PIPP. Finally, the bottom-line taxable profits approach does not, by itself, provide guidance as to the computation of PIPP when there are net taxable losses under Code Sec. 702(a)(8). However, the bottom line taxable profits ratio could be made applicable even in years when the partnership has a net loss.\(^ {226}\)

2. The “Book Operating Income” Approach

Here, the partners’ respective shares of operating income (determined on a “book” basis, using Code Sec. 704(b) capital account maintenance principles) would be the relevant measuring stick. A partner’s share of gain on sale of the partnership’s properties would be disregarded. This would be best justified for partnerships (including most service partnerships) that generate their economic profit primarily from operations, rather than sale or disposition of their property.

This approach would better measure the economic consequences of the partners’ profits shares. However, it also has several infirmities. First, it excludes gains from sales or dispositions of assets (except to the extent such gains are themselves includible in “operating income,” such as inventory). It would require clarification as to whether “operating income” includes dividend, interest or other income from passive sources. However, it would not require a determination of whether “book” gain or taxable gain (including the Code Sec. 704(c) component) is the more appropriate, because gain on sale would be irrelevant. Its appeal in the service partnership context, while being less than an ideal solution in the investment partnership setting, may necessitate a second or alternative measurement rod for PIPP in nonservice partnerships. Additionally, it requires all partnerships to determine the computation of operating income on a “book” basis, using Code Sec. 704(b) principles, which may be an administrative burden on smaller, less sophisticated partnerships. Finally, as is true of most other alternatives, it gives no guidance as to the measurement of PIPP when the partnership has operating losses, and oftentimes it cannot be determined with accuracy at the moment that the operative event mandates measurement.

3. The “Book Gain on Sale” Approach

Here, PIPP would be measured by determining each partner’s proportionate share of book gain on sale of the partnership’s underlying property. This would be best suited for partnerships that generate or are expected to generate their economic profit primarily from appreciation in the value of their assets, rather than from annual operating income.

The “gain on sale” approach, being based on book gain, would better measure the economic consequences of the partners’ profit shares arising from ownership of appreciated assets. Moreover, by being based on “book” gain, it would exclude from the computation of PIPP any inherent pre-contribution (i.e., built-in) gain that otherwise would be recognized under Code Sec. 704(c).

However, it is a far from ideal solution. First, it would require clarification of whether gain on sale arising from disposition of all property including inventory and other ordinary income assets, is also to be included in the computation, in addition to gain on capital and Code Sec. 1231 assets. Second, it has only limited application, i.e., such gain would not be realized in a service business or other trade or business that will not dispose of its underlying property so long as it is a going concern. Why then should such a rarely-occurring event be the measuring stick for determining PIPP for such operating businesses? Perhaps this alternative could be given only limited effect, i.e., it could be made applicable for measuring PIPP for partnerships whose income is primarily (or predominantly?) generated from gain on sales or disposition of the partnership’s property. Lastly, this approach gives no guidance as to the measurement of PIPP when the partnership has losses (not gains) on sales of property.

4. The “Hybrid Book Operating Income/Gain on Sale” Approach

PIPP would be determined by each partner’s proportionate share of book operating income, except in a year or years in which some defined level of profit is attributable to book gain on sale of the partnership’s property.
The hybrid approach would better measure a meaningful economic factor than most of the alternative approaches because it would compute PIPP based on book operating income while the partnership is primarily in operational mode, and would compute PIPP based on gain on sale in years where the primary source of income is gain from disposition of the partnership's property. It would require a determination of which hybrid factor applies at any given time or year.

The hybrid approach also has its shortcomings. This approach could lead to wide swings in the computation of PIPP, depending upon whether the operating income factor or the gain on sale factor is applicable. Such swings may not be determinable until (well) after the partnership’s year end, because computations may not be timely completed. Such swings may have operative effect with unanticipated (adverse or favorable) tax consequences. As in Alternative 3, above, the definitional issue of what types of gains on sale count for this purpose would need to be addressed. The approach oftentimes cannot determine PIPP with accuracy at the moment that the operative event mandates measurement of PIPP. Finally, the hybrid approach does not give guidance as to the measurement of PIPP when the partnership has losses. (However, rules could be constructed to provide, inter alia, that if the partnership has operating losses but gains on sale of property (or vice versa), PIPP is based on that factor that actually recognizes income or gain (which, again, might vary from year to year with the attendant lack of predictability depending on what ultimately occurs). This “solution” has its own problems.)

5. The “Initial Tier of Significant Book Profits” Approach

The profit allocation ratio that is applicable to the first (i.e., easiest to attain) significant portion of partnership profits (again determined on a Code Sec. 704(b) “book” basis) would initially apply, and continue to apply, even in years after that tier of profits has been exceeded. This approach is justified in partnerships that initially recognize small profits, and seems well-suited for partnerships that initially recognize net losses, as the first future economic profits (once the partnership recovers to breakeven) will ultimately be allocated to the initial tier. Thus, this approach would give guidance to the measurement of PIPP even in years when the partnership has net book losses.

Implicit in this approach is that the “initial tier of significant book profits” does not include the income or gain chargeback that typically arises when the partnership first recognizes book losses, followed by gains that restore the partners’ book capital accounts to their “starting points” (i.e., initial capital account balances). Thus, even where there is a substantial capital investment (say, $1 million cash by the partners in year 1) and a cumulative book loss in years 2 and 3 of comparable magnitude (again, $1 million), followed by significant profitability in year 4 (say $1.5 million), PIPP would not reflect the income or gain chargeback allocation with respect to the first $1 million (as that merely represents the recovery of prior losses previously allocated to the partners), but rather would focus on the (possibly different) allocation of the remaining $500,000 of profit or gain, as under these facts $500,000 of book profit is significant, and represents the first future economic profits (once the partnership recovers to break-even).

This alternative has the advantage of providing the partners with a measurement of PIPP even in initial years when book losses are being recognized by the partnership. However, it is not a perfect solution, either, as it continues to apply the profit allocation ratio applicable to the first significant tier of profits indefinitely, even if additional profits are allocated in a decidedly different fashion. Moreover, in close cases there may be uncertainty (amongst the partnership, its partners and/or the IRS) as to whether the amount of profits allocated in the initial tier (after breakeven) is in fact “significant,” or rather whether it should be disregarded as insignificant and the next (significant) tier of profit be applied ab initio as PIPP.

Implicit in the term “significant profits” is another definitional box-within-a-box, namely what are the “profits” that we are measuring? If operating income and gain on sale of property are allocated differently, is the initial tier of significant profit focusing on significant gains; significant operating income; a blend of both (and if so, how is that blend to be computed?); or something else?

6. The “Last Tier of Significant Book Profits” Approach

Here, the profit allocation ratio that is applicable to the last significant tier of partnership book profits would be utilized for all years. This approach is best justified by reflecting the partners’ own expectations that the venture will ultimately be so successful that the top tier is achieved, and their presumed arm’s-length negotiations as to the profits split in that residual tier.

Under this “last tier” approach, the partners again have the ability to measure PIPP even in initial years when there are book losses. In addition, this approach
does not suffer from the infirmity of determining what is the first “significant” profit tier. However, it does run smack into the rear-end version of the same question, i.e., what is the last “significant profit” tier? In situations where the residual tier of operating income is allocated differently from the residual tier of gain on sale of property, which applies (or is a blended approach required)? Moreover, in situations where the residual profit share is initially extremely unlikely to be attained, should it be disregarded?

The “last tier of significant profits” approach suffers from at least two other concerns. If the last tier is initially deemed realistic to be accomplished, but subsequent events indicate there is no realistic possibility that the residual tier will ever by accomplished (e.g., due to changes in the market place), should PIPP be modified to reflect the penultimate (or any other) tier that now looks likely to be the residual profits tier? If so, how often must PIPP be re-evaluated? Can it go down and up and down again over time, as re-evaluations of potential profitability are periodically revised?

7. The “Gross Book Income” Approach
Under this alternative, the total (positive) book income allocated to the partners for the year (under Code Sec. 704(b) capital account maintenance principles) would be tallied, including gross ordinary income, tax-exempt income, capital gain, and special allocations of income and gain. This would exclude from the computation the partners’ respective shares of book losses and specially allocated items of deductions, since such are not items of profit for the year in question. Each partner’s PIPP would be his or her proportionate share of the (positive) gross income so computed. This “gross book income” approach is arithmetically more complex, as it requires the partnership (and IRS) to properly compute items of gross income and gain. The status of items of deductions and loss that are not specially allocated is unclear—should they merely be deducted from the “bottom line” allocation of ordinary income (i.e., thereby making this a “net income” concept for items that are not subject to specially allocated deductions, but a “gross income” concept if corresponding deductions are specially allocated)? One might prefer consistency in approach, i.e., only gross income items come into the equation.

The gross book income approach often will result in differing measurements of PIPP in different years, unless the partnership is the atypical “straight-up” partnership. Moreover, it would not provide a readily administrable measurement stick to determine PIPP if the partnership itself has an ownership indirect in one or more additional pass-through entities, as it would necessitate computation of the partner’s share of the subsidiary partnership gross book income to provide pure gross book income data at the parent partnership level. Even assuming the subsidiary partnership is technically required by Code Sec. 702(c) and/or Reg. §1.702-1(a) to do so, it is problematic that noncontrolling partners will be able to force the subpartnership to so comply. Finally, the approach oftentimes cannot be determined with accuracy at the moment that the operative event mandates the measurement of PIPP.

8. The “Net Book Profits” Approach
This is a variant to the “gross book income” approach. Here, the total book income, net of any book losses or specially allocated deductions, would be computed for the year, and each partner’s PIPP would be his or her proportionate share of the (positive) net book income so computed.

Under this net book profits approach, there would be the need to compute net book profits rather than just net tax profits. However, those partnerships complying with the capital account maintenance rules of Code Sec. 704(b) most likely are already making these net profits allocations computations. This approach does not provide for the measurement of PIPP in years that the partnership has net book losses. Moreover, as each partner’s share of net book profits varies (due to flip-flops or tiers of allocations, preferred returns, etc.), the computation of each partner’s PIPP may change periodically. Oftentimes, this approach cannot be determined with accuracy at the moment that the operative event mandates the measurement of PIPP. However, to the extent these periodic changes reflect the ongoing changes in the partners’ economic interests in the partnership, the “net book profits” approach has some theoretical soundness to it.

9. The “Gross Taxable Income” Approach
Unlike the prior two approaches, the partnership here would (1) look annually to each partner’s Schedule K-1, (2) add up those items having positive allocations of taxable income or gain (other than Code Sec. 704(c) built-in gain), and (3) compute each partner’s proportionate share of the total gross amounts for the year. Tax-exempt income, as well as all items of taxable loss and deduction, would be disregarded.

The “gross taxable income” approach has in its favor a certain appeal from an administrative viewpoint. If one were to, say, merely add up all of the items of gross
income on the top half of the first page of the U.S. Partnership Tax Return, Form 1065, one might assume that the aggregate gross income for the purposes was easily computed, and all that would be left to do would be to compute each partner’s proportionate share thereof.

However, that assumption of simplicity is not well-founded. If the partnership owns interests in other pass-through entities, the subsidiary partnership’s gross income again must be separately computed and separately stated as required by Reg. §1.702-1(a) and Code Sec. 702(c). Furthermore, determining the share of each partner (in each partnership) in gross income requires a thorough analysis of the allocations of income, gain, profit, deduction and loss, and again special allocations or tiers of allocations of net book income likely will affect the computation of each partner’s share of gross taxable income under this proposed fact for purposes of PIPP.

Another problem with the gross taxable income approach is that oftentimes it cannot be determined with accuracy at the moment that the operative event mandates the measurement of PIPP.

The gross taxable income approach does not suffer from the infirmity of the there being no measurement of PIPP merely because these are not tax losses (i.e., there will be gross taxable income in such case). However, this approach will not result in a computable PIPP in years in which the partnership has no gross taxable income—a scenario rarely encountered.

10. The “Net Taxable Profits” Approach

Like the last approach, the partners’ annual Schedule K-1s would be the starting point for measuring PIPP. Here, the “gross” taxable profits (as computed in the preceding approach) would be reduced by all items of taxable loss and deduction (other than Code Sec. 704(c) built-in loss). Tax-exempt income again would be excluded in computing tax profits.

Support for the “net taxable profits” approach can be found in Reg. §53.4943-3(c)(2), dealing with taxes on excess business holdings of a private foundation in a partnership. That regulation provides that such foundation’s (or disqualified person’s) PIPP shall be determined in the same manner as its distributive share of partnership taxable income.

The net taxable profits approach has the same conceptual and practical problems as the gross taxable income approach. In addition, it is more likely to suffer the infirmity that there is the measurement of PIPP at a given time or year because the partnership has a net tax loss (even if it has some amount of gross taxable income).

11. The “Expected Net Taxable Profits” Approach

Under this approach, PIPP would be determined on an annual basis based on the manner in which the partnership “expects” to allocate its net taxable income for the year. For this purpose, all items of expected taxable income that are ordinarily taken into account in determining a partner’s distributive share of net income (including Code Secs. 704(b), (c) and (e), and 736 and 743) would be included in the projection. The estimate would be based on all facts and circumstances known to the partnership as of the first day of the current tax year. The partnership’s tax-exempt income again would be excluded in computing the projected taxable income.

This approach is utilized in Reg. §1.706-1(b)(4), discussed above. It has the advantage of greater predictability, i.e., the partnership will not be struggling to determine with accuracy the actual net taxable income at the moment that the operative event mandates the measurement of PIPP, because the partners’ percentages have been pre-determined as of the first day of the partnership’s tax year.

Some of this approach’s infirmities were discussed earlier. However, this approach lends itself to a potential solution in the event the partnership has a net taxable loss at the moment that measurement is mandated. In such case PIPP may be the partner’s (reasonably estimated) percentage share of net taxable income for the first tax year in which the partnership expects to have net taxable income. Again, the projection of future years’ taxable income would need to be made as of the first day of the current tax year, and the more distant the prediction, the more likely the protectors of the fisc (wrongly using 20-20 hindsight) may challenge the partnership’s reasonable estimate, thereby eroding the desired objective of predictability.

12. The “Any Significant Economic Item” Approach

This approach derives from the approved method of determining a partner’s share of profits for purposes of allocating nonrecourse deductions and nonrecourse liabilities under Reg. §1.704-2(e)(2). The latter permits the partners to provide for such allocations “in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.” Once the “significant partnership item” is so selected, the percentages should be applied consistently thereafter; otherwise, the combined PIPP percentages of A and B might exceed or be less than 100 percent, which theoreti-
cally and practically seems to be an improper result. Thus, under this approach if Partner A in Partnership AB (which owns property X) has a 10 percent share of operating income from property X and a 50 percent share of gain on sale of property X, with Partner B being allocated the balance, then commencing with the partnership’s first tax year and thereafter throughout the full term of the partnership, A’s PIPP could be either 10 percent or 50 percent and B’s PIPP could be 90 percent or 50 percent, respectively, by mutual agreement.

Implicit in this “any significant items” approach is that the sum of all partners’ shares of the significant item selected by the partnership will always be 100 percent. Thus, the sum of A’s and B’s PIPP must be 100 percent in the above example.

This approach provides some flexibility to the partners in measuring PIPP. However, the proposed requirement that the partners must utilize the same significant item through the full term of the partnership mitigates some potential game-playing by the partners.

The approach places tension on the determination of “significant items.” (Such tension already exists under Reg. §1.704-2(e)(2), which itself has not been the subject of cases or rulings.) It also raises questions in the event that the partnership initially acquires more than one property—assuming the partners have valid special allocations under Code Sec. 704(b) for each property, will they have a different PIPP for each property? Similarly, if the partnership disposes of or adds property at a later date, with different special allocations applying thereafter, how is PIPP to be measured? Is the initial PIPP truly locked in place for the life of the partnership?

13. The “Any Significant Item, or Anything in Between” Approach

This is a variant of the preceding alternative. Reg. §1.704-2(m), Example 1 (ii), in illustrating the application of Reg. §1.704-2(e)(2), permits the partners, acting consistently, to allocate nonrecourse deductions in any percentage between the partnership’s significant items. Thus, under this approach, if Partner A has a 10-percent share of operating income and a 50-percent share of gain on sale of AB’s property, A could be allocated 10 percent, 50 percent or any percentage between 10 percent and 50 percent, for purposes of PIPP, and Partner B’s PIPP would be the difference (i.e., 90 percent, 50 percent or any percentage between 90 and 50 percent).

Under this approach, the sum of all partners’ PIPP would still be 100 percent, and once the “significant item, or anything in between” amounts are selected, the percentages again would have to be applied consistently thereafter. In comparison to the prior approach, the partners would have greater flexibility in measuring PIPP. However, that flexibility does not necessitate an anti-abuse rule, given that the partners might have chosen any extreme (i.e., any significant item; in the prior example, Partner A’s PIPP could have been 10 or 50 percent, by mutual agreement), and selecting any percentage between the significant items (e.g., 30 percent, the mid-point) does not appear to materially increase the opportunity for A (or B) to partake in any abusive tax planning with regard to PIPP.

All of the other infirmities and uncertainties that apply to the prior approach appear to remain present under this variant.

14. The “Facts and Circumstances” Approach

Here, the computation of PIPP would take a page from its near-namesake PIP, i.e., the “partner’s interest in the partnership,” as defined in Reg. §1.704-1(b)(3). PIP is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. This in turn could refer solely to the manner in which the partners agree to share the economic benefits of income and gain (i.e., the upside aspects) only, or it could additionally take into consideration the economic burden associated with losses and deductions.

Support for a “facts and circumstances” approach is found in Reg. §1.752-3(a)(3), relating to the allocation among partners of excess nonrecourse liabilities, which is to be determined in accordance with PIPP. The Regulation provides that PIPP is determined “by taking into account all facts and circumstances relating to the economic arrangement of the partners.” The Regulation gives no guidance to application as to application of the facts-and-circumstances approach.

In determining PIPP it would appear preferable not to take into consideration the burdens (i.e., losses and deductions) associated with the partner’s interest. Those factors instead are relevant in determining the partner’s share of partnership losses. Indeed, the economic burdens of losses essentially are the difference between PIPP (the partner’s profits interest) and PIP (the partner’s overall interest in the partnership) that signifies the manner in which the partners have agreed to share the economic benefit or burden (if any) corresponding to the income, gain, loss, deduction or credit (or item thereof) that is allocated.

Like any facts-and-circumstances test, the taxpayer’s measurement of PIPP is subject to the IRS’s challenge, and thus uncertainty as to outcome. In TAM 200436011 (Apr. 30, 2004) this problem was raised by the taxpayer,
who stated that the method of determination of a partner's share of excess nonrecourse liabilities under Reg. §1.752-3(a)(3) in accordance with PIPP requires that all facts and circumstances relating to the economic arrangement of the partners be taken into account. The taxpayer contended that a partner can never know with certainty what the correct percentage is for the allocation, because the partner can never know with certainty its share of the partnership profits.

15. The “Historical Profits” Approach

One may recognize that profits may change annually, but wish to avoid trip-faulting over operative Code provisions that may have significant (and typically unanticipated) tax consequences that arise from changes in PIPP. Therefore, another approach would be to compute PIPP based upon a look-back approach, whereby the partners compute the weighted average of partnership profits (or just use the prior year’s PIPP) for one or two additional years, until a recomputation is made (a “ripe” time to be determined by Congress or the Treasury). This approach might be appropriate when the partners’ interests in profits have changed in prior years (e.g., Partner A’s profits interest was 50 percent in each of the first three years, and 60 percent thereafter). Your author knows of no analogous situations in the tax law where a multiple-year “look-back” approach is used for any operative Code provision.

16. The “Average Future Profits Interest” Approach

Again recognizing that profits may change annually, but wishing to avoid trip-faulting over operative tax rules that may have significant tax consequences that arise from changes in PIPP, perhaps partners should be allowed to look forward, not back. Specifically, the partners might be able to compute PIPP based on their respective average distributive shares of profits over the life of their interests in the partnership. This is the opposite of the historical profits approach, discussed above; here, average future profits are prognosticated, rather than looking at one or more prior years’ profits to determine PIPP.

The merits of such a future profits alternative would be that it would permit the partners to adopt a multiple-year approach in determining when a PIPP threshold is met. The infirmities include (1) uncertainties as to the accuracy of the future profits prognostication; (2) risk of IRS challenge (and uncertainty as to the accuracy of the IRS’s prognostication); (3) whether future profits should be re-forecast annually, and if so, should such be required or elective; and (4) if future profits are not recomputed, must newly admitted partners be burdened with the predictions made in the partnership’s initial year, which may have become woefully inaccurate?

Support for this “average future profits interest” approach can be found in Rev. Proc. 94-46. For purposes of determining the meaning of the term “majority in interest” for purposes of former Reg. §301.7701-2(b)(1), the revenue procedure provides that profits are determined by taking into account both present and future allocations of profits under the partnership agreement that is in effect as of the date of the dissolution event. A high-ranking Treasury official, speaking at a tax conference shortly after Rev. Proc. 94-46 was promulgated, reportedly reminded practitioners that to correctly value the interest in profits under the revenue procedure, partners must take into account shifts in percentages of interests “down the road” and not those fixed at the outset by agreement.

17. The “Most Likely Allocation of Marginal Profits” Approach

Under this approach, PIPP would again be determined by looking forward. Under this proposal, PIPP would be the most likely allocation of marginal profits (i.e., the last dollar of reasonably expected profits). Here, future profits are prognosticated, with the most likely tier that the last dollar of reasonably expected profits will fall into being dispositive.

Support for this approach can be found in a 2005 Joint Committee on Taxation Staff Report, with respect to a proposed legislative change regarding allocation of nonrecourse deductions being consistent with the partners’ interest in the partnership.

The merits of such a “most likely residual profits” alternative would be that it would permit the partners to look beyond the current year’s profits (if any) in determining when a PIPP threshold is met. Again, the same infirmities raised in the immediately preceding (“average future profits interest”) approach would also apply to this prognostication of profits.

18. The “Highest Profits Percentage” Approach

Under this approach, PIPP would be defined to be a partner’s largest percentage in any item of partnership income or gain, at any time over the life of the partnership. This approach is used in a handful of regulations under Subchapter K, e.g., for determining whether a partner meets the de minimis exception of Reg. §1.752-2(d) with respect to certain nonrecourse loans made to the partnership.
One problem with the “highest profits percentage” approach is that it is easy for taxpayers to foot-fault over the line of “relatedness.” If the approach looks to the highest profits percentage at any time over the life of the partnership, a partner who has (and will have) a small interest in PIPP for many years to come may nonetheless exceed the relatedness threshold because of a large profits interest (that may or may not materialize) applicable only many years later. Moreover, a high profits interest in an insignificant item could trigger “relatedness,” with potentially adverse tax consequences. If a partner will bear the risk of adverse tax results when he bargains for a high percentage interest of any profits item, the tax tail may wag the dog and cause the partners to change their economic deal.

19. The “Highest Profits Percentage of Any Significant Item” Approach
A variation of the highest percentage profits approach was proposed by the ALI Subchapter K Project as being the general rule for determining PIPP. The ALI proposed that each partner’s PIPP should be the largest percentage interest in any significant present or future item of partnership profits. My esteemed co-commentator, Philip Postlewaite, responds directly to the ALI proposals in his paper that immediately follows this article.247

When reviewing the ALI’s “highest profits percentage” proposal 20 years ago, the Postlewaite Article stated that the ALI’s approach would deal with partners who use the flexibility available under Subchapter K to institute complex sharing agreements by preventing them from misrepresenting their actual interest in the partnership.248 The Postlewaite Article forcefully argued that tax policy goals are undercut by limiting the highest profits item rule to “significant items,” as defined by the ALI elsewhere in their proposal,249 and that he would then define PIPP to be a partner’s largest percentage interest in partnership profits (not limited to only those of significant items).

Neither the ALI nor the Postlewaite Article discusses the fact that in a complex partnership, the sum of the partners’ largest percentage interests can substantially exceed 100 percent. For example, Partners A and B may share profits 60 percent to A and 40 percent to B in the initial years, and 40 percent to A and 60 percent to B in later years. In such case, A and B each would be deemed to have a 60 percent interest in PIPP (a total of 120 percent). As a result, both A and B would be subject to the “relatedness” standards that apply (as reflected in Appendix III) to literally hundreds of Code and Regulations provisions that spring into operation when a partner has PIPP of 50 percent (or more than 50 percent). In contrast, if A and B each were equal (i.e., 50/50) partners, none of the provisions triggered by ownership of “more than 50 percent” of PIPP would apply to A or B. Recognizing that most of the relevant Code Sections impose adverse tax consequences on partners who exceed some specified percentage, the highest percentage interest test would generally be unpopular with taxpayers while preferable to those intent upon protecting the fisc. As the Postlewaite Article points out, if a partner must bear the risk of adverse tax results when he bargains for a high percentage interest of any profits item, the benefits of varied interests are no longer as attractive and the partner may accept a constant, rather than varied, percentage interest in all partnership items. That article states that the ALI “Proposal M would encourage such [straight-up] agreements—a sound policy result.”250

Your author takes a different view. Notwithstanding the goal of simple, straight-up allocations (and economic deals), the genie has long been out of the bottle. In today’s sophisticated world, the multitude of complex economic deals—the vast majority of which arising for nontax reasons as negotiated among the partners—is the norm, and adopting an approach—whether that of the ALI or that in the Postlewaite Article—which pushes more partners into the adverse tax consequences of “relatedness” arguably serves no policy other than to maximize tax revenues. In absence of statutory directive or legislative history to do so, it is submitted that the highest profits interest approach is inappropriate.

20. The “Lowest Profits Percentage of Any Significant Item” Approach
Alternatively, we might consider adopting as the appropriate measurement of PIPP a method that is generally pro-taxpayer, in that each partner’s PIPP should be the smallest percentage interest in any significant present or future item of partnership profits. This is the reverse side of the coin that is the ALI Proposal. It prevents taxpayer partners from being unintentionally caught in those adverse tax consequences that arise when “relatedness” is present. Moreover, there is economic justification for this result—a partner who does not have a meaningful (percentage threshold) share of a significant item arguably is not one who should be potentially penalized under the plethora of percentage interest thresholds—in stark contrast to a partner who meets the percentage interest test for all significant items.
One disadvantage of this approach is that it still requires a determination of "significant items." However, it reduces the burden on taxpayers (and the IRS) to the partner finding just one significant item as to which his profits interest is below the percentage threshold. In contrast, under the highest profits percentage approach, the partner must identify every significant item in his or her partnership interest, and then prove that he or she has not exceeded the percentage interest threshold as to any of those significant items.

Support for the lowest profits percentage approach is found in Reg. §1.707-4(b), which contains a presumption that a distribution of operating cash flow to a partner will not be treated as part of a sale of property by the partner to his partnership. Reg. §1.707-4(b)(2)(i) provides that transfers of money to the partner by the partnership during a tax year will be treated as operating cash flow distributions if, among other requirements, they do not exceed the product of (1) the net cash flow of the partnership from operations for that year multiplied by (2) the lesser of (a) the partner's "percentage in overall partnership profits for that year" or (b) the partner's "percentage interest in overall profits for the life of the partnership." Reg. §1.707-4(b)(2)(ii) provides a safe harbor in determining the partner's operating cash flow distributions for the year, namely, the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such tax year. Again, as in our significant item approach, the regulation still requires a determination of "material items," and Reg. §1.707-4(b) provides no guidance with respect to what constitutes a "material item of partnership income or gain." Nonetheless, it is an illustration of the lowest profits percentage approach being utilized with respect to a regulation issued under Subchapter K.

21. The "Multiple PIPPs" Approach

Each of the 20 preceding approaches to defining PIPP have focused upon finding the "magic bullet" whereby a single approach to measuring PIPP would be applied for the life of the partnership (or at a minimum, for the tax year in question), and that single measurement methodology would apply across-the-board to all potentially operative provisions of the Code and regulations. After reviewing these 20 alternatives, it appears that none is clearly satisfactory or meets all or nearly all of our proposed objectives. It seems ripe to consider one or more alternative approaches to computing PIPP.

Under this 21st approach, one might recognize that more than one measurement of PIPP is appropriate in any given year (or even at the same moment in time). Specifically, PIPP might be measured with respect to each property or source of income, with the partners potentially having a different PIPP in each property or source. To illustrate, if Partner A has a 40-percent interest in all items of Property X (owned by Partnership AB) and a 60-percent interest in all items of Property Y owned by AB, then A's PIPP with respect to X is 40 percent and with respect to Y is 60 percent. For those items (such as tax credits) that may turn solely on items of income, gain, deductions (such as depreciation) or loss on a property-by-property basis, our focus should be on that partner's PIPP with respect to the property in question, and not on some theoretical "overall" or "blended" PIPP. Indeed, what would A's "overall" PIPP be in AB, given two different properties with presumably different and unrelated income, gain, loss and cash flow? A "blended" PIPP of 50 percent seems hard to justify conceptually, even if it is the arithmetic average of A's 40 percent PIPP in Property X and 60 percent PIPP in Property Y.

By focusing, for purposes of PIPP, on the partner's interest in each property are we effectively identifying the partner's interest in each relevant item of income or gain attributable to such property? For those operative Code and regulations provisions that key off of PIPP with respect to PIPP pertaining to a particular property or income stream, such special PIPP inquiry appears relevant.

Support for this property-by-property approach can be found in Reg. §1.46-3(f)(2)(ii), which provides an exception to the general rule (i.e., the bottom-line general profits approach24)). Under the special rule, if all related items of income, gain, loss and deduction with respect to any item of partnership Code Sec. 38 property are specially allocated in the same manner and if such special allocation is recognized under Code Sec. 704 and Reg. §1.704-1(b), then each partner's share of the basis of such item of Code Sec. 38 property is determined by reference to such special allocation effective for the date on which the property is placed in service.

However, for those other operative provisions that are not property-specific and do not track a particular income stream, there remains a need to identify the overall PIPP for each partner. In such case, each partner conceivably can have a myriad of PIPPs! Returning to our example, Partner A may have a PIPP of 40 percent in Property X, a 60-percent PIPP in Property Y, and (assuming no other assets or sources of income in AB), an "overall" PIPP with respect to AB of 48 percent or
52 percent, or any other number between 40 percent and 60 percent! And with so many operative Code and regulations provisions (thanks in large part to the references to Code Secs. 267(b) and 707(b)) turning on the 50-percent/more-than-50-percent threshold, the importance to A, B and Partnership AB of the measurement of A’s and B’s PIPP(s) can be quite significant!

22. The “Whatever the Partnership Agreement Says It Is” Approach

One can sympathize with those drafters of regulations and Code provisions who recognize that taxpayers and field agents may have difficulty in interpreting and measuring PIPP (or PIPC) under the regulatory or Code provision they are drafting. One solution would be to let the partners agree (within reason) on the designation of their respective interests in PIPP, and (so long as the percentages add up to 100 percent) let that be the default rule.

This approach is utilized in Reg. §1.401-10(d), which provides that a partner’s interest in the profits of the partnership shall be determined by the partnership agreement.252

What exactly does it mean to measure PIPP as “determined by the partnership agreement?” Assume the “general partner’s services and compensation” portion of the ABC Partnership Agreement provides that Partner A is to receive compensation for services equal to 30 percent of ABC’s profits. The net profit of the partnership, after deducting A’s compensation, is described in the “allocation of profits and loss” provisions of the partnership agreement. It there states that ABC’s net profit is to be divided equally between A, B and C (i.e., rounded to 33 percent each). If ABC’s profit before A’s compensation is $100,000, then A’s compensation will be $30,000 and his share of the profits, after compensation, will be $23,333 (i.e., one-third of $70,000). The total of A’s compensation and share of profits is 53 percent (i.e., $53,333) of the partnership’s $100,000 profit. Query: Is A’s PIPP 33 percent (as specified in the partnership agreement) or is it 53 percent (the total of A’s compensation and share of profits)?253 The answer will make a huge difference for all those operative Code and regulations provisions that are measured by PIPP being at or over 50 percent. Should the physical location in the partnership agreement of the profits allocations (i.e., separate from the services/compensation provision) affect the measurement of PIPP for A (and the remaining partners)?

How much leeway would the partners’ agreement be given in allocating PIPP? Depending on the facts and circumstances, assuming anything other than a straight up (vertical slice) interest in profits, there likely would be room for interpretation. Would the residual profits percentage be the interest in profits “determined by the partnership agreement”? Would “any provision regarding the sharing of profits” be sufficient?254

23. The “Whatever It Says on the Partner’s K-1 Tax Return” Approach

Finally, one can sympathize with those taxpayers and their return preparers who must select “the” correct percentage of PIPP and PIPC to put on the Form 1065, Schedule K-1 tax returns for each and every partner (with the responsible partner or LLC member signing the return under penalties of perjury). The K-1 calls for those percentage interests at the beginning of the year and the end of the year (as well as a supplemental schedule for changes in percentages during the year).255 In the real world, a large number of taxpayers (and, one might speculate, many if not most IRS field agents) would select those K-1 percentages as the laymen’s understanding of what PIPP and PIPC represent.

Support for this approach is found in the tax matters partner (TMP) regulations, which deal with the question of which partner is the TMP. Where no partnership designation of a TMP has been made, it is the general partner having the largest profits interest in the partnership at the close of that tax year. For this purpose, the general partner with the largest profits interest is determined based on year-end profits interests on the Schedules K-1 filed with the partnership income tax return for the tax year for which the determination is being made.256

For those operative Code and regulations provisions that turn on the PIPP measured as of the last day of the partnership’s tax year, this “K-1 tax return” approach would be the easiest to implement—so long as the ending percentages are filled in on the partners’ relevant K-1s. For those operative provisions that turn on PIPP as of the first day of the partnership’s tax year, the “beginning percentage interests” in PIPP as reflected on the partners’ K-1 returns would control. Nothing could be easier from an administrative viewpoint.

As is true of all other approaches to PIPP, this “whatever it says on the K-1 return” approach has its weaknesses. First, as stated above, a fair number of K-1 tax returns contain no percentage, but rather the word “various,” or “VAR,” to signify there are a number of different percentage interests that apply to the partners’ sharing of profits. Second, the blind reliance on the preparer’s determination of each partner’s PIPP can lead
to possible gaming of the operative Code and regulatory provisions (or traps for the unwary)—particularly where the percentage interests are at or close to a significant percentage threshold. It is one thing to rely on the returns for purposes of designating a TMP, whose role (although potentially vital) is primarily procedural; it is another thing to have significant tax consequences (e.g., potential disallowance of losses under Code Sec. 707(b) or partnership termination under Code Sec. 708(b)) turn solely on whether the return preparer places “49 percent,” “50 percent” or “51 percent” in those K-1 boxes for partners’ profit shares.

A final infirmity of this approach is that the beginning and ending percentages don’t necessarily reflect the partners’ PIPP during any other days of the partnership’s tax year, which days may themselves be relevant measurement dates. However, there is something to be said for administrative convenience (and practicality in application) in determining PIPP. If the IRS and the Treasury are concerned about mid-year gaming, an administrable rule might be in order. 257

24. The “Any Reasonable Method” Approach
Next we look at a pragmatic approach (akin in some ways to the flexible approaches discussed above), which allows the partners to select any reasonable estimate of PIPP. Under this approach, a reasonable estimate, as of the relevant determination date, of projected future profits associated with the partners’ economic interest would suffice.

Support for this “reasonable estimate” approach can be found in Rev. Proc. 94-46,258 which applied for a few years in the context of determining whether an entity was classified as a partnership under the regulations that preceded the check-the-box regime. That revenue procedure provides that profits are determined and allocated based on “any reasonable estimate of profits” from the date of the dissolution event to the projected termination of the partnership, taking into account present and future allocations of profits under the partnership agreement that is in effect as of the date of the dissolution event. While Rev. Proc. 94-46 retains no vitality in the check-the-box era, it is always refreshing to see the IRS accepting “reasonable estimates.”

Unfortunately, the usual culprits prevent this approach from being fully satisfying. Is the determination to be made by the partnership or each partner? What if two partners disagree on the PIPP amount? What facts and circumstances should affect the determination of “reasonableness”? Should the “estimate” be solely of profits “from the date of the dissolution event to the projected termination of the partnership,” as in Rev. Proc. 94-46? Exactly how does that test work in practice? Alas, we have no answers or guidance to share with the reader.

25. The “Elective Combinations” Approach
Finally, PIPP could be measured by providing taxpayers with an election to use either of two approaches, as a matter of administrative convenience. For example, in determining whether a partner owns a 50-percent PIPP, the partnership might use either the net book profits approach or the net taxable profits approach, just to pick two of the 24 alternatives discussed above.

Why should a taxpayer-friendly elective approach to PIPP be given consideration? One explanation would be to provide flexibility to taxpayers, and in some cases reduce the cost of measurement compliance, recognizing that no one approach or method is clearly superior to all others. If, once having elected, the partners are required to take a consistent approach that minimizes the risk of the IRS getting whipsawed, there is something to be said for giving a choice to taxpayers. However, there is no authority known to this writer to support an elective approach in measuring PIPP.

What can we conclude as to the 25 alternative approaches to measuring PIPP described above? First, it seems clear that none of these alternatives are ideal; each has its shortfalls. Few are readily administrable. Many utilize a mathematical approach or formula, but their results do not necessarily approximate what one would conclude is the proper measurement of PIPP, particularly in connection with sophisticated partnership arrangements. It would appear that no single solution fits all or almost all situations. (This is not truly surprising; if there was a “magic bullet,” Congress, the Treasury or the IRS likely would have implemented it long ago.)

C. Principles for Proper Measurement of PIPC
Let us now shift our focus to PIPC: What would be the appropriate measurement method? A proper methodology for determining PIPC should meet virtually the same objectives proposed for the appropriate measurement of PIPP, i.e., it should approximate the partners’ economic sharing of capital in the event of a liquidation (as compared to the economic sharing of profit or income, as for PIPP); it should not be overly complex; it should be administrable; it should cover the vast majority of situations that arise in partnerships; it should be predictable; it should be fair (or at least perceived as fair); and it should be flexible.
D. Potential Approaches to PIPC

One can identify several potentially viable approaches, each having its advantages and areas of concern. The following ten approaches come to mind (in no particular order):

1. The “Liquidation Value” Approach

Under this approach, PIPC would be determined through reference to the assets of the partnership that the partner would be entitled to upon the liquidation of the partnership. This approach may best replicate what the partner would receive if he or she remained a partner for the duration of the partnership’s existence, at which time the partnership sold all its assets for fair market value, paid all its liabilities, and distributed the net proceeds to the partners in accordance with the terms of the partnership agreement. Moreover, the liquidation value approach has been adopted in IRS and Treasury pronouncements which distinguish the receipt of a (taxable) compensatory capital interest from a (nontaxable) compensatory profits interest.259

This approach, although the most popular to date, is not without its problems. First, it requires valuation of the partnership’s property (net of liabilities)—a potentially expensive consequence for the vast majority of partnerships. Second, value (like beauty) often lies in the eyes of the beholder. When an IRS auditor estimates the value of the partnership in a hypothetical liquidation mode, he may arrive at a number substantially different from the one used by the partnership. Thirdly, the determination of liquidation value may not be relevant to a partnership (such as a personal service partnership) whose partners may come and go, while the entity remains (or at a minimum is intended to remain) a going concern indefinitely. Would it not be better in such situations to focus more on what each partner would receive upon withdrawal from the partnership? In some cases, the number would be the same; in others, it would differ. Lastly, does the “liquidation value” approach to PIPC require the partnership to revalue its assets every day of the year, if operative events requiring measurement of PIPC could come into play on any and every day of the partnership’s year?

2. The “Partner’s Withdrawal Payment” Approach

Under this measurement approach the partner’s percentage would be the amount that each partner would be entitled to receive if he or she withdrew from the (continuing) partnership on the measurement date, in ratio to the total amount all partners would receive if they were to withdraw on that date. For example, if AB LLC owned assets (net of liabilities) valued on the measurement date of $200,000, but AB’s Operating Agreement calls for A and B to receive $80,000 and $90,000, respectively, if they were to withdraw from the partnership prior to its dissolution, A’s PIPC would be 47 percent (i.e., $80,000/$170,000) and B’s would be 53 percent (i.e., $90,000/$170,000). These amounts may better reflect the economic realities of what the partners are to receive—in effect, their restated (but not truly revalued) payment)—upon their exit from the partnership.

This “partner’s withdrawal payment” approach is not conceptually pure. If the concept of a “capital interest” derives from partnership accounting principles, one’s capital interest should (in some fashion) reflect his adjusted capital investment, and not merely his redemption or buy-out price should he withdraw. (If the two numbers are the same, there is no need to compute the withdrawal payment amount for each partner, in the first place.)

3. The “Disjunctive Liquidation Value or Withdrawal Value” Approach

Both of the first two approaches to computing PIPC have their flaws. What about a disjunctive approach, i.e., determine PIPC through reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon the liquidation of the partnership? This disjunctive approach can be found in Regs. §§1.704-1(e)(1)(v) and 1.706-1(b)(4)(iii).

As pointed out in the preceding approach, the two alternatives (withdrawal payment versus liquidation value) can generate different results. Who is to choose which of the two is to apply to a particular scenario—the partnership? Each affected partner? The IRS? The courts? What happens if one partner selects the method most favorable to his own personal situation, while another partner chooses the other method? Wouldn’t the IRS risk being whipsawed by giving each partner his choice? The problem could be mitigated by requiring the election to be made at the partnership level, binding on all partners. (Query whether the partnership could make a new election annually, so long as it is applied by all partners with respect to measurement events arising during that partnership year.)

A better solution would be to specify in the applicable Code or regulation provision that either the greater of the two, or the lesser of the two, alternatives shall apply in determining PIPC. Reg. §1.401-10(d) selects the greater of the amounts that...
would be distributable to such partner either upon his withdrawal from the partnership, or upon liquidation of the partnership.\(^{260}\)

This alternative solution also has its flaws, as the following illustrates: Assume A, B and C are the sole members of ABC LLC. Pursuant to the terms of the ABC Operating Agreement the amounts each partner would receive on withdrawal are as follows: A—51 percent; B—48 percent; and C—one percent. The amounts each partner would receive on liquidation of ABC LLC are A—48 percent; B—51 percent; and C—one percent. By using the “greater of liquidation value or withdrawal value” approach, A will be deemed to have a 51 percent PIPC and B will have a 51 percent PIPC. Thus, both A and B will be deemed to own more than 50 percent of ABC’s PIPC, and both will be subject to the (generally adverse) relatedness rules in the Code and regulations. This seems to be an unduly harsh result, even if it brings greater certainty to the measurement of PIPC.

4. The “Tax Basis Capital” Approach

Under this approach the ratios of the partners’ respective tax basis capital accounts would constitute their respective percentages of PIPC. This approach has the advantage of simplicity in that the tax basis capital is quantifiable for each partner.

There are several infirmities to using the partners’ respective tax basis capital to establish PIPC. First, if the partners have zero or negative capital accounts, is such that partner’s capital percentage zero? If all of the partners have such (zero or negative) accounts, does this approach lead to the ludicrous position that no partners have any PIPC?

Second, this method would exclude all built-in gain (or loss) from the equation. If A contributes $100,000 cash and B contributes property with a value of $100,000 but a basis of $0, B will have a zero percent PIPC under the tax basis capital approach. The obviously correct answer is that B should have a 50-percent PIPC, and A the remaining 50-percent PIPC, as they each contributed $100,000 (and assuming all distributions and other factors are equally shared by A and B).

5. The “Tax Basis of Assets” Approach

Under this approach PIPC would be determined with reference to the ratios of the partners’ respective shares of the adjusted basis of partnership property. Each partner’s PIPC would equal that partner’s share of the adjusted basis of partnership property (within the meaning of Reg. §1.743-1(b)(1)), reduced by the partner’s share of partnership liabilities.

Such an approach is supported by Notice 88-99,\(^{261}\) which authorizes a partnership to elect this method to determine PIPC, which in turn is relevant in determining the partners’ share of interest that is subject to the interest capitalization rules.

6. The “Book Capital” Approach

In response to the infirmity of disregarding the built-in gain of any property contributed to the partnership, the approach could explicitly include the property’s built-in gain or loss, thereby effectively converting the tax basis approach into an initial (i.e., date of contribution) book capital approach. Support for this approach can be found in Code Sec. 743(b)(2) of the Code, which requires for purposes of Code Sec. 743(b) that a partner’s share of the adjusted basis of partnership property be determined in accordance with PIPC, and in the case of property contributed to the partnership by a partner, Code Sec. 704(c) shall apply in determining such share.

Support for a “book capital” approach based on Code Sec. 704(b) capital accounts is found in LTR 200310014. There, the “book capital” approach was utilized to measure a REIT’s capital interest in a partnership.

That letter ruling involves a REIT owning direct and indirect interests in partnerships. In determining whether a REIT will meet the assets and gross income requirements of Code Sec. 856(c), Reg. §1.856-3(g) provides that a REIT that is a partner in a partnership will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of Code Sec. 856, the regulation provides that the REIT’s interest in the partnership’s assets shall be determined in accordance with its capital interest in the partnership.

Reg. §1.856-3(g) does not define the term “capital interest.” In LTR 200310014, the IRS stated that a partner’s capital account generally reflects its net investment in partnership capital and the partnership agreement requires that liquidating distributions be made in accordance with positive capital account balances. A partner’s capital account may therefore reflect a partner’s net investment in the partnership for purposes of Reg. §1.856-3(g). Consequently, the IRS reasoned that a partner’s capital account balance as a portion of the sum of all partners’ capital account balances may be used to define its capital partner interest. The IRS then ruled that solely for purposes of Code Sec. 856(c), the REIT’s capital interest in the partnership will be determined by dividing its capital account, as

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determined and maintained by the regulations under Code Sec. 704(b), by the sum of all partners’ capital accounts as so determined and maintained.262

Additional support for the “book capital” approach can be garnered from Rev. Proc. 94-46, discussed above,263 which provides a safe harbor that may be used to determine a “majority in interest” for purposes of former Reg. §301.7701-2(b)(1). Under that revenue procedure, the partners must determine a “majority of the capital interests” owned by the remaining partners. For this limited purpose, capital is determined as of the date of the event that causes a dissolution of the partnership. The revenue procedure provides that if capital accounts are determined and maintained through the date of the dissolution event in accordance with the capital accounting rules of Reg. §1.704-1(b)(2)(iv), then “capital determined as of the date of the dissolution event represents the capital account balances determined on that date.”264 Thus, if partners owning in the aggregate a majority of the total capital account balances (as measured under Reg. §1.704-1(b)) agree to continue the partnership, a “majority of the capital interests” has been attained, for purposes of the safe harbor of Rev. Proc. 94-46.

7. The “Facts-and-Circumstances” Approach
This is the same alternative (of the same name) discussed earlier with respect to approaches to measuring PIPP.265 Under this approach, the computation of PIPC would require an analysis and weighing of all facts and circumstances relating to the partners’ economic arrangements.

Such an approach is supported by Reg. §1.613A-3(e)(4), which provides that for purposes of Reg. §1.613A-3(e), PIPC or PIPP is determined by taking into account all facts and circumstances relating to the economic arrangements of the partners. The regulation states, “See the factors listed in Reg. §1.704-1(b)(3)(ii).”266

The factors listed in Reg. §1.704-1(b)(3)(ii) are (a) the partners’ relative contributions to the partnership, (b) the interests of the partners in economic profits and losses (if different from that in taxable income or loss), (c) the interests of the partners in cash flow and other nonliquidating distributions, and (d) the rights of the partners to distributions of capital upon liquidation.

There are several problems with applying the facts and circumstances test to determine PIPC. First and foremost is the inherent uncertainty and unpredictability of the percentage interests that would arise, in any event. Second, in determining PIPC, should the “facts and circumstances” factors listed in Reg. §1.704-1(b)(3)(ii) be limited to those which apply solely or primarily to capital, e.g., the partners’ relative capital contributions and the rights of the partners to distributions of capital upon liquidation, or do all four of the listed factors apply (which appears to be the intent of Reg. §1.613A-3(e)(4), given its reference without limitation of the factors in Reg. §1.704-1(b)(3)(ii) to be applied)?

8. The “Whatever the Partnership Agreement Says It Is” Approach
As discussed with reference to PIPP,267 still another alternative is to let the partners agree on the designation of their respective interests in PIPC, and (so long as the percentages add up to 100 percent), let that be the default rule. This approach is utilized in Reg. §1.401-10(d), which provides that a partner’s interest in the capital of the partnership shall be determined by the partnership agreement.268

The infirmities of this “whatever ...” approach are similar to those relating to the PIPP version of this approach, discussed earlier.269

9. The “Whatever It Says on the Partner’s K-1 Tax Return” Approach
Alternatively, as discussed with reference to the approaches to determining PIPP,270 the partners’ respective interests in PIPC could be the percentage interests entered by the return preparer on the Form 1065, Schedule K-1 tax forms for each partner. The advantage of this approach is ease in application, and the percentage is readily identifiable by each partner (and IRS auditors) in determining that partner’s PIPC for determining his or her tax consequences under all relevant operative provisions of the Code and regulations.

The criticisms of this approach are the same as those raised with respect to its potential application for PIPP purposes. For example, many returns fail to reflect a percentage entry for the beginning and ending PIPC balances. Second, the IRS should not be bound by what the preparer puts in those K-1 boxes lest gaming be the result. Third, the beginning and ending percentages do not necessarily reflect the partners’ PIPC during any other days of the partnership’s tax year, which themselves may be measurement days.

10. The “Elective Combinations” Approach
Finally, as discussed with respect to PIPP,271 PIPC could be measured by providing taxpayers with an election to use either of two (or more) approaches, as a matter of administrative convenience. For example, in deter-
mining whether a CFC owns a 25 percent or greater PIPC for purposes of the capital interest threshold under Code Sec. 954(c)(4) (relating to obtaining look-through treatment), the CFC could be permitted to elect to determine its capital interest using either fair market values or Code Sec. 704(b) book capital accounts.

Why should a taxpayer-friendly elective approach to PIPC be given serious consideration? Returning to the CFC 25 percent PIPC threshold test under Code Sec. 954(c)(4), it has been argued that where the partnership’s profit allocation and liquidation rights are complex, a requirement that a CFC must measure its PIPC based on fair market values could be burdensome. If the CFC were to dispose of its entire partnership interest in a series of discrete tranches over a period of months or years, a requirement that a fair market appraisal be performed at the time of each disposition would impose a significant administrative burden on the CFC and, per year, a requirement that a fair market appraisal be performed at the time of each disposition would impose a significant administrative burden on the CFC and, moreover, as a practical matter may be difficult to arrange where the CFC is not a controlling partner. In such a case, reliance on Code Sec. 704(b) book capital accounts would be simpler and less costly to the taxpayer. Nonetheless, determining PIPC based on fair market values arguably presents the most accurate picture of the CFC’s economic interest in the partnership. Balancing these considerations, it has been recommended that taxpayers should be provided flexibility to measure PIPC in a partnership based on either Code Sec. 704(b) book capital account values or fair market values.

A variant of the “elective combinations” approach would be to permit the partnership to determine the partners’ respective PIPC percentages under any of three sets of rules: accounting (GAAP) rules, tax rules, or Code Sec. 704(b) book capital account rules (based on a fair market value constructive liquidation of the partnership). The partnership’s election, once made, might be irrevocable, i.e., it must be consistently applied to avoid potential abuses.

Philip observes that, in enumerating the potential approaches to measuring PIPC, “possibly with fatigue setting in, Shelly could only come up with ten.” Both mental and physical fatigue came into play; if more alternatives to measuring PIPC exist, we couldn’t think of them!

E. Simplification

Once definitions of “PIPP” and “PIPC” are achieved, can we give more than mere lip service to the long-desired goal of simplification in this little corner of the tax world? Appendix III, “Partnership Percentage Interest Thresholds,” identifies over 50 different permutations of thresholds found in the Code and regulations. One can observe there are several variables at hand, which create this crazy patch quilt of thresholds:

- Different numeric percentages: thresholds of “relatedness” include zero, one, two, five, ten, 20, 25, 30, 35, 50, 70, 80 and 90 percent.
- Different floors: some provisions are drafted as being “X percent or more”; others are “more than X percent.”
- Different ceilings: some provisions are drafted as being “X percent or less”; others are “less than X percent.”
- The capital/profits combination: some provisions solely measure PIPP; some solely measure PIPC; others measure a combination of both PIPP and PIPC; and still others measure for the presence of PIPP or PIPC.

Taken together, there are mathematically far more permutations (computed by taking into consideration the permutations in each of the four aforementioned variables) than Congress and the Treasury have employed to date. However, given the seeming lack of rhyme or reason as to why the existing (50 plus) multitude of threshold levels has evolved, perhaps your author is committing a grievous error by publicizing the possibility that permutations previously unperurbed are potential prospects for further mischief.

There is a corollary problem that arises in deciphering and dealing with the patch quilt of thresholds: Congress on rare occasions refines the percentage thresholds, on an ad hoc (section-by-section) basis.

For example, prior to October 23, 1986 (the effective date of the Tax Reform Act of 1986), Code Sec. 707(b)(2)(A), which deals with certain gains on sales of property being treated as ordinary income, applied if, inter alia, the sale or exchange was between a partnership and a person owning more than 80 percent of the profits or capital interest in such partnership. In 1986 Congress changed the rule, substituting “50 percent” for “80 percent,” thereby increasing the applicability of Code Sec. 707(b)(2)(A).

Why is the line of percentage demarcation drawn where it is, in various operative Code sections and Treasury regulations? Why is “50 percent” used in some places, while numerous other percentages (ranging from one percent to 90 percent) are used in other places? If the underlying theme is to identify when a partnership is “related” or “unrelated” to one or more of its partners, why are there any—much less so many—differing standards? Should the percentage be made uniform?

If the concern is whether a partner has influence over the partnership so that it should be deemed a “controlled partnership,” so as to avoid potential collusive tax planning (e.g., the recognition of losses, while the...
economic ownership of the property remains in a controlled entity, as in Code Sec. 707(b), that concern permeates many operative provisions. Therefore, one would think that a more uniform percentage test would apply to all such sections of the Code and regulations. What percentage would be appropriate? This depends in part on how much ownership constitutes “control.”

Assuming a “controlled partnership” is one in which the partner has a very substantial ownership interest, the question becomes one of line-drawing. For this purpose, either a “50 percent or more” ownership test or, better yet, a “more than 50 percent” ownership interest in the partnership, seems to meet a common sense approach to what a “controlling” interest would be.

Phillip defends the lack of uniformity that exists throughout the Code and regulations with respect to the percentage of relatedness and to the different permutations of thresholds found in the Code and regulations (as reflected in our Appendix III). Speaking to the issue of consistency in the percentage of relatedness, Phillip reminds us of the issue discussed for the past decade of whether a uniform definition of a “child” for purposes of the Code and Regulations should be developed. Observing that more than 40 or 50 definitions of a “child” exist throughout the Code and Regulations, Phillip nonetheless defends the variety. He states that it is logical to assume that each time the definition presented itself to the tax writing machinery, policy reasons entered into the determination of whether to employ an existing definition of a “child” or to utilize a variation thereof. Thus, Philip cautions that it may be inappropriate to conclude that there was not method to the madness of selecting significant variations in the standards employed. In the context in which the provision is to operate, Philip states that such precision was deemed appropriate by Congress, the Treasury or the IRS in formulating the standard (Philip claims) was a conscious decision. He then analogizes to the measurement of PIPP and PIPC, stating that the fact that the percentage of relatedness may vary in the Code and Regulations also should not be surprising.

Based on the anecdotal experiences relating to Reg. §1.706-1(b)(4) (for which we owe a debt of gratitude to Deborah Harrington for both her participation in the project and her revelation of how the “relatedness” provisions of the regulation evolved), and other anecdotal evidence, we do not agree with Phillip that it is logical to assume that each time the definitions of PIPP and PIPC presented themselves to the tax-writing machinery, policy reasons entered into the determination of what standard to use. Rather, 11th-hour pressures and fatigue more likely set in, and there certainly is no single “method to the madness” that can possibly justify the nearly 60 variations identified in Appendix III to this article. Nonetheless, we agree with Philip’s conclusion that historically, there has been a move to a “more than 50 percent” standard where there is a search for control.

Coincidentally, 11 days after our presentation at the Tax Conference, that harbinger of cutting edge tax law developments—the Maine Bureau of Revenue Services—proposed changes to its rules, to better measure the meaning of a “controlling interest” in partnerships, corporations and other entities. By way of background, in 2002 Maine enacted amendatory legislation whereby the transfer or acquisition within any 12-month period of a direct or indirect controlling interest in any entity with a fee interest in real property located in Maine for which a deed is not given is subject to Maine’s real estate transfer tax. The State Tax Assessor’s construction of the pre-2002 law interpreted the meaning of “controlling interest” as being, in the case of a partnership (or other non-corporate entity) “50 percent or more of the capital, profits, or beneficial interest in such partnership ... or other entity.” (Emphasis added.) Thus, a 50-percent ownership interest was a controlling interest, even if another partner owned the remaining 50 percent.

On November 22, 2006, the State Tax Assessor’s construction of Maine Law applying the real estate transfer tax to the transfer or acquisition of a “controlling interest” was proposed for revision. The Assessor proposed that a “controlling interest” be changed to be “more than 50 percent” of the capital, profits or beneficial interest in such partnership or other non-corporate entity. Thus, a transfer of a partnership interest by one of two equal partners would not trigger a real estate transfer tax. Had someone concluded that a “controlling interest” was not the equivalent of a “equal” interest in a two-person venture?

Maine’s rule change was in response to 2002 legislation that changed the definition of controlling interest from “either 50 percent or more” to “more than 50 percent.” Your author inquired of the drafter of the Maine proposed rule change, who responded that she had futilely searched the legislative history to the statutory change, in hopes of finding why the (50 percent) standard was originally selected and more relevantly, why the change to “more than 50 percent” occurred. Her unsuccessful experience mirrors that of your author, in futilely searching the legislative history to a number of the Subchapter K provisions dealing with capital and profits interests.
VII. The Corporate Analogs for Defining “Relatedness”

The concepts of “relatedness” contained in the Code are by no means limited to partnerships and partners. Indeed, “relatedness” has long been embedded in the Code with respect to the measurement of a shareholder’s corporate stock ownership. Does the corporation/shareholder analogue provide us with any useful analysis or benchmarks in our thinking about “relatedness” amongst partnerships and partners? Are the methodologies used in measuring corporate “relatedness” (in comparison to those used for PIPP and PIPC) different but good, different but bad or just “different”?

In the corporate context, the concept of “relatedness” has not been used as a standard “x percent” of the capital and profits interests of the corporation. Although the terms “capital and profits interests” are prevalent in the world of unincorporated entities, they do not adequately describe the ownership interests of a corporation. Stated simply, stock is not discussed as having a “capital” component and “profits” component.

Nonetheless, the economic bundle of rights that comprise the ownership interests of a partnership and a corporation have much in common. The ALI Subchapter K Project, in its proposals on measurement of a partner’s percentage interests in a partnership, identified seven (nonexclusive) factors that can make a partnership interest valuable:

- The partner’s share in the initial contributions
- The partner’s rights in a liquidation
- The partner’s right to share in (or suffer from) any unrealized appreciation or depreciation in the value of partnership assets in comparison to book or tax basis
- The partner’s rights to share in current profits
- The partner’s right to current payments from the partnership other than out of profits
- The partner’s right to any future payment other than out of profits
- The partner’s rights in each category of potential profit if such a profit is earned

The ALI Project identified the first two items as being “capital” in flavor, and the last four items as all having a “profits” flavor. (The third item, unrealized appreciation or depreciation, was capable of being categorized as either capital or profits, depending on the facts.)

Similarly, most if not all of these factors can make a shareholder’s interest in a corporation valuable. Thus, it does not appear that the economic bundle of rights inherent in a partner’s interest are substantially different from those of a shareholder’s interest. To paraphrase Phil’s title, if we do “DNA Testing for Subchapter K” and also do so for Subchapter C, we find many more common than uncommon characteristics.

One might conclude that since these are valuable rights inherent in both partnership and stock ownership interests, the measurement of valuation of stock and partnership interests would be a tool that, if viable (i.e., tried, tested and true) in the context of shareholder/corporation “relatedness,” could also be meritorious in the partner/partnership realm of “relatedness.”

In the corporate context, there are numerous examples involving measurement of shareholder/corporation relatedness based on the value of the shareholder’s stock. The valuation standard has been widely adopted in Subchapter C and elsewhere notwithstanding the well-known fact that the vast majority of corporations are not publicly traded (much less actively traded) sufficient to establish true and accurate daily valuations of the shares of all classes of a corporation’s outstanding stock. Thus, for purposes of shareholder/corporation relatedness, one must conclude that illiquid, untraded shares of stock can and at various requisite times must be valued. Moreover, for federal transfer tax purposes, following gifts and deaths, such illiquid and untraded stock must be valued, typically on dates (when gifts are made or deaths occur or on alternative estate tax return valuation dates) that do not coincide with the date on which the corporation’s fiscal year ends, i.e., such valuations often must be done at times for which no audited accounting data or appraisal information exists.

To date, the drafters of the Code and regulations have not utilized a “valuation of partnership interests” standard as to the pass-through entity analog to corporate stock relatedness, at least in those provisions that simultaneously address both shareholder and partner “relatedness” tests. Thus, in determining whether a corporation and a partnership are “related” for purposes of Code Sec. 267(b)(10), the Code looks to see if the same persons own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership. Wouldn’t it have been just as easy for the drafters to see if the same persons owned more than 50 percent in value of the interests in the partnership? Clearly. Yet that was not the test adopted. Does anyone know why? (That is not a rhetorical question.) Just wondering.

Similarly, for purposes of Code Sec. 1239(c)(1), which creates the bright line for determining when gain recog-
nized on the sale or exchange of depreciable property held by certain related persons shall be treated as ordinary income, Congress chose not to adopt an approach requiring valuation of both the stock and partnership interests to identify controlled entities that would be treated as “related persons.” Rather, Congress adopted the same double standard as in Code Sec. 267(b)(10).

In contrast, our informal, nonscientific and nonexhauitive analysis revealed not one “related person” provision involving stockholders and partners, respectively, that both turn solely on the value of the interests being tested.

The above leads to the observation that, for purposes of determining “relatedness,” Congress has not chosen to link as parallel measuring sticks the valuation of stock with the valuation of partnership interests. One can speculate on the reasons why; they don’t seem to be enunciated in any legislative history or other written explanations that we have encountered in preparing this article (or in the last 32 years of practice, your author adds anecdotally).

In addition to valuation of stock, an alternative measurement stick for determining “relatedness” found in the corporate/shareholder arena is voting power. Numerous Code sections look to a threshold of voting power in the corporation as being the sole indicator of “relatedness”—regardless of how small the value or percentage of economic rights owned by the shareholder. A standard based on voting control is understandable and at first glance seems relatively simple to compute. (As often is the case, the devil lies in the details; that devil is beyond the scope of this article.)

Our focus again is on whether the measurement tool used in the corporate analog (this time, looking at “voting power”) should be emulated for purposes of measuring relatedness in the partnership context. And once again, it becomes evident that Congress, the Treasury and the IRS have not used “voting power” as the parallel measuring stick. For example, take Code Sec. 163(j)(6)(D)(ii), whereunder the so-called interest stripping rules may disallow the interest deduction where there is a disqualified guarantee of such indebtedness. Such disallowance does not include a guarantee if, e.g., the taxpayer owns a controlling interest in the guarantor. With respect to corporations, a “controlling interest” means ownership of at least 80 percent of the total voting power and value of all classes of stock. With respect to partnerships, a “controlling interest” means ownership of at least 80 percent of the profits and capital interests of the entity. Thus, the voting power of the partners is not relevant under Code Sec. 163(j)(6)(D)(ii), but the voting power of the corporate shareholders is. Similarly, in Code Sec. 2701(b)(2), “control” means (1) in the case of a corporation, ownership of stock possessing at least 50 percent of the total combined voting power or the value of all classes of stock, and (2) in the case of a partnership, ownership of at least 50 percent of the profits or capital interests of the entity.

Again, the voting power of the partners is not relevant, but the voting power of the shareholders is.

Three other Code provisions that we have identified, i.e., Code Secs. 501(q)(1)(E), 954(d)(3) and 4943(c), use the shareholder’s voting power in measuring relatedness, but fail to use the partner’s voting power as the operative measurement tool in the partnership context. Code Sec. 4943, which imposes an excise tax on a private foundation’s excess business holdings in a business enterprise, is unique in its “disconnect” for purposes of measuring “relatedness” with respect to corporate stock and partnership interests, respectively. In summary, Code Sec. 4943(c) aligns a percentage voting stock threshold with the same percentage profits interest (PIPP) threshold, while aligning a percentage nonvoting stock threshold with the same percentage capital interest (PIPC) threshold. Again, Congress is not applying the corporate analog (or voting power) in the context of determining partner/partnership relatedness. There clearly is a pattern here: Congress has not equated either valuation or voting power of shareholder stock with valuation or voting power, respectively, of partnership interests.

In conclusion, the concepts of measuring “relatedness” with respect to shareholders and their corporations do not seem to be a model of consistency or logic themselves. Appendix V illustrates some of the variations arising in Subchapter C and elsewhere. Rather than being a model to be emulated in measuring PIPP and PIPC, the shareholder-corporation measurement of “relatedness” itself appears in need of simplification and reform. Philip’s comments regarding the transmogrification of Subchapter K are clearly correct here—incorporation of Subchapter C concepts into the measurement of PIPP and PIPC is a bad idea.

**VIII. Alternative Approaches to “Relatedness” for Partnerships and Partners**

Some operative Code provisions turn on the valuation of a partner’s interest in the partnership. However, in at least one situation a circular definition results: for purposes of Reg. §1.904-5(i), (h)(1) and (h)(2), a part-
ner is considered as owning 10 percent (or 50 percent, or more than 50 percent, respectively) “of the value” of a partnership if the partner owns 10 percent (or 50 percent, or more than 50 percent respectively) of the capital and profits interests of the partnership.  

To be sure, there are conceptual and administrative problems in using value as the means for determining relatedness between partners and their partnerships. In a publicly traded partnership (akin to a publicly traded corporation), the “Wall Street” pricing of the partnership interests (looking at the interests’ current trading price, on a going concern basis) may be substantially different from the amount each partner would receive under a liquidation approach (i.e., if the partnership were to sell all its assets for fair market value and distribute them to the partners in accordance with the partnership agreement) on the measurement date. Substantial valuation differences may also arise with respect to interests owned in non–publicly traded partnerships. Neither the value of the interests themselves nor the value of the assets owned by the partnership are easily determinable, as a general rule; however, in the non–publicly traded sector there are further complications arising from minority and marketability discounts and other factors. These discounts apply to illiquid stock, as well, and again, when essential to do so, a rough approximation of the value of the stock usually can be accomplished. Yet no commentator to date (including Philip and his co-authors) has championed the valuation of partnership interests as a desirable or viable method of determining relatedness (nor did the ALI Project’s report). One would presume that the administrative burdens of such valuations remain a major concern, which Philip shares.

Nonetheless, it would be conceptually wrong to dismiss valuation of a partner’s interest in a partnership solely because of administrative concerns. As stated in Mark IV Pictures, “the value of the capital interests is determinable,” and the Court found a methodology for valuating compensatory capital interests that were received at the time the partnership was formed. Similarly, the courts have, on rare occasion, valued compensatory profits interests.

Moreover, in a noncompensatory context the valuation of capital interests arises for both gift and estate tax purposes. Taxpayers, the IRS and the courts generally have each come up with “determinable” valuation approaches in such cases.

Should managerial control over the partnership be the standard for determining whether a partner and his controlled partnership should be subject to special restrictions under the tax laws? If the concern underlying “relatedness” is manipulation or collusion for tax purposes by a partner and his controlled partnership, “control” can be defined other than by reference to PIPP, PIPC or the relative value of the partners’ interests. For example, “control” could focus on whether the partner had voting power sufficient to cause the partnership to submit to the partner’s desires, e.g., to purchase property that would generate a taxable loss for the partner. However, in traditional partnership settings, the controlling partner would be subject to fiduciary duties to the other partners, and thus would be subject to potential litigation from his partners if he were to utilize partnership assets for his own benefit (e.g., to fund the sale of the partner’s unwanted, high-basis, low-value assets to the partnership for cash, where the partnership has little or no use for the assets). Such fiduciary duty would apply regardless of the size of the partner’s ownership interest in the partnership. Although modern partnership and LLC statues permit fiduciary duties to be reduced or eliminated in substantial part in many states, merely having voting control of the enterprise should not be the measurement stick.

If neither valuation of partnership interests nor voting control are viable alternatives, are there other proposals? Philip recommends a PIPP-based variation on the approaches described earlier in this paper, which we address below in our “Conclusions” to avoid repetition.

**IX. Conclusions**

If one practices in Subchapter K (where your author has toiled since 1974) to even a limited extent, one likely will come across the need to determine a client’s interest in partnership profits and/or capital at some juncture. For your author, the meaning and measurement of PIPP and PIPC have long been uncertain and, in many cases, perplexing. (This article may provide some evidence that our confusion and apoplexy were not without cause.)

Somehow, somewhere along the Subchapter K highway, your author managed to amass many misconceptions about PIPP and PIPC. Here are just a few of the gross misconceptions I had before delving more deeply into this topic:

- The definition of what is PIPP or PIPC is primarily a Subchapter K problem; it has little relevance outside of Code Secs. 701 through 775.
- You can count on your fingers and toes the number of Code or regulations provisions that require measurement of PIPP or PIPC.
The IRS and the Treasury have internally wrestled with measurement of PIPP and PIPC, and there is some general institutional understanding of how to apply it other than in just a “straight-up,” vanilla partnership setting; to avoid potential gaming of the system, the government just hasn’t gotten around to telling any of us where those boundaries are! 107

There must be more than two articles since the advent of the 1954 Code that have attempted to analyze and synthesize this topic on a big picture, multi-dimensional basis.

Philip Postlewaite had all the answers in 1986, so he’ll certainly have all of the answers in 2006 when we do our panel!

Silly me!

There is a paucity of guidance (legislative, administrative or judicial) as to the meaning of the terms using a partner’s interest in partnership profits (PIPP) and partner’s interest in partnership capital (PIPC) for federal tax law purposes. These terms emerged long ago (i.e., 1954, if not earlier) as a way to measure “relatedness” in the partnership tax area. They are very difficult to administer in a world that does not have “straight up” (i.e., “vertical slice”) allocations of capital and profits. Moreover, as described herein, what little guidance exists is not consistent.

That scant guidance that does exist is almost always limited to the operative Code provision or regulation in question. This may be due in part because Congress has not provided uniformity in defining the terms, and in part from the administrative viewpoint, there does not seem to have been an appetite to undertake a Code-wide (or even Subchapter K-wide) approach to the meaning of these terms (as that presumably would require the Treasury and every IRS branch or group potentially affected by the definitions to sign off on the uniform definition).

It is fair to ask why to date the measurement of PIPP and PIPC has received so little attention from Congress, the IRS and the Treasury, and the courts. There is no one overriding reason, but several factors come to mind. First, from the Congressional viewpoint, there has been no hue and cry for reform, clarification or simplification, other than the input from the ALI’s Subchapter K Project 25 years ago. In today’s world of revenue-scoring, there is nothing compelling about technical clarification of PIPP and PIPC.

From the viewpoint of the Treasury and the IRS National Office, there reportedly has been no institutional groundswell to tackle the question. One might speculate that the groups and branches not having primary responsibility for Subchapter K assume that those having such responsibility (e.g., the pass-throughs and special industries group) have amassed institutional knowledge (or lore) that they would apply, should interpretative measurement issues arise. Our informal discussions with several current and former high-ranking IRS and Treasury officials with Subchapter K responsibility and expertise indicate there is no institutional lore or unpublished guidance. Those officials informed us that issues as to measurement of PIPP or PIPC have rarely (if ever) come across their desks.

Why, then, have the PIPP and PIPC measurement issues not come under focus at the Treasury and the IRS National Office level? First and foremost, it apparently is not being raised on audit, in technical advice, or in letter ruling requests. Second, there has been no across-the-board (or even across–Subchapter K) initiative by practitioners to obtain broad guidance (the ALI Project being the sole exception). Requests for guidance irregularly have arisen from practitioners, bar associations and accounting groups with respect to a particular Code or regulation provision, but not for a broad-based or Code-wide project.

This, in turn, raises the question of why neither practitioners nor IRS field agents are seeking guidance on PIPP and PIPC issues. It should be remembered that guidance is only necessary where the answer is not clear. After eliminating “straight up” partnerships, there are still huge numbers of partnerships where the issue potentially lurks. However, if the operative Code or regulation provision has a threshold of (say) 50 percent, and the universe of potentially applicable measurement alternatives all would result in being below (or above) the 50 percent threshold, then there is no need to seek guidance.

Even if guidance is appropriate, there may be little audit activity arising inside or outside Subchapter K on these issues. There is no IRS initiative on the measurement of PIPP and PIPC (nor is one called for). Similarly, tax return preparers and tax advisors are not clamoring for guidance. Perhaps the question is below most everyone’s radar—and has been for 52 years, with the exception of certain “hot buttons,” e.g., Code Sec. 708(b) terminations and mergers, and Code Sec. 707(b)(1) and (b)(2) transactions.

If our speculations are correct, then it is understandable that measurement issues do not make it to court. No reported case (known to us) has arisen in the last 30 years (since Hill, Farrer). That is strong evidence that PIPP and PIPC measurement uncertainties are not generating numerous tax controversies.
One can speculate that sophisticated tax advisors who are aware of the operative Code and regulatory provisions listed in Appendices I and II are attempting to plan around potential problems where possible, and often they take the conservative “lowest common denominator” approach in advising clients when they can’t plan around their measurement problems. Un-sophisticated advisors and blissfully ignorant return preparers may be missing the issue.

If no one asks for guidance, no one will get it. If no one needs guidance, no one will ask for it.

Earthquake scientists say it’s not a question of whether California will get hit with The Big One, it’s a question of when. With the proliferation of PIPP and PIPC references in the Code and regulations—particularly with the ever-increasing derivative inclusions of Code Sec. 707(b)—the question is not whether taxpayers and IRS auditors will need PIPP and PIPC guidance, it’s again a question of when. In fairness to the government, there has been no seismic activity since the Hill, Farrer case to indicate that PIPP and PIPC measurement matters are even registering on the tax law equivalent of the seismograph.

It is possible that the general lack of detailed guidance in the allocation provisions discussed above reflects an acknowledgement, on the part of numerous drafters of statutory and regulatory provisions over the years, that there are no simple measurement rules that can provide an intuitively correct answer for every conceivable partnership arrangement (or even every reasonably common partnership agreement) that may arise. The drafters may have concluded that it is preferable for taxpayers and the IRS to resolve the more complex matters that are as administrable and predictable in their application as possible, while remaining consistent with the underlying purposes of measuring PIPP and PIPC.

One should be cautious in requesting guidance: we remember the old adage, “be careful what you ask for—you might get it.” If the measurement of PIPP or PIPC will require the IRS, taxpayers and ultimately the Courts to divine Congressional concerns or policies underlying the operative Code and regulations provisions that employ PIPP or PIPC standards, it is quite possible that there will be no agreement as to what those concerns or policies are, or how they should be applied. Hill, Farrer illustrates the substantially different interpretations by the majority and dissenting judges, respectively, as to the Congressional concerns and policies relevant in determining who is an “owner-employee” for purposes of Code Sec. 401. Moreover, the approach taken by the majority (and affirmed per curiam by the Ninth Circuit) in Hill, Farrer has the result of retroactively disqualifying a retirement plan after profits are determined and allocated at the end of the year—an inequitable result that conceivably might have led to the firm’s termination of the firm’s retirement plan, which in turn could harm all of the plan’s participants and not merely the partners deemed (in hindsight) to be owner-employees for the years in question. The minority opinion identified as a matter of policy the inappropriateness of waiting until year end to make the determination, for purposes of the PIPP measurement at hand, and the need for certainty for a viable, functioning profit-sharing plan.

A much more enlightened approach was taken by the Treasury and the IRS in Reg. §1.706-1(b)(4). There, a “front-end” methodology of estimating PIPP (and PIPC) on the first day of the partnership’s tax year was adopted by the government “to give the partnership early knowledge of its required tax year so that it can plan its affairs accordingly.” In the absence of abusive tax planning, there is much to be said for providing partners and their partnerships with “simplicity, flexibility, and equity,” which was clearly Congress’s intent in enacting Subchapter K.

Philip’s article focuses on the proper temporal approach to measuring PIPP. Philip states that the determination of a partner’s profits interest where the partnership agreement provides for different allocations and/or for differing types of income is an easily administered concept if the determination of the profits interest is limited to the events of the year under scrutiny. He observes that difficulty arises only when one looks into the future and attempts to access such standards based on contingent and speculative events. Philip acknowledges, admittedly with the benefit of hindsight, that this was the biggest mistake made by the ALI Study and by Philip in his response thereto. Both the ALI and Philip considered the test to be forward looking, attempting to take contingencies and uncertainties into account, rather than viewing the test as an annual snapshot at year end, looking back at the profits actually generated, at which time a “certain and sure” determination can be made.

Philip submits that if the determination is limited to the current year and is made at the end of the year, one can accumulate the various categories of income and easily determine what percentage of the overall
identifying partners’ interests in profits and capital

Profits has been earned by a particular partner. He states that a year-end approach allows for a snapshot picture of where one stands—akin to the administration of a DNA Test. Year-end results are in place and measurable; in contrast, speculative items with regard to future allocations are still uncertain. Professor Postlewaite postulates that such an approach would be in keeping with much of the treatment of Subchapter K, which tests distributions and availability of the flow-through of losses at year end.  

In my categorization of 25 potential approaches to measuring PIPP, I have come to realize that many of these approaches are forward-looking; others are current year snapshots; and still others are ambiguous as to whether they would be applied only with respect to the current year, or with respect to the current year and a forward look to all years. Indeed, the question of when should PIPP and PIPC be measured, as raised in Part IV above, establishes that a number of approaches can be utilized, and some are more appropriate for certain operative Code and regulation provisions than others. Philip has selected an approach (requiring end-of-the-year measurement) for determination of PIPP that has substantial merit.

Whether Philip’s proposal should be given uniform application as the solution for all purposes of the Code (or even for all purposes of Subchapter K’s provisions only) is a different matter. As the preamble to Reg. §1.706-1(b)(4) specifies, a front-end approach (rather than measurement of the year’s income on a retroactive basis) is preferred, as a matter of policy, for purposes of providing taxpayers with front-end predictability as to determining their partnerships’ tax years. Moreover, the harsh and inequitable result in Hill, Farmer—a case which is a poster child for using front-end allocations wherever possible so as to avoid the draconian disqualification of a profit-sharing plan, as there occurred retroactively—also supports a front-end measurement with respect to the current year’s anticipated profits, rather than measurement of the partners’ distributive shares of profits at the end of that year on a look-back basis.

We certainly agree with Philip’s observation regarding determining relatedness, i.e., that great confusion exists as to whether this is an event-specific determination, a year-end determination, or a determination that must take all future possible developments into account. However, a one-size-fits-all solution, such as Philip’s proposed DNA snapshot test, may be too extreme (albeit it clearly has its advantages).

It has been recognized by other commentators that it is administratively convenient to measure PIPP based on how current year profits are allocated. However, most taxpayers would likely conclude that this administrative convenience is outweighed if recognizing a change in PIPP percentages creates adverse tax consequences unsupported by the economic arrangement among the partners. For example, such a change in PIPP percentages could result in a change in the required tax year under Code Sec. 706(b) or a deemed distribution (in which gain might be recognized prematurely) under Code Sec. 752. If there is no material change in the partners’ underlying economic agreement, such a result is inappropriate.

This is another reason why a one-size-fits-all solution is not ideal. For example, if the partners have provided for a change in the profits ratio on the occurrence of a specified time or event, the commentators suggest that a partner’s PIPP percentage should reflect the manner in which the partners have agreed to share economic profits over the partnership term (i.e., a “look-forward” approach). When the partnership was formed, the partners made only one agreement as to the sharing of profits, and a previously bargained change in the profits ratio does not alter that basic agreement, according to the commentators. Thus, they contend it is unsound to suggest that a partner’s PIPP percentage differs before and after the event giving rise to the change in profits—the partners’ PIPP arguably should reflect the manner in which the partners have agreed to share economic profits over the partnership term.

Might a middle-of-the-road (“MOR”) approach be adopted? Perhaps one viable solution would be for the IRS and the Treasury to issue a regulation under Code Sec. 701 that lays out a general rule, with exceptions applicable both inside and outside Subchapter K. The general rule might be to adopt a year-end measurement approach (e.g., Philip’s DNA Testing approach), which would be subject to explicit exceptions to the contrary contained in Code and regulations provisions. Under this MOR approach, one exception would be that contained in Reg. §1.706-1(b)(4), which calls for a forward-looking approach. (That exception is easy, because the Regulation is already in place.) Another potential exception could be made for those provisions that determine a partner’s share of profits as being based on the highest item of income that may occur during the life of the partnership. Such a measurement of PIPP by definition cannot be limited to the current year’s profits share among the partners, but rather must take a forward-looking approach.

Our proposed MOR approach effectively would put the burden on the IRS and the Treasury to identify the relevant exceptions. Taxpayers would be far less likely
to be subject to the infirmities of the courts in attempting to determine the meaning or measurement of PIPP by attempting to divine Congressional concerns or policies. Focusing on the *Hill, Farrer* decision, would the case be decided differently under an MOR approach? Recollect that the applicable regulation (Reg. §1.401-10(d)) provides in relevant part that “in the absence of any provision regarding the sharing of profits, the interest in profits of the partners will be determined in the same manner as their distributive share of income.” Where the agreement provides for the sharing of profits, including a specified formula based in part on factors such as future operations or profitability, a front-end measurement approach would be used. As the taxpayers in *Hill, Farrer* contended, no partner there “owned” a 10-percent interest in partnership profits, as there was no provision regarding the sharing of profits that entitled any partner to such percentage. On the other hand, in the absence of a provision regarding the sharing of profits in the partnership agreement, Reg. §1.401-10(d) requires the partners’ interest in profits to be determined in the same manner as their distributive shares of income. As Philip observes,

In conclusion, our proposed MOR approach—using a general definition to be applicable both inside and outside of Subchapter K with respect to the measurement of PIPP (and PIPC)—should provide a greater level of certainty and administrability, by looking at the end-of-the-year results. (Whether the end of the year results are based on book profits, taxable net profits; taxable net profits exclusive of Code Sec. 704(c) built-in gains and losses; or other alternatives would need to be clarified, as part of the project.)

The MOR approach could be initially limited to a regulation under Code Sec. 701 that applies solely for purposes of measurement of PIPP and PIPC in Subchapter K itself, *i.e.*, Code Secs. 701 through 775. By so limiting the proposed provision, the bureaucratic nightmare of having all IRS and the Treasury groups involved with the various aspects of the Code is reduced. As the IRS’s and the Treasury’s proposed compensatory options and interests for services project (Proposed Reg. §1.83-3) illustrates, having merely two different teams (*i.e.*, the Subchapter K and the government entities/exempt organizations groups) involved in an area of mutual interest (*i.e.*, “shared turf”) has led to an odd duck that (as of the date this article was prepared) has remained in proposed regulation status, most likely because of the collision between Subchapter K and just one provision (Code Sec. 83) outside of Subchapter K. To bring multiple branches of regulations writers into the PIPP and PIPC measurement controversy well might lead to more strange tongues speaking than at the Tower of Babel.

On the other hand, an MOR approach that applies to Subchapter K would, by definition, incorporate Code Sec. 707(b), and thereby set the ground rules for the 160 Code and regulations provisions that incorporate Code Sec. 707(b) into their measurements of “relatedness.” Code Sec. 707(b) measurements clearly should be solely in the domain of the Subchapter K experts; moreover, one can’t help but conclude, after dealing with this topic, that other groups would happily continue to “punt” on the measurement of PIPP and PIPC, and gladly defer to the Subchapter K mavens to deal with this quagmire.

Why have references to (and thus the potential need for measurement of) PIPP and PIPC proliferated outside of Subchapter K, in both the Code and (even more predominantly) in regulations? Informal discussions with a few high-ranking IRS and Treasury officials indicate that the inclusion of Code Sec. 707(b) into myriad regulations typically arises towards the end of the drafting process. At that time, the proverbial light bulb goes off, with the recognition that “relatedness” rules under Code Secs. 267 and 707(b) are needed to avoid an end run on the policy objectives inherent in the regulation at hand. Indeed, this 11th-hour scenario helps explain why there exist several variants or permutations of the language introducing Code Sec. 707(b) into the operative regulation: the draftsperson may grab the last (perhaps totally unrelated) reg project in which he or she hastily drafted a Code Sec. 707(b) reference, and slap that same verbiage into the new regulation before shipping it off!

Philip takes issue with those approaches (including the approach to Code Sec. 706(b) by the Treasury and the IRS) which, by definition, failed to take losses into account. He recognizes that the enumeration of interests only in capital and profits in the statutes addressing relatedness suggests a conscious decision by Congress to ignore losses as well. However, Philip states that the search in some cases is for the degree of identity to serve as a measure for self-dealing, in which case it is arguable that losses should be taken into account. For example, Philip suggests that the relatedness of a partner to a partnership who has a 60-percent interest in profits and a 30-percent interest in losses is clearly in a different position from that
of a partner having a 60-percent interest in profits and an 80-percent interest in losses.\textsuperscript{1}20

That is true. However, it is difficult, as a matter of policy, to conclude that a partner who must bear a large amount of losses therefore is in “control” of the partnership. Rather, it may merely signify that that partner has a disproportionate amount of capital invested in the partnership, in which case Code Sec. 704(b) principles would mandate allocation of disproportionate losses to such partner, absent a special arrangement among the partners. Philip argues that PIPC should not be relevant in determining “relatedness,” yet it is a partner’s capital that generally bears the first risk of loss. Philip’s suggestion that a partner’s overall interest in profits could be adjusted for losses\textsuperscript{321} seems misplaced.

Moreover, if the underlying concept of “relatedness” is control of the partnership by a partner, the partners likely to have “control” are those who have the largest economic upside potential (whether measured in profits, capital, or both). Additionally, those who are allocated the largest portion of losses are likely to be allocated the largest gains, as well, as parties dealing at arm’s length normally demand obtaining returns (profits) commensurate with their risks (losses).

A final observation: This article has analyzed the corporate analogs for defining “relatedness,”\textsuperscript{322} and found that the concepts of PIPP and PIPC are not translatable into (or applied in) the shareholder/corporation relatedness tests. The latter typically look to voting power or value of stock in defining relatedness; in contrast, partner/partnership provisions rarely look to voting power or value. As a matter of policy, is it desirable to obtain similar results in the corporate and partnership areas where there is no basic reason for a difference? Or is there more than merely an historical evolution for the shareholder and partner relatedness tests going down different paths, much like the evolution of homo sapiens and neanderthals (i.e., seemingly alike but substantively, quite different!).\textsuperscript{321} We agree with Philip that this is another area in which the transmogrification of Subchapter K is not desirable.\textsuperscript{324}

Your author commends the members of the ALI Subchapter K Project for attempting to flesh out the meaning and measurement of PIPP and PIPC, as published in Part M of the ALI Project.\textsuperscript{325} Ultimately, the ALI’s recommendations were not implemented, and they do not today receive the endorsement of this author or my co-presenters. Nonetheless, they yeoman effort provides a detailed analysis and the first serious thinking on the PIPP/PIPC topic on a Code-wide basis.

I also commend Philip for undertaking a review of his earlier work, facing himself in the mirror and correcting some of his “youthful errors in judgment,” to use his phrase.\textsuperscript{326} His good-natured approach to retreading the road he walked 20 years ago is both admired and appreciated. His contribution to the thinking on this topic, both then and now, cannot be undervalued.

For those who have read this article in its entirety,\textsuperscript{327} it is apparent that this article is long (very long!) on raising issues, identifying problems, and pondering the strengths and weaknesses of alternative approaches to measuring PIPP and PIPC; and very short on suggesting sure-shot solutions. The “Hemingway of Subchapter K,” in his accompanying article, has submitted a series of solutions. We recognize that a quick resolution is not at hand, but we are hopeful that our readers (and those in the government who can effectuate resolution of these problems) will find our articles to be helpful in thinking about the problems and potential resolutions.

\textbf{ENDNOTES}

\textsuperscript{1} The author acknowledges the thoughtful insights provided by Deborah Harrington and Professor Philip Postlewaite, his University of Chicago Law School Tax Conference Commentators on this topic, and Adam C. Cohen and Steven R. Schneider. The author also thanks Adam for his compilation of Appendix II (which proved to be far more extensive than either of us had imagined). The author’s particular comments about Professor Postlewaite (“The Hemingway of Subchapter K”) can be found in the text at the end of the “Overview.” The views stated herein (and all omissions and errata) are solely those of the author.

\textsuperscript{2} Unless the context requires to the contrary, references in this article to “partnerships” include all domestic entities taxable as partnerships under Code Sec. 7701, e.g., limited and general partnerships, limited liability partnerships (LLPs) and multiple member limited liability companies (LLCs). References herein to “partners” include members of such passthrough entities.


\textsuperscript{4} See text accompanying notes 77, 189–190, 212 and 278, infra.

\textsuperscript{5} For example, where a person wants to recognize an economic loss but does not wish to give up economic control of the property. By selling the asset to his controlled partnership, he would recognize a taxable loss, but would still retain control of the property.

\textsuperscript{6} A sale by a person of appreciated depreciable property to his controlled partnership could generate a capital gain, and the subsequent ordinary income generated from operation of the property would be proportionately reduced by the depreciation deduction.


\textsuperscript{8} Anderson and Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis

9 See, e.g., Reg. §1.7704-1(a)(2)(ii)(A) (for purposes of Code Sec. 7704(b) and this regulation, an interest in a partnership includes “any interest in the capital or profits of the partnership (including the right to partnership distributions”).

10 E.g., Reg. §§1.152-1(d)(2)(iii), 1.864-16(d). Prior to amendments in 1986, Code Sec. 707(b)(2)(A) and (B) both utilized thresholds requiring “more than 80 percent” of PIPP and PICP.

11 E.g., Code Sec. 2057(e)(1)(B)(ii)(III) and (III)(ii).


13 See generally Part VI.E., “Simplification,” infra, and Appendix III.

14 E.g., Code Sec. 707(b)(1) and (2).

15 E.g., Code Sec. 708(b)(1)(B).

16 See Example 1, “Proportionate Ownership of Profits and Capital,” infra.


19 Your author has previously pontificated at this Tax Conference on the tax consequences of such non-vertically sliced partnership interests. See Sheldon I. Banoff, Mr. Popiel Pushes Partial Partnership Interests Through the Veg-O-Matic: You Can Slice ‘Em, You Can Dice ‘Em, But How Do You Tax ‘Em? 72 TAXES 833 (Dec. 1994).


21 I.e., Reg. §§1.704-1 through 1.704-4.

22 See Appendix III.

23 See text accompanying note 308, infra.

24 Cf. Reg. §1.6038-3(b)(2) and (3) (alternative tests stated as 50 percent and 10 percent, respectively, or more of PIPP, PICP or deductions or losses).


26 Reg. §301.7701-3(c)(1)(iv), relating to permission of the IRS for an existing entity to change its classification by election within 60 months if there has been a change of “more than 50 percent of the ownership interests” in the entity.

27 Under that section, stock of a corporation owned, directly or indirectly, by a partnership shall be considered as “owned proportionately” by its partners.

28 See Code Sec. 6046A(a)(3).

29 E.g., Code Secs. 267, 318, 544 and 1504. Attribution rules often have the effect of making a person the owner of stock for purposes of some other Code provision, or to make that person the owner of stock so that such stock can be reattributed to one or more other persons whose stock ownership is relevant for purposes of some other Code provision. For a catalogue of those attribution rule inconsistencies, as viewed long ago through the eyes of two young practitioners perplexed by that aspect of the Code’s incoherencies, see Fried and Banoff, How to Structure Related Party Deals so as to Avoid Denial of Tax Benefits, 22 TAX’N FOR ACCOUNTANTS 334 (June 1979). For an example of attribution rules causing a partner to have constructive ownership of PIPP and PICP, which in turn caused an excise tax under Section 4975 on a loan from a qualified defined pension plan to a partnership in which the plan fiduciaries held partnership interests, see Davis, DC Md., 93-2 USTC ¶50,492, 841 FSupp 696, affidavit per curiam, CA-4, 95-1 USTC ¶50,153, 46 F3d 1123.


32 This experience is humorously recounted in Postlewaite, The Transmogrification of Subchapter K, TAXES, Mar. 2005, at 189. My citation of three different Postlewaitean articles in three successive footnotes is a mere token of my gratitude to him.

33 Code Sec. 708(b)(1)(B). See Appendix I, 43.

34 Code Sec. 707(b)(1). See Appendix I, 39 and 40.

35 Code Sec. 761(c). See Appendix I, 50.

36 Code Sec. 706(b). See Appendix I, 36–38.

37 See Appendix I, 102.

38 See Appendix I, 66.

39 See Appendix I, 52.

40 See Appendix I, 77.

41 See Appendix I, 72.

42 See Appendix I, 19 and 20.

43 See Appendix I, 53 and 54.

44 See Appendix I, 33.

45 As to a proposal to use PIPP and PICP as the best way to determine the partners’ interest in the partnership for purposes of intercompany gain restoration with respect to Code Sec. 721 (capital contribution) transactions following intercompany sales, see Attorney says Gain Should Not Be Restored on Capital Contributions of Intercompany Gain Property to Partnerships, 37 HIGHLIGHTS & DOCUMENTS 1475 (Apr. 28, 1995) (letter from Terence Floyd Cuff to Glen A. Kohl, Tax Legislative Counsel). Mr. Cuff, a prior presenter at this Tax Conference, concluded that an arbitrary rule based on profits and loss percentage would be the best way to determine the partners’ interests in the partnership for this purpose.

46 California imposes on every LLC a graduated fee based on total annual income. If multiple LLCs are formed for the primary purpose of reducing fees, the LLCs’ total income from all sources could be aggregated to include all commonly controlled members. For this purpose, “commonly controlled” means “control of more than 50 percent of the capital interests or profits interests of the taxpayer [LLC] and any other LLC or partnership by the same persons.” Calif. 2005 Form 568 Booklet, Part F, “Limited Liability Company Tax and Fee,” at 4 (rev. 1/06).

47 For another example of the measurement of PIPP and PICP affecting state taxes, see notes 285–88, infra, and accompanying text (re: Maine real estate transfer tax).

48 See New York State Bar Association Tax Section Report No. 1105, Report on Proposed Amendments to Article 9-A Regulations Relating to the Taxation of Corporate Partners, Mar. 2, 2006. The Tax Section recommended that the New York State Department of Taxation and Finance reconvene the working group at a later time to address this (PICP) issue. Report, at 22.


50 Of course, state law definitions are not binding in determining the meaning of federal tax statutes, but they may define the legal (property) rights which in turn are subject to characterization for federal tax purposes. Cf. Estate of Bosché, SCI, 67-2 USTC ¶12,472, 387 US 456.

51 805 ILS 205/24.

52 805 ILS 205/26. This apparently has long been the statutory definition; in Rossmoor, CA-2, 35-1 USTC ¶9277, 76 F2d 520, Judge Learned Hand referred to New York Partnership Law §61, which declares that “a partner’s interest in the partnership is his share of the profits and the surplus.”

53 805 ILS 206/101(i).

54 805 ILS 206/401. The 1997 Act provides that the only transferable interest of a partnership is the partner’s share of the profits and losses of the partnership and the partner’s right to receive distributions. 805 ILS 206/502. This does not shed light on how the partner’s profits interest is defined or measured under state partnership law.

55 805 ILS 206/807.

56 805 ILS 210/210(10).

57 805 ILS 215/701.

58 805 ILS 215/504.

59 805 ILS 215/503.

60 805 ILS 215/702.
Delaware statutes are not helpful, either. See, e.g., Del. Uniform Partnership Law, Secs. 15-101(6), (15); 15-401.


Id. As the court recognized the assignment as a transfer of Evans’ entire (50 percent) interest in PIPP and PIPIC, it held (and the Seventh Circuit agreed) that the partnership terminated under Code Sec. 708(b)(1)(B).

Simons and Karrenbrock, ADVANCED ACCOUNTING—COMPREHENSIVE VOLUME (South-Western Publishing Co., 4th ed. 1968). Insofar as I obtained my accounting degree in 1971, never sat for the CPA exam and never looked back, this textbook remains authoritative, timely and the latest work on the topic, in my little world. (I could be wrong.) Can Philip use this bold statement, unsupported by any authority, to bootstrap his argument that losses should be taken into consideration in measuring one’s interest in profits? See text accompanying note 320, infra. Or at least it did in 1968.


Of course, this second item in turn covers a nearly infinite number of permutations. Does “partners’ capitals” mean their respective capital account balances or rather their respective capital contributions (perhaps net of withdrawals), if the two ratios differ? Simons and Karrenbrock, note 62, supra, at 12.

In fairness to Philip, who has long urged the repeal of Code Sec. 707(c) in whole or substantial part, I did not consult my dusty, musty, trusty treatise until a month after our Tax Conference Panel, and thus did not then provide him an opportunity for response. Philip’s position is that Code Sec. 707(c) guaranteed payments should be excluded from the computation of PIPP. Philip’s DNA Article, at 311.

WILLIS, note 47, supra ¶¶4.05–4.06. Although Postlewaite clearly is the current driving force (perchance due to his status as sole survivor) of the esteemed triumvirate, to date he has graciously retained third position in the line-up.

Reg. §1.704-1(e)(1). See generally WILLIS, supra note 47, chapter 2. Code Sec. 704(e)(1) provides that a person shall be recognized as a partner for purposes of this subtitle [the income tax provisions] if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. Rev. Proc. 93-27, 1993-2 CB 714.


If AB had elected to be a limited liability limited partnership (LLLP) under applicable state law, general partner A’s liability might not be unlimited. It is assumed for purposes of Example 2 that AB is not an LLLP. I.e., B, the limited partner, does not indemnify A for any losses and B does not have a capital account deficit restoration obligation as described in Reg. §1.704-1(b).

This is equal to A’s 2007 net income of $50,000. At allocation of all of AB’s 2007 net income of $50,000 to A, A will have a capital account of $0 (as will B, whose $100,000 capital contribution in 2006 was offset by $50 allocable share of 2006 losses of $100,000). That is as required by Reg. §1.704-1(b).

As we have stipulated that book and tax income are the same for 2006 and 2007, respectively, we do not here deal with the measurement of PIPP and PIPIC when book and tax differ. See, e.g., text accompanying note 138, infra. See text accompanying notes 120–21, infra. The AUL Project and the Postlewaite Article, note 17, supra, both employed long-term, forward-looking approaches.

This allocation comports with the AB Agreement’s distribution provisions, which requires A and B to receive aggregate distributions equal to their $200,000 aggregate capital contributions. I.e., $125,000/200,000 = 62.5 percent.


Steinberg, note 86, supra, at 568.

E.g., treating guaranteed payments under an entity approach for purposes of all such provisions (i.e., excluding them from the computation of PIPP) may better enable partnerships and their partners to determine, at the beginning of a transaction, whether or not the applicable PIPP threshold will be met. Steinberg, note 86, supra, at 568. If instead the aggregate approach is used (so that guaranteed payments are included in PIPP), such might result in partners qualifying for the exception in certain years but not others, depending on the particular results in each tax year, with qualification being generally undeterminable until the end of the relevant year. Id. WILLIS, note 47, supra §1.07(4), at 1–113. Accord: Steinberg, note 86, supra, at 568. For example, do guaranteed payments come into play in computing PIPP under Reg. §1.752-3(a)(3), dealing with the allocation of nonrecourse partnership liabilities? Compare Cui, Current Issues in Partnership Taxation, 49 NYU INST. FED. TAX’N, at §13.04(4)[a][iii], note 321 (1991) (stating that Code Sec. 707(c) applies to have no role in allocation of liabilities under Code Sec. 752), and Banoff, note 87, supra, at 852 (stating that “it is quite possible” that guaranteed payments should be included under Reg. §1.752-3(a)(3), which requires “all facts and circumstances relating to the economic arrangement of the partners” to be taken into account in determining PIPP).

Philip’s DNA Article, at 311 (Philip states, “There is already support for [the exclusion of guaranteed payments] from the determination of profits in the Regulations. Reg. §1.707-1(c) provides for the exclusion of such payments in the determination of a profits interest for purposes of three enumerated Code provisions [i.e., Code Secs. 706(b)(3), 707(b), and 708(b)].”) Philip implies that if guaranteed payments are properly excludable for those three purposes, why should they not be similarly treated for all purposes? I read Reg. §1.707-1(c) as supporting the opposite approach to that implication, i.e., there is support in the Regulations suggesting guaranteed payments should be included. (not “ignored”) in the determination of PIPP generally, except for Code Secs. 706(b)(3), 707(b) and 708(b).

Of course, if Parent owned 100 percent (rather than 90 percent) of A, A would be treated as a disregarded entity (absent a check-the-box election) and Parent would be deemed to own a 60-percent PIPP. Similarly, if A is a grantor trust and Parent is treated as the owner of the trust, Parent would be deemed to own a 60-percent PIPP. Such does not result from attribution, but rather from the tax laws’ rules of ownership.


Id.

E.g., a gift, a payment for services, a dividend or a capital contribution. Cf. Rev. Rul. 74-269, 1974-1 CB 87.

Reg. §1.46-3(i)(2).

That this adds up to 150 percent is neither mathematically incorrect nor surprising:
nothing in PIPP principles mandates a maximum aggregate percentage of only 100 percent.

In Example 11, the $5,000 preferred return is 25 percent of the year’s ($20,000) net income, which arguably is significant. If the preferred return was only five percent of AB’s net income, it presumably would be insignificant.

I.e., AB’s $3,000 preliminary net profit minus the $5,000 gross income allocation, equals a $2,000 net loss for the year.

I.e., when the principal balance on non-recourse debt is reduced, via use of rent or other operating revenues.

I.e., when the principal balance on non-recourse debt is reduced via use of sales proceeds from disposition of the property.

Per Examples 13 and 3.

Reg. §1.704-1(b)(4), Example 1(iii).

Reg. §1.704-2(m), Example 1(ii).

Reg. §1.704-2(m), Example 1(ii).

Reg. §1.706-1(b)(4)(ii)(A).

Reg. §1.706-1(b)(4)(ii)(B).

Reg. §1.706-1(b)(4)(ii)(C).

Reg. §1.706-1(b)(4)(ii)(D).

Reg. §1.46-3(f)(2)(i).

TAM 8931001 (Mar. 15, 1989).

Reg. §1.704-2(m), Example 1(ii).

Reg. §1.704-2(m), Example 1(ii).

Reg. §1.706-1(b)(4)(ii)(A).

Reg. §1.706-1(b)(4)(ii)(B).

Reg. §1.706-1(b)(4)(ii)(C).

Reg. §1.706-1(b)(4)(ii)(II).

Reg. §1.46-3(f)(2)(i).

Reg. §1.46-3(f)(2)(i).

Reg. §1.704-2(m), Example 1(ii).

Reg. §1.706-1(b)(4)(ii)(C).

Reg. §1.706-1(b)(4)(ii)(I).

Reg. §1.706-1(b)(4)(ii)(II).

Reg. §1.706-1(b)(4)(ii)(III).

Reg. §1.706-1(b)(4)(ii)(IV).

Reg. §1.706-1(b)(4)(ii)(V).

Reg. §1.706-1(b)(4)(ii)(VII).

Reg. §1.706-1(b)(4)(ii)(VIII).

Reg. §1.706-1(b)(4)(ii)(IX).

Reg. §1.706-1(b)(4)(ii)(X).

Reg. §1.706-1(b)(4)(ii)(XI).

Reg. §1.706-1(b)(4)(ii)(XII).


Reg. §1.706-1(b)(4)(ii)(XIV).

Reg. §1.706-1(b)(4)(ii)(XV).

Reg. §1.706-1(b)(4)(ii)(XVI).

Reg. §1.706-1(b)(4)(ii)(XVII).

Reg. §1.706-1(b)(4)(ii)(XVIII).

Reg. §1.706-1(b)(4)(ii)(XIX).

Reg. §1.706-1(b)(4)(ii)(XX).

Reg. §1.706-1(b)(4)(ii)(XXI).

Reg. §1.706-1(b)(4)(ii)(XXII).

Reg. §1.706-1(b)(4)(ii)(XXIII).


Reg. §1.706-1(b)(4)(ii)(XXV).

Reg. §1.706-1(b)(4)(ii)(XXVI).

Reg. §1.706-1(b)(4)(ii)(XXVII).

Reg. §1.706-1(b)(4)(ii)(XXVIII).

Reg. §1.706-1(b)(4)(ii)(XXIX).

Reg. §1.706-1(b)(4)(ii)(XXX).

Reg. §1.706-1(b)(4)(ii)(XXXI).

Reg. §1.706-1(b)(4)(ii)(XXXII).

Reg. §1.706-1(b)(4)(ii)(XXXIII).

Reg. §1.706-1(b)(4)(ii)(XXXIV).

Reg. §1.706-1(b)(4)(ii)(XXXV).

Reg. §1.706-1(b)(4)(ii)(XXXVI).

Reg. §1.706-1(b)(4)(ii)(XXXVII).

Reg. §1.706-1(b)(4)(ii)(XXXVIII).

Reg. §1.706-1(b)(4)(ii)(XXXIX).

Reg. §1.706-1(b)(4)(ii)(XL).

Reg. §1.706-1(b)(4)(ii)(XLI).

Reg. §1.706-1(b)(4)(ii)(XLII).

Reg. §1.706-1(b)(4)(ii)(XLIII).

Reg. §1.706-1(b)(4)(ii)(XLIV).

Reg. §1.706-1(b)(4)(ii)(XLV).

Reg. §1.706-1(b)(4)(ii)(XLVI).

Reg. §1.706-1(b)(4)(ii)(XLVII).

Reg. §1.706-1(b)(4)(ii)(XLVIII).

Reg. §1.706-1(b)(4)(ii)(XLIX).

Reg. §1.706-1(b)(4)(ii)(L).
In other words, C has obtained from A a
Preamble, Part D.3, note 113,
Reg. §1.706-1(b)(4)(iii).

The current year’s measure of profits and capital is the entire measurement exercise, if the answer to our first question is that (1) applies, i.e., we should take into account only the current year’s profits/current year’s events. Alternatively, the current year’s PIPP and PIPC computation is merely a component of the total profits/future events measurement, if the answer to our first question is that (2) applies, i.e., that we must include future years’ anticipated events, as well.

Our views of Philip’s “current year, lookback at the end of the year” solution are discussed in Part IX, “Conclusions,” infra.

Reg. §1.706-1(b)(4)(iii). Similarly, the determination of the tax year that results in the least aggregate deferral of income generally must be made as of the beginning of the partnership’s current year. Reg. §1.706-1(b)(3)(ii). A partnership using the least aggregate deferral computation does not take into account changes in the identities of partners after the first day of the partnership’s current tax year, unless the IRS determines that the partners engaged in a transaction that has as its principal purpose the manipulation of the partnership’s tax year. LTR 8907042 (Nov. 23, 1988).

Reg. §1.708-1(b).

Kemp, Dispositions of Partnership Interests: Termination of a Partnership, 718 Tax Mgmt. Portfolio (1993) at A-46. The most extreme case would be a sale of a partnership interest on January 1, 2006, with profits not being determined until April 15, 2007, pursuant to Reg. §1.761-1(c).

Reg. §301.6231(a)(2)-1(m)(2). For this purpose, the general partner with the largest profits interest is determined based on the year-end profits interest reported on the Schedules K-1 filed with the partnership income tax return for the tax year for which the determination is being made. Id.

Code Sec. 6231(d)(1)(A); Reg. §301.6231(d)(1)(b).

Special rules exist where the partner’s interest is terminated through several partial dispositions. See Reg. §301.6231(d)(1)(c).

Reg. §1.7704-1(k)(i)(ii). A partnership may use any reasonable convention in determining the interests that are outstanding for a month, provided the convention is consistently used. Reasonable conventions include a determination by reference to interests outstanding at the beginning of the month, on the 15th day of the month, or at the end of the month. Reg. §1.7704-1(k)(i)(iii).


E.g., by April 15 of the following calendar year, with respect to calendar year partnerships.


The discussion regarding the interim closing of the books method is dictum because the court found that the record did not indicate that Foxfire used the interim closing of the books method in 1982, and therefore would not be entitled to use the mid-month convention. The Tax Court also upheld the Commissioner’s assertion of the negligence penalty under Code Sec. 6653.

Reg. §1.708-1(b)(i).

E.g., Reg. §1.706-1(b)(3)(i). See LTR 8907042, note 177, supra.

Reg. §1.6046A-1(b)(3), (7), Example 3.

Reg. §1.6046A-1(b)(3).


Letter from Deloitte & Touche LLP, Washington, D.C. dated September 1, 2000, to IRS, available at 2000 TNT 198-42. Reporting is required if the reporting thresholds are breached with respect to any of these measures.

I.e., $11,000 sales proceeds minus $6,000 cost basis.

See Code Sec. 707(b)(1).

See, e.g., IR-2002-83 (June 28, 2002), Enhanced Schedule K-1 Compliance Efforts in Effect.


WILLIS, supra note 47, ¶ 10.06(2), at 10–110.

See text following note 127, supra.

Reg. §1.707-1(c) states that for purposes of the federal tax laws (other than Code Secs. 706(b)(3), 707(b) and 708(b)), a guaranteed payment is included in partner’s distributive share of partnership income.

LTR 8326024 (Mar. 24, 1983).

The attribution rules do not apply for purposes of determining whether a payment to a nonpartner that is the affiliate of a partner constitutes an income allocation to the partner; the separate existence of the entities should be respected, absent a sham or lack of any business purpose. Compare Moline Properties, Inc., SCT, 43-1 LUSC ¶9464, 319 US 436.

See, e.g., Hambuechen, 43 TC 90, Dec. 27,018 (1964).

A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partner to the partnership. Reg. §1.707-1(a).

See text accompanying notes 188–90, supra.

McKee, Nelson & Whitmore, note 95, supra, ¶ 12.03[2], at 1–14.

E.g., it is not viewed as merely transitory.

Reg. §301.6231(d)(1)(d).

For purposes of Code Sec. 707(b)(1), the ownership of a capital or profits interest is in a partnership is determined in accordance with the rules for constructive ownership of stock provided in Code Sec. 267(c), other than Code Secs. 267(c)(3). Code Sec. 707(b)(3).

ABA Section of Taxation Partnership and LLCs Committee Fall CLE Meeting, Panel, Identifying Partners’ Interests in Partnership Profits and Capital Sheldon I. Banoff, Moderator, Steven R. Schneider and Adam M. Cohen, Panelists, Denver, Colorado, October 20, 2006.

Kemp, Dispositions of Partnership Interests: Termination of a Partnership, 718 Tax Mgmt. Portfolio (1993) at A-46. That author concludes it is unclear what effect the fact that the allocation of partnership profits does not have substantial economic effect, for purposes of Code Sec. 704(b), will have on a Code Sec. 708(b) termination.

Code Sec. 706(b)(1)(B)(i).

Code Sec. 706(b)(1)(B)(ii). If there is no tax year that meets either the majority interest tax year or the principal partners’ tax year, then the partnership uses the calendar year except to the extent otherwise prescribed by regulations. Code Sec. 706(b)(1)(B)(iii).

See text accompanying note 125, supra.

To calculate the amount that is excluded from Code Sec. 707 disguised sale amounts under the facts in the TAM, the taxpayer’s share of liability is determined with reference to Reg. §1.707-5(a)(2)(iii). The regulations in turn require the application of the same percentage used to determine the partner’s share of excess nonrecourse liability under Reg. §1.752-3(a)(3) (“third tier allocation regulations”) to be used as the partner’s share of liability in the Reg. §1.707-5(b) calculation. See, e.g., Banoff, Partnership Ownership Realignments via


The FSA cites Reg. §1.704-1(b)(3)(ii) (which relates to determining a partner's interest in the partnership); Rev. Rul. 95-41, 1995-1 CB 132 (which states that PIPP is determined by taking into account all the facts and circumstances relating to the economic arrangement of the partners, for purposes of allocating nonrecourse liabilities under Reg. §1.752-3(a), and Rev. Proc. 94-46 (which provides that for purposes of determining "majority in interest" for purposes of former Reg. §301.7701-2(b)(1), profits are determined by taking into account present and future allocations of profits under the partnership agreement that is in effect as of the date of the dissolution event). The FSA further (correctly) states that all agreements among the partners are to be considered as part of the partnership agreement.


E.g., by capitalizing costs that otherwise might be deducted, by postponing payments of expenses until 2007 and/or by accelerating income into 2006.

In determining each partner's share of the basis (or cost) of Code Sec. 38 property for purposes of the investment credit, Reg. §1.46-3(h)(2)(ii) provided that such share "shall be determined in accordance with the ratio (in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in Code Sec. 702(a)(9) [now Code Sec. 702(a)(8)])) regardless of whether the partnership has a profit or loss for its tax year during which the Code Sec. 38 property is placed in service."

See LTR 8651050 (Sept. 22, 1986).

Such gain might not be included in the Code Sec. 702(a)(8) income allocation to the extent it is validly allocated specially under Code Secs. 702(a)(1)–(7).

This solution was applied in Reg. §1.46-3(h)(2) (general ratio of taxable income is applied "regardless of whether the partnership has a profit or loss.").

In some partnerships, the allocation of losses attributable to contributed capital will be in a substantially different ratio among the partners than the manner in which they allocate upside gains (after breakeven and/or recovery of losses has occurred).

For example, if the last two profits tiers are "50 percent to A and 50 percent to B on all profits over $100,000 per year, but 80 percent to A and 20 percent to B on all profits over $10,000,000 per year," the latter being extremely unlikely to be achieved, is the residual profits interest 50/50 or 80/20 for purposes of PIPP?

Thus, the sum of the partners' "gross" items of book income and gain will exceed the partnership's actual net profits in any year that the partnership has losses or specially allocated items of deduction or loss.

Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class of item described in Reg. §1.702-1(a)(1)-(9). Accordingly, in determining his or her income tax, each partner must take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take an item into account separately. Reg. §1.702-1(a)(8)(iii).

Thus, if the tax treatment of a partner in a parent partnership would be affected (e.g., in determining PIPP, if the "gross book income" approach were adopted), then the partnership and the subsidiary partnership must provide all relevant information as to that partner's share of gross income of the subsidiary partnership.

Consistent with the above, Code Sec. 702(c) requires that in any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include the partner's distributive share of the partnership's gross income. The partner's distributive share of the partnership's gross income is the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss. Reg. §1.702-1(c)(1).

Although this does not speak directly to determining a partner's share of partnership book income, similar principles ought to apply.

Code Sec. 704(c) built-in gain (and loss) should not be included in the computation of PIPC because the partner's "profit" (when the gain is ultimately recognized by the partnership) is not a post-contribution economic profit. Moreover, in most situations the contributing partner would have been given capital contribution credit for the then-current value of the (appreciated) contributed property, which effectively may have been included in the computation of his or her PIPC; double-counting of such built-in gain (i.e., for both PIPP and for PIPC purposes) should not be condemned.

See Reg. §1.702-1(c)(1), which is on point with respect to the requirement to separately state each partner's share of a partnership's gross tax-able income, i.e., the amount of gross income of the partnership from which was derived the partner's distributive share of partnership taxable income or loss (including items described in Code Secs. 702(a)(1) through (8)). Such might occur if, e.g., the partnership (1) is in the pre-opening stage; (2) has investments that do not generate any income or gain recognition for the tax year; or (3) has as its sole source(s) of income tax-exempt income, e.g., interest on tax-exempt bonds or life insurance policy death benefit proceeds.

See text accompanying notes 119–21, supra.

See text following note 124, supra.

Reg. §1.704-1(b)(3)(ii).

Consistent with the above, Code Sec. 702(a)(9) (i.e., outside basis) should not be included in the computation of tax-exempt bonds.

See Officers Discuss Recent Passthrough Developments, 36 Highlights & Documents 3378 (Mar. 3, 1995) (statement attributed to John Rooney, Office of Tax Legislative Counsel).

Joint Committee on Taxation Report, JCS-02-05, "Options to Improve Tax Compliance and Reform Tax Expenditures," Jan. 28, 2005, Part E, "Modifies Safe Harbor for Allocation of Nonrecourse Deductions and Exclude Nonrecourse Liabilities from Outside Basis (Secs. 704 and 752)." Under the proposal, the Joint Committee anticipates that partnerships will allocate nonrecourse deductions consistent with the most likely allocation of marginal profits (i.e., the last dollar of reasonably expected profits) unless such allocation is not reflective of the partners' interest in the partnership. This alternative would not be available to...
Identifying Partners’ Interests in Profits and Capital

partnerships that do not reasonably expect to have significant residual profits. The exception applies if, in general, the partner has an interest “in each item of partnership income, gain, loss, deduction or credit for every tax year that the partner is a partner in the partnership is 10 percent or less.” Reg. §1.752-2(d)(1), (2).

Philip’s DNA Article, at 302 and 318.

The Postlewaite Article, note 17, supra, at 509.

Id.

Id. The Postlewaite Article’s complete discussion of the PIPP and PICP portion of the ALI Project is reprinted as the Appendix to Philip’s DNA Article, which follows at 320.

Reg. §1.46-3(f)(2)(i).

The Postlewaite Article, note 17, supra, at 302, supra and accompanying text.

In the absence of any provision in the partnership agreement regarding the sharing of profits, Reg. §1.401-10(d) provides an alternative measurement approach.

A variation to this approach is found in Reg. §1.6038-3(b)(5), which defines 50-percent and 10-percent controlling interests (respectively) in PIPP to be determined “by reference to the agreement of the partners relating to such interests during that tax year.” This example is based upon Willis, W ILLIS ON PARTNERSHIP TAXATION, note 76, supra, §5.05, at 47. Willis was of the view that one can reasonably infer from Reg. §1.707-1(c) (based on the statement that a guaranteed payment is not a part of PIPP) that a partner’s compensation, if it is based on partnership income, may be included in determining his interest in partnership profits. Id.

Note that the alternative measurement of PIPP under Reg. §1.401-10(d) states, “[i]n the absence of any provision regarding the sharing of profits, the interest in profits of the partners will be determined ...” in the manner described thereafter. The Hill, F arrer case, note 134, supra, interprets Reg. §1.401-10(d). In a reviewed decision of the Tax Court, the judges could not agree as to whether the partnership agreement’s formula approach constituted the presence or absence of a provision regarding the sharing of profits. 2006 Instructions for Form 1065, at 23. Reg. §301.6231(a)(7)-1(m)(2).


See Appendix I, 33.

See “Potential Approaches to PIPP—22. The ‘whatever the partnership agreement says it is’ approach,” supra.

In the absence of any provision in the partnership agreement regarding the partners’ capital interests, Reg. §1.401-10(d) provides the alternative measurement approach discussed in Paragraph 3, above.

See text accompanying notes 253–54, supra.

See “Potential Approaches to PIPP—23. The ‘whatever it says on the partner’s K-1 tax return’ approach,” supra. The 2006 Instructions for Form 1065, at page 23, state the “[o]n the line for Capital [Percentage] enter the portion of the capital that the partner would receive if the partnership was liquidated by the distribution of undivided interests in partnership assets and liabilities.”

See “Potential Approaches to PIPP—25. The ‘elective combinations’ approach,” supra.

See Kolligs, note 241, supra.

Id.


Philip’s DNA Article, at 315. A further variant arises in those (relatively few) provisions that use as their threshold whatever the partnership agreement says. Reg. §1.414(c)-2(c)(2). The 2006 Instructions for Form 1065, at page 23, state the “[o]n the line for Capital [Percentage] enter the portion of the capital that the partner would receive if the partnership was liquidated by the distribution of undivided interests in partnership assets and liabilities.”

See “Potential Approaches to PIPP—27. The ‘control’ approach discussed in Paragraph 3, above.”

See text accompanying notes 299, infra.

Also see Reg. §§1.414(c)-2(c)(2) and 1.414(c)-2(b)(2) (identical, except substituting “80 percent” for “50 percent”). Contrast the Code Sec. 2701(b)(2) test with that used in Code Sec. 163(j)(6)(D)(ii), supra, which uses a conjunctive (“and”) rather than a disjunctive (“or”) standard.

See note 293, supra.

Also see Temporary Reg. §1.7874-1T(c)(1)(i) (referring to 80 percent or more of the stock (by vote or value) or the capital or profits interest in the domestic entity).

Even those provisions that focus solely on the shareholder’s total combined voting power are inconsistent with respect to their partnership analogues. Compare Code Sec. 501(q)(1)(E) (voting power for shareholders, profits interests for partners) with Proposed Reg. §1.871-14(g)(2)(ii) (voting power for shareholders, profits or capital interests for partners).

Specifically, in the corporate context, Code Sec. 4943(c)(2)(A) and Reg. §53.4943-3(b) provide that the permitted holdings of a private foundation is 20 percent of the voting stock held by the percentage of voting stock owned by all disqualified persons. If all disqualified persons together do not own more than 20 percent of the voting stock, the nonvoting stock held by the private foundation shall also be treated as permitted holdings. Code Sec. 4943(c)(3)(A) and Reg. §53.4943-3(c) provide that in the case of a partnership (including a limited partnership), “profits interest” shall be substituted for “voting stock” and “capital interest” shall be substituted for “nonvoting stock.” Thus, in the noncorporate context, the rule under Code Sec. 4943(c)(2)(A) and Reg. §53.4943-3(b) is that the permitted holdings of a private foundation is 20 percent of the profits interest reduced by the percentage of profits interests owned by all disqualified persons. If all disqualified persons together do not own more than 20 percent of the profits interests, then capital interests held by the...
private foundation shall also be treated as permitted holdings. (A similar rule applies with respect to the so-called 35 percent of the voting stock limitation rule in Code Sec. 4943(c)(2)(B) and Reg. §53.4943-3(b)(3); again, “profits interest” is substituted for “voting stock” in the case of partnerships.) See LTR 200611034 (Dec. 19, 2005).

For example, under Code Sec. 7704, certain partnerships can avoid publicly traded partnership tax consequences if they have sufficient “qualifying income,” which includes real property rents. Code Sec. 7704(d)(1)(C). “Real property rents” means amounts which would qualify under Code Sec. 856(d), with the caveats that stock owned, directly or indirectly, by or for a partner would not be considered as owned under Code Sec. 318(a)(3)(A) by the partnership unless five percent or more (by value) of the interests in such partnership are owned, directly or indirectly, by or for such partner. Code Sec. 7704(d)(3)(B). Also see Reg. §1.7704-2(e)(3) (operative tax effect given to partners owning “5 percent or more by value (directly or indirectly)’” of the existing partnership); Reg. §1.904-5(h)(1) (regarding foreign tax credit limitation: application of certain look-through rules where the partner receiving a payment owns “10 percent or more of the value of the partnership”); Reg. §1.904-5(h)(2) (general rule that if any limited partner or corporate general partner owns “less than 10 percent of the value in a partnership,” partner’s distributive share of partnership income is passive income); Code Sec. 954(d)(1) and Reg. §1.954-1(f)(2)(ii) (with respect to a partnership, “control” means the ownership of “more than 50 percent (by value) of the capital or profits interest in the partnership”); Reg. §1.1374-4(i)(5)(ii) (exception to the rule involving S corporation recognition of built-in gain if corporation owns a partnership interest having a fair market value less than $100,000), and Reg. §25.2701-6(a)(3) (a person is considered to own an equity interest held by or for a partnership in the proportion that the fair market value of the larger of the person’s profits interest or capital interest in the partnership bears to the total fair market value of the corresponding profits interests or capital interests in the partnership, as the case may be).

Reg. §1.904-5(h)(4).

Philip’s DNA Article, at 313. Another commentary observes that the determination of value absent an arm’s-length transaction is highly subjective and invites controversy with the IRS; moreover, the cost of appraisals often is prohibitive. Hamill and Alltizer, Alternative Methods for Measuring a Partnership Interest, TAX’N FOR ACCOUNTANTS 10 (July 1993), at 15.

Mark IV Pictures, Inc., 60 TCM 1171, Dec. 46,963(M), TC Memo. 1990-571.

There are several definable methods of valuing a compensatory capital interest. See, e.g., Shop Talk, What’s the Value of a Capital Interest Received for Services? 96 J. TAX’N 57 (Jan. 2002), and cases cited therein.

E.g., Diamond, 56 TC 530, Dec. 30,838 (1971), aff’d, CA-7, 74-1 ustc ¶9306, 492 F2d 286; Campbell, 59 TCM 236, Dec. 46,943(M), TC Memo. 1990-162.


Philip’s DNA Article, at 317.

“The law is nothing if not an exercise in line drawing. If you are on one side, you get one result, if you are on the other side, you get a different result.” Henderson, Controlling Hyperlexis—the Most Important ‘Law and ...’ 43 TAX LAW, 177 (1989).

The same observation was recently made in connection with identifying each partner’s “proportionate share” of such partnership’s property, for purposes of Code Sec. 362(e)(ii). See NYSSBA Tax Section Comments on Corporate Loss Limitation Rules, 80 HIGHLIGHTS & DOCUMENTS 337 (Jan. 9, 2006), at 347.

See notes 119–21, supra, and accompanying text.

LTR 8907042. See note 126, supra.


Philip’s DNA Article, at 312.

Philip’s DNA Article, at 312, citing Code Secs. 731 and 704(d).

See Part VI, above.

Philip’s DNA Article, at 307.

Hamill and Alltizer, note 301, supra, at 16.

Id.

Philip’s DNA Article, at 311, note 55.

Philip’s DNA Article, at 312. One treatise, which bolsters Philip’s conclusion, points out that if all of the partnership loss is allocated to the partner to whom the property is sold, the normal assumption of arm’s-length dealing is absent. For example, the sales price may be fixed artificially low, because the partner purchasing the property can use the partnership loss specifically allocated to him for that year. The treatise concludes that on balance, “the intent of Code Sec. 707(b)(1)(A) is better effectuated” if the phrase “more than 50 percent of ... the profits interest” is construed as including interests in losses as well as profits. The treatise is... surprise! WILLIS, note 47, supra, ¶11.05(1)[1], at 11–57.

See Part VII, supra.

No offense intended to the draftspersons of subchapters C and K; no inference intended as to either or both drafting groups being neanderthals.

Philip’s DNA Article, at 316.

See note 20, supra.

Philip’s DNA Article, at 318.

I.e., Philip and Deborah; my CCH editors and any TAXES subscribers with incurable insomnia.

Appendix I. Partnership Interests in Capital and/or Profits

The following is a partial listing of Code and regulatory provisions which may have significant tax consequences, depending upon the measurement of PIPP and PIPC:

1. For purposes of allocating the new markets tax credit under Code Sec. 45D, an “equity investment” includes any capital interest in a partnership (Code Sec. 45D(b)(6)(B)). The Secretary is directed to give priority to any entity that (among other things) intends to make “qualified low-income housing investments” in one or more businesses in which persons unrelated to such entity hold the majority equity interest (Code Sec. 45D(f)(2)(B)).

2. For purposes of investment credit allocation under Code Sec. 46 (since amended), each partner will take into account separately his share of the basis of partnership new Section 38 property and his share of the cost of partnership used Section 38 property placed in service by the partnership during such partnership tax year. Each partner’s share of the basis (or cost) of any Section 38 property was determined in accordance with the ratio in which the partners divide the general profits of the partnership (Reg. §1.46-3(f)(2)).
3. For purposes of investment credit allocation under Code Sec. 46, notwithstanding the general allocation rule in Reg. § 1.146-3(f)(2)(i), a partner shall not take into account the basis (or cost) of any Section 38 property placed in service by the partnership during such tax year if, inter alia, such partner’s interest in the general profits of the partnership during the tax year is five percent or less (Reg. § 1.146-3(f)(2)(iii)).

4. For purposes of the work opportunity credit, in determining qualified first-year wages under Code Sec. 51(a), no wages shall be taken into account with respect to any individual who owns more than 50 percent of the capital and profits interest in the partnership (Code Sec. 51(i)(1)(A)).

5. For purposes of determining a “parent-subsidiary group under common control” (being thereby a group of “trades or businesses that are under common control” as used in Code Sec. 52), a chain of organizations that are deemed connected through ownership of a “controlling interest” includes, in the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest in the partnership (Reg. § 1.52-1(c)(2)(iii)). Similarly, in determining a “brother-sister group under common control,” a “controlling interest” includes, in the case of a partnership, ownership of at least 80 percent of the profit interest or capital interest of the partnership (Reg. § 1.52-1(d)(2)(iii)). For purposes of determining whether “effective control” exists, the term means, in the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership (Reg. § 1.52-1(c)(3)(iii)).

6. In determining the amount taxable as a fringe benefit, special rules relate to a “control employee,” which is any employee who owns a one percent or greater equity, capital or profits interest in the employer (Reg. § 1.61-21(f)(5)(iv)). For certain valuation rules relating to non-commercial flight valuation, a “control employee” includes any employee who owns a five percent or greater equity, capital or profits interest in the employer (Reg. § 1.61-21(g)(8)(ii)(C)).

7. Discharge of indebtedness income is created when a taxpayer’s debt is acquired at a discount by a related person, defined as including a person related under Code Sec. 707(b)(1) (Code Sec. 108(e)(4)(B); Reg. § 1.108-2(a), (d)(2)(i)).

8. Deductions for amounts contributed under qualified group legal services plans are disallowed if excess payments are made on behalf of a partner who owns more than five percent of the capital or profits interest in the employer (Code Sec. 120(c)(3); Proposed Reg. § 1.120-2(f)(2)(iii)).

9. Exclusions from gross income from educational assistance programs for principal owners (or their spouses or dependents), each of whom (on any day of the year) owns more than five percent of the capital or profits interest in the employer (Code Sec. 127(b)(3); Reg. § 1.127-2(f)(ii)).

10. For purposes of the interest stripping rules of Code Sec. 163(j), a special rule as to “related persons” applies for certain partnerships. Any interest paid or accrued to a partnership which would be a related person (but for this exception) will not be treated as paid or accrued to a related person if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no federal income taxes are imposed on such interest (Code Sec. 163(j)(4)(B)(ii)).

11. The interest-stripping rules of Code Sec. 163(j) may disallow the interest deduction in certain circumstances for interest where there is a disqualified guarantee of such indebtedness. Such does not include a guarantee if, e.g., the taxpayer owns a controlling interest in a guarantor partnership; a “controlling interest” being defined as at least 80 percent of the profits and capital interests of the partnership (Code Sec. 163(j)(6)(D)(ii)).

12. Pursuant to Notice 88-99, 1988-2 CB 422, §XII(F)(1) and (2), the interest capitalization rules of Code Sec. 263A(f) do not apply to (1) the owner’s interest expense with respect to the production expenditures of a flow-through entity and (2) interest expense of a flow-through entity with respect to the production expenditures of the owner, if the owner owns 20 percent or less of the entity during all of the owner’s tax year. The ownership of a partnership for purposes of Notice 88-99 shall be based upon the partner’s interest in the capital of the partnership (Notice 88-99, §(G)(1)).

13. For purposes of Code Sec. 267(b), a related person includes a corporation and a partnership if the same persons own (i) more than 50 percent in value of the outstanding stock of the corporation and (ii) more than 50 percent of the capital or profits interest in the partnership (Code Sec. 267(b)(10)).

14. With respect to Code Sec. 267(a)(1) applying if the other requirements of Code Sec. 267(a)(1) are met: if the two partnerships have one or more common partners (i.e., if any person owns directly, indirectly or constructively any capital or profits interest in each of such partnerships), a portion of the selling partnership’s loss will be disallowed under Code Sec. 267(a)(1) (subject to a de minimis test) (Reg. § 1.267(a)-2T(c), Answer 2).

15. If the other requirements of Code Sec. 267(a)(2) are met, Code Sec. 267(a)(2) applies to defer an otherwise
deductible amount arising as a result of transactions entered into between two partnerships which have one or more common partners (i.e., if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships) (Code Sec. 267(e)(1)(C)).

16. For purposes of Code Sec. 267(a)(2), in the case of a partnership, any person who owns (directly or indirectly) any capital interest or profits interest of such partnership shall be treated as persons specified in Code Sec. 267(b) (Code Sec. 267(e)(1)(B)(i)).

17. For purposes of Code Sec. 267(b), there is an exception to the disallowance rule with respect to qualified expenses and interest paid or incurred by a partnership owning low-income housing to any qualified 5 percent or less partner of such partnership. A “qualified five percent or less partner” means any partner who has an interest of five percent or less in the aggregate capital and profits interests of the partnership and who meets certain other requirements (Code Sec. 267(e)(5)(A)(i) and (B)).

18. For purposes of determining the value of a transferee foreign corporation under Reg. §1.367(a)-3(c)(iii)(A), assets acquired outside the ordinary course of business by the transferee within the 36-month period preceding the exchange may include certain interests in a qualified partnership (Reg. §1.367(a)-3(c)(iii)(B)(1)(ii)). A “qualified partnership” in general is a partnership in which the transferee foreign corporation, inter alia, owns a 25 percent or greater interest in the partnership’s capital and profits (Reg. §1.367(a)-3(c)(5)(viii)(A)(2)). However, a partnership is not a “qualified partnership” if the U.S. target company or any of its affiliates held a five percent or greater interest in the partnership’s capital and profits at any time during the 36-month period prior to the transfer (Reg. §1.367(a)-3(c)(5)(viii)(B)).

19. For purposes of qualified plan treatment with respect to owner-employees, in the case of a partnership, it is a partner who owns more than 10 percent of either the capital interest or the profits interest in such partnership (Code Sec. 401(c)(3)(B); Reg. §1.401-10(d)).

20. For purposes of identifying qualified plans covering an owner-employee, or group of owner-employees, who control another trade or business, “control” is defined to include ownership by the owner-employee(s) of more than 50 percent of the capital or profits interest of a partnership (Reg. §1.401-12(l)(3)(ii)(b)). (Note: only applicable prior to amendment of Code Sec. 401(d)(1)(B) in 1996).

21. For purposes of identifying “two or more trades or businesses under common control” for purposes of Code Sec. 414(c), a “controlling interest” exists in the case of a partnership, where there is a parent organization that owns at least 80 percent of the profits or capital interest in such partnership (Reg. §1.414(c)-2(b)(2)(i)(C)). Similarly, in determining whether the same five or fewer persons are in “effective control” of two or more organizations so as to establish a “brother-sister group of trades or businesses under common control,” the threshold is whether such persons own an aggregate of more than 50 percent of the profits interest or capital interest of such partnership (Reg. §1.414(c)-2(b)(2)(i)(iii)).

22. For purposes of Code Secs. 401, 408(k), 408(p), 410, 411, 415 and 416, all employees of trades or businesses (whether or not incorporated) which are under “common control” are treated as employed by a single employer (Code Sec. 414(c)). If a “parent organization” owns, in the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether the parent organization or such other (subsidiary) organization is a member of a parent-subsidiary group of trades or businesses under common control, an interest in such subsidiary organization otherwise excluded under Reg. §1.414(c)-3(b)(3), (4), (5) or (6) shall be treated as not outstanding (Reg. §1.414(c)-3(b)(iii)). Similarly, in determining whether a “brother-sister group of trades or businesses under common control” exists, if “common owners” (as defined in Reg. §1.414-3(c)) own, in the case of a partnership, 50 percent or more of the profits or capital interest in such partnership, then for purposes of determining whether such organization is a member of a brother-sister group of trades or businesses under common control, an interest in such organization excluded under Reg. §1.414(c)-3(c)(2), (3) or (4) shall be treated as not outstanding (Reg. §1.414(c)-3(c)(iii)).

23. For the same purposes, in determining whether an interest which is an interest in or stock of such organization shall be excluded if owned by an organization which is controlled by an individual, estate or trust that is a “principal owner” of such organization, a “principal owner” includes a person who owns, in the case of a partnership, five percent or more of the profits or capital interest of such partnership (Reg. §1.414(c)-3(d)(2)(i)(iii)).

24. In determining an “interest in an organization” for purposes of Reg. §1.414(c)-2 and 1.414(c)-3, an interest owned by or for a partnership shall be considered as owned by any partner having an interest of five percent or more in either the profits or capital of the partnership in proportion to such partner’s interest in the profits or capital, whichever such proportion is greater (Reg. §1.414(c)-4(b)(2)).
25. For purposes of determining a “highly compensated active employee” under Code Sec. 414(q), an employee who is a “five percent owner” is included. If the employer is not a corporation, a “five percent owner” is any employee who owns more than five percent of the capital or profits interest of the employer (Reg. §1.414(q)-1T, Q&A-8).

26. In determining whether a qualified plan is top-heavy under Code Sec. 416, if the employer is not a corporation, a “one percent owner” is any employee who owns more than one percent of the capital or profits interest in the employer (Reg. §1.416-1, T-16) and a “five percent owner” is an employee who owns more than five percent of the capital or profits interest in the employer (Reg. §1.416-1, T-17).

27. For purposes of qualifying to elect the tax year of certain partnerships under Code Sec. 444, where more than 50 percent of the profits and capital interest of a partnership are owned by another partnership or S corporation, such entity is treated as a “downstream controlled partnership” and is a member of a tiered structure. Therefore, it must have the same tax year as all other members of the tiered structure in order to qualify for or maintain the Code Sec. 444 election. Similarly, if more than 50 percent of a partnership’s profits and capital are owned by a downstream controlled partnership, such owned partnership is also considered a downstream controlled partnership. (Temporary Reg. §1.444-2T(e)(2)(ii)).

28. The installment sales rules under Code Sec. 453 do not apply to sales of depreciable property to related persons. For this purpose, “related persons” includes a partnership more than 50 percent of the capital or profits interests in which is owned (directly or indirectly) by or for a taxpayer, as described in Code Sec. 1239(b) (Code Sec. 453(g)(3)).

29. With respect to a partnership’s active business, if the taxpayer corporation is a “qualified corporate partner,” and other requirements are met, then the taxpayer’s proportionate share of the partnership’s activities in such business will be treated as activities of the taxpayer. A “qualified corporate partner” is a corporation that, inter alia, has an interest of 10 percent or more in the partnership’s profits and losses (Code Sec. 465(c)(7)(D)(ii)(II)).

30. In determining whether certain rules (applicable before January 23, 1997) under Code Sec. 475 apply to items held by a dealer in securities, “control” of a partnership means the ownership of 50 percent or more of the capital or profits interest in a widely held or publicly traded partnership (Reg. §1.475(b)-1(e)(1)(ii)(B)).

31. For purposes of determining whether an organization is exempt from tax under Code Sec. 501 as a credit counseling organization, it must not own more than 35 percent of the profits interest of any partnership which is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, or similar services (Code Sec. 501(q)(1)(E)(ii), enacted August, 2006).

32. In connection with permitted allocations under Code Sec. 514(c)(9)(E), a de minimis interest rule applies if, inter alia, qualified organizations do not hold, in the aggregate, interests of greater than five percent in the capital or profits of the partnership (Reg. §1.514(c)-2(k)(2)(i)(A)).

33. For purposes of the depletion allowance under Code Sec. 613A(c)(7), the depletion allowance shall be computed separately by the partners, and the partnership shall allocate to each partner his proportionate share of the adjusted basis of each partnership oil or property. A partner’s proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital or income (Code Sec. 613A(c)(7)(D); Reg. §1.613A-3(e)(2)(ii)).

34. For purposes of Code Sec. 613A(d), a related person is one owning a “significant ownership interest,” which, with respect to a partner, means 5 percent or more interest in the partnership’s profits or capital (Code Sec. 613A(d)(3)(B); Reg. §1.613A-7(m)(1)(ii)).

35. For purposes of the family partnership rules under Code Sec. 704(e)(1), an individual’s status as a partner can depend upon whether he has an interest in partnership capital. Furthermore, the tax consequences to the donee partner can then vary, depending on the extent of his capital interests (Code Sec. 704(e)(1); Reg. §1.704-1(e); see ALI Project, page 300).

36. For purposes of determining the tax year of a partnership which is determined by reference to the tax year of all of the principal partners of the partnership pursuant to Code Sec. 706(b)(1)(B)(iii), a “principal partner” is defined as “a partner having an interest of five percent or more in partnership profits or capital.” (Code Sec. 706(b)(3)).

37. In determining the tax year of a partnership, a partnership shall not have a tax year other than the majority interest tax year (as defined in Code Sec. 706(b)(4)), if there is such a tax year. A “majority interest tax year” means the tax year (if any) which, on each testing day, constituted the tax year of one or more partners having (on such day) an aggregate interest in partnership profits and capital of more than 50 percent (Code Sec. 706(b)(4)(A)(i)).
38. For purposes of determining the tax year of a partnership under Code Sec. 706(b), any interest held by a disregarded foreign partner is not taken into account. However, if each partner that is not a disregarded foreign partner under Reg. §1.706-1(b)(6)(i) holds less than a 10 percent interest in the capital and profits of the partnership, and the regarded partners, in the aggregate, hold less than a 20 percent interest in the capital and profits of the partnership, then Reg. §1.706-1(b)(6)(i) shall not apply (Reg. §1.706-1(b)(6)(iii)).

39. Disallowance of losses from sales or exchanges of property between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership (Code Sec. 707(b)(1)(A); Reg. §1.707-1(b)(1)(i) and (3)).

40. Disallowance of losses from sales or exchanges of property between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests (Code Sec. 707(b)(1)(B); Reg. §1.707-1(b)(1)(i) and (3)).

41. In the case of a sale or exchange of property which, in the hands of the transferee, is property other than a Code Sec. 1221 capital asset, if the sale or exchange is between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, any gain recognized shall be treated as ordinary income (Code Sec. 707(b)(2)(A)).

42. In the case of a sale or exchange of property which, in the hands of the transferee, is property other than a Code Sec. 1221 capital asset, if the sale or exchange is between partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests, any gain recognized shall be treated as ordinary income (Code Sec. 707(b)(2)(B)).

43. Whether a partnership has terminated for tax purposes because there has been a sale or exchange of at least 50 percent of the interests in partnership profits and capital (Code Sec. 708(b)(1)(B)).

44. In the case of a merger or consideration of two or more partnerships, the resulting partnership shall, for purposes of Code Sec. 708, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership (Code Sec. 708(b)(2)(A)).

45. In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) is considered a continuation of the prior partnership, for purposes of Code Sec. 708 (Code Sec. 708(b)(2)(B)).

46. In connection with partnership distributions of marketable securities, for purposes of Code Sec. 731(c)(3)(C)(iv), an upper-tier partnership ("UTP") is not treated as engaged in a trade or business engaged in by (or as holding the assets of) a lower-tier partnership ("LTP") in which the UTP holds a partnership interest if (i) the UTP does not actively and substantially participate in the management of the LTP, and (ii) the interest held by the UTP is less than 20 percent of the total profits and capital interests in the LTP (Reg. §1.731-2(e)(4)).

47. In determining a distributee partner's net contribution gain for purposes of Code Sec. 737, such is the net gain (if any) that would have been recognized by the distributee partner under Code Sec. 704(c)(1)(B) if all property that had been contributed to the partnership immediately before the distribution had been distributed by the partnership to another partner other than a partner who owns more than 50 percent of the capital or profits interest in the partnership (Reg. §1.737-1(c)(1)).

48. For purposes of determining the amount of a basis adjustment of partnership property in the case of a transfer of an interest in a partnership under Code Sec. 743(b), a partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital (Code Sec. 743(b)(2)).

49. For purposes of determining a partner's share of the nonrecourse liabilities of a partnership, the partner's share of partnership profits must be determined. For purposes of Reg. §1.752-3(a)(3), PIPP "is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the Code Sec. 704(b) regulations) of some other significant item of partnership income or gain...." (Reg. §1.752-3(a)(3)).

50. For purposes of an election out of Subchapter K, an unincorporated organization which has not made the proper form of election shall nevertheless be deemed to have made the election if it can be shown from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from all of Subchapter K beginning with the first tax year of the organization. Among the facts which may indicate the requisite intent is "the members of the…"
organization owning substantially all of the capital interest report their respective shares of the items of income, deductions, and credits of the organization on their respective returns in a manner consistent with the exclusion of the organization from Subchapter K beginning with the first tax year of the organization" (Reg. §1.761-2(b)(2)(ii)(b)).

51. For purposes of meeting the 100 partner requirement to be an electing large partnership (ELP) under Code Sec. 775, individuals who perform or performed substantial services in connection with the ELP’s activities are excluded. For this purpose, the activities of an ELP include the activities of any other partnership in which the ELP owns at least an 80 percent interest in the capital and profits of the lower tier partnership (Code Sec. 775(b)(3)).

52. For purposes of determining a REIT’s share of assets (for purposes of the assets test under Code Sec. 856), “the trust will be determined to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. For purposes of Code Sec. 856, the interest of a partner in the partnership’s assets shall be determined in accordance with his capital interest in the partnership” (Reg. §1.856-3(g)).

53. For purposes of allocating a partner’s distributive share of partnership interest expense, such is allocated to the partner’s distributive share of the partnership’s gross income, in the case of a partner with a less-than-10 percent partnership interest (except an individual general partner) (Reg. §1.861-9T(e)(4)(i)). A partner’s distributive share of partnership interest expense is apportioned based on all the assets of the partner, including his pro rata share of all the assets of the partnership, in the case of a partner with a 10 percent or greater interest (Reg. §1.861-9T(e)(2) and (3)).

54. For purposes of allocating a partner’s own interest expense, such is apportioned based on all the partner’s assets, including the value of the partner’s partnership interest, in the case of a partner with a less-than-10 percent partnership interest (except an individual general partner) (Reg. §1.861-9T(e)(4)(i)).

55. For lessors of certain ships, aircraft or spacecraft who lease such craft to a U.S. person that is not a member of the same controlled group of corporations, the lessor must include gross income with respect to the craft as U.S. source income. Solely for purposes of Reg. §1.861-16, if at least 80 percent of the capital or profits interest in a partnership is owned by a member or members of a controlled group of corporations, then the partnership is considered a member of that controlled group. In addition, if at least 80 percent of the capital or profits interest in a partnership is owned by a corporation, then the partnership and that corporation shall be considered members of a controlled group of corporations (Reg. §1.861-16(d)).

56. For purposes of determining under Code Sec. 864(b)(2)(A) whether certain foreign persons are considered to be engaged in trade or business within the U.S. solely because such person is a member of a partnership that effects transactions in the U.S. in stocks or securities for the partnership’s own account, under a special exception applies to a member of a partnership in which, at any time during the last half of its tax year, more than 50 percent of either the capital interest or the profits interest is owned, directly or indirectly, by five or fewer partners who are individuals and that meet certain other requirements (Reg. §1.864-2(c)(2)(ii)).

57. For purposes of the foreign tax credit limitation under Code Sec. 904, a partner will be considered as owning 10 percent of the value of a partnership for a particular year if the partner owns 10 percent of the capital and profits interest of the partnership (Reg. §1.904-5(h)(4)). This is relevant under look-through rules involving a partner’s ownership of 10 percent or more of the value of a partnership (i.e., Reg. §1.904-5(h)(1)) and for certain partners’ ownership of less than 10 percent of the value in a partnership (i.e., Reg. §1.904-5(h)(2)(ii)).

58. For purposes of the foreign tax credit limitation under Code Sec. 904 and Reg. §1.904-5T(ii)(1), a partnership (the first partnership) is considered as owning more than 50 percent of the value of another partnership (the second partnership) if the first partnership owns more than 50 percent of the capital and profits interests in the second partnership (Reg. §1.904-5(h)(4)).

59. For purposes of determining foreign base company income under Code Sec. 954, a look-through rule applies in the case of a sale by a CFC of an interest in a partnership with respect to which such corporation is a 25 percent owner. A “25 percent owner” means a CFC which owns directly 25 percent or more of the capital or profits in a partnership (Code Sec. 954(c)(4)(B)).

60. For purposes of determining foreign base company income under Code Sec. 954, a person is a “related person” with respect to a CFC if (i) such person is a corporation which controls, or is controlled by, the CFC, or (ii) such person is a partnership which is controlled by the same person or persons which control the CFC. For this purpose, in the case of a partnership, “control” means the ownership of more than 50 percent (by value) of the capital or profits interest in the partnership (Code Sec. 954(d)(3); Reg. §1.954-1(f)(2)(ii)).
61. For purposes of basis reductions following a discharge of indebtedness under Code Sec. 1017, a taxpayer must request a partnership's consent to reduce inside basis if, at the time of the discharge, the taxpayer owns a greater than 50 percent interest in the capital and profits of the partnership (Reg. §1.1017-1(g)(2)(ii)(B)).

62. For purposes of basis reductions following a discharge of indebtedness under Code Sec. 1017, a partnership must consent to reduce its partners' shares of inside basis with respect to that indebtedness by partners owning an aggregate of more than 80 percent of the capital and profits interests of the partnership, or five or fewer partners owning an aggregate of more than 50 percent of the capital and profits interests of the partnership (Reg. §1.1017-1(g)(2)(ii)(C)).

63. The nonrecognition rule provided by Code Sec. 1033 as to involuntary conversions is not available to (among others) a partnership in which one or more C corporations own more than 50 percent of the capital or profits interest in such partnership at the time of the involuntary conversion (Code Sec. 1033(i)(2)(B)).

64. For purposes of treating gain from sale of depreciable property between certain related taxpayers as ordinary income rather than capital gain, the term “related persons” includes a person and all entities which are controlled entities with respect to such person. A “controlled entity” includes a partnership more than 50 percent of the capital or profits interest in which is owned by or for such person (Code Sec. 1239(c)(1)(B)).

65. For purposes of computing an S corporation’s built-in gain during a recognition period, the S corporation includes gain from its distributive share of partnership items unless (i) the S corporation’s partnership interest represents less than 10 percent of the partnership’s capital and profits at all times during the tax year and prior tax years in the recognition period, and (ii) the fair market value of the S corporation’s partnership interest as of the beginning of the recognition period is less than $100,000 (Reg. §1.1374-4(i)(5)(ii)).

66. For purposes of constructive ownership under the consolidated return rules, stock owned by or for a partnership shall be considered as owned by any partner having an interest of five percent or more in either the capital or profits of the partnership in proportion to his interest in capital or profits, whichever such proportion is the greater (Code Sec. 1563(e)(2); Reg. §1.1563-3(b)(2)(i)).

67. For purposes of meeting the requirements for a qualified domestic trust (QDOT), in determining whether no more than 35 percent of the fair market value of the QDOT assets consists of foreign real property, if the QDOT owns more than 20 percent of the capital interest of a partnership with 15 or fewer partners, then all assets owned by the partnership are deemed to be owned directly by the QDOT to the extent of the QDOT's pro rata share of the partnership's assets. The QDOT partner's pro rata share is based on the greater of its interest in the capital or profits of the partnership (Reg. §20.2056A-2(d)(1)(ii)(B)).

68. For purposes of the estate tax deduction under Code Sec. 2057 for qualified family-owned businesses, the requisite ownership of a partnership carrying on a trade or business so as to constitute a “qualified family-owned business interest” is (i) at least 50 percent ownership by the decedent's family; (ii) at least 70 percent owned by members of two families; or (iii) at least 90 percent owned by members of three families, with at least 30 percent of such entity in (ii) and (iii) having been owned by the decedent and members of the decedent's family. Ownership of the partnership is determined by the owner of the appropriate percentage of the capital interest in such partnership (Code Sec. 2057(e)(3)(A)(ii)).

69. For purposes of Code Sec. 2701, a “controlled entity” includes a partnership by certain individuals holding at least 50 percent of the capital or profits interest in the partnership (Reg. §25.2701-2(b)(5)(iii)).

70. For purposes of Code Sec. 2701, in the case of a limited partnership, “control” means the holding of any equity interest as a general partner (Reg. §25.2701-2(b)(5)(iii)).

71. For purposes of Code Sec. 2701, in determining the indirect holding of interests a person is considered to hold an equity interest held by or for a partnership in the proportion that the fair market value of the larger of the person's profits interest or capital interest in the partnership bears to the total fair market value of the corresponding profits interests or capital interests in the partnership, as the case may be (Reg. §25.2701-6(a)(3)).

72. In connection with taxes on excess business holdings of a private foundation, the permitted holdings of a private foundation in a partnership turn on ownership of a 20 percent or 35 percent profits interest in the partnership (Code Sec. 4943(c)(2)(A), (2)(B) and (3)(A); Reg. §53.4943-1).

73. The tax on excess business holdings of supporting organizations may apply to an organization which meets certain requirements and is effectively controlled by (or substantially all of the contributions were made by) the same person or persons. Such a “person” is defined to include an owner of more than 20 percent ownership...
of the profits interest of the partnership (Code Sec. 4943(f)(4)(B)(iii)(II), enacted August, 2006).

74. For purposes of taxes on self-dealing transactions between a trust and a “disqualified person,” the latter includes a person who is the owner of more than 10 percent of the profits interest of a partnership which is a contributor to the trust (Code Sec. 4951(e)(4)(C)(iii)). A “disqualified person” also includes a partnership in which certain specified persons own more than 35 percent of the profits interest (Code Sec. 4951(e)(4)(G)).

75. For purposes of the tax on excess benefit transactions under Code Sec. 4958, a “disqualified person” includes a partnership in which certain persons own more than 35 percent of the profits interest (Code Sec. 4958(f)(3)(A); Reg. §53.4958-3(b)(2)(ii)(B)).

76. For purposes of the tax on excess benefit transactions under Code Sec. 4958, in identifying an “excess benefit transaction,” all economic consideration and benefits exchanged with the applicable tax-exempt organizations and all entities the organization “controls” are taken into account. For this purpose, “control” includes the tax-exempt organization’s ownership of more than 50 percent of the profits or capital interests in a partnership (Reg. §53.4958-4(a)(2)(ii)(B)(1/iii)).

77. In determining whether a prohibited transaction has occurred with respect to a “disqualified person,” the latter includes an owner of 50 percent or more of the capital interest or the profits interest of a partnership which is an employer or an employee organization described in Code Sec. 4975(e)(2)(C) or (D) (Code Sec. 4975(e)(2)(E)); Reg. §301.6231(a)(7)-1(e)). A “disqualified person” also includes a partnership in which 50 percent or more of the capital interest or profits interest of such partnership is owned by certain persons having designated relationships with the plan (Code Sec. 4975(e)(2)(G)). A “disqualified person” also includes a 10 percent or more (in capital or profits) partner or joint venturer of certain persons having designated relationships with the plan (Code Sec. 4975(e)(2)(I)).

78. In connection with information returns required of certain U.S. persons with respect to controlled foreign partnerships (CFPs) under Code Sec. 6038, a “controlling 50 percent partner” means a U.S. person that controlled the foreign partnership, i.e., is owner of more than a 50 percent interest in the partnership (Code Sec. 6038(e)(3)(A); Reg. §1.6038-3(a)(1)). A “50 percent interest in a partnership” is an interest equal to 50 percent of the capital interest, 50 percent of the profits interest, or an interest to which 50 percent of the deductions or losses of such partnership are allocated (Reg. §1.6038-3(b)(2)); Reg. §301.6231(a)(3)-1(c)(4)(iii)).

79. In connection with information returns required of certain U.S. persons with respect to CFPs, a “controlling 10 percent partner” is a U.S. person who owned a 10 percent or greater interest in the partnership while the partnership was controlled by U.S. persons owning 10 percent or greater interests (Reg. §1.6038-3(a)(2)). A “10 percent interest in a partnership” is an interest equal to 10 percent of the capital interest, 10 percent of the profits interest, or an interest to which 10 percent of the deductions or losses of such partnership are allocated (Reg. §1.6038-3(b)(3)).

80. For purposes of the extension of time for payment of estate taxes where the estate consists largely of interests in closely held businesses, which include an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest is included in determining the decedent’s gross estate (Code Sec. 6166(b)(1)(B)); Reg. §20.6166A-2(a)(2)).

81. With respect to IRS administrative proceedings, IRS does not have to mail notices to each partner if the partnership has more than 100 partners and the partner has a less than one percent interest in the profits of the partnership (Code Sec. 6223(b)(1)).

82. However, if a group of partners in the aggregate having a five percent or more interest in the profits of a partnership so request and designate one of their members to receive the notice, the member so designated shall be treated as a partner entitled to such notices (Code Sec. 6223(b)(2); Reg. §301.6223(b)-1(a)).

83. For purposes of the TEFRA rules in determining whether items are more appropriately determined at the partnership level, with respect to transactions to which Code Sec. 707(a) applies, the partnership must determine the percentage of the capital interests and profits interests in the partnership owned by each partner (Reg. §301.6231(a)(3)-1(c)(4)(iii)).

84. For purposes of determining the tax matters partner if no general partner has been so designated, the general partner having the largest profits interest in the partnership at the close of such tax year involved shall so act (Code Sec. 6231(a)(7)(B); Reg. §301.6231(a)(7)-1(m)(2)).

85. For purposes of designating a tax matters partner for a partnership tax year pursuant to Reg. §301.6231(a)(7)-1(e), a statement to be filed with the appropriate IRS service center shall be signed by the persons who were general partners at the close of the year and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all general partners as of the close of the tax year (Reg. §301.6231(a)(7)-1(e)(4)).
86. For purposes of designating a tax matters partner in a partnership tax year pursuant to Reg. §301.6231(a)(7)-1(f), a statement to be filed with the appropriate IRS service center shall be signed by all persons who were partners at the close of the year and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all partners as of the close of the tax year (Reg. §301.6231(a)(7)-1(f)(2)(iv)).

87. For purposes of selecting the tax matters partner if no general partner may be selected (for reasons discussed in Reg. §301.6231(a)(7)-1(p)(2) or (3)(ii)), “the Commissioner may consider” six criteria including “the profits interest held by the partner” and “the views of the partners having a majority interest in the partnership.” (Reg. §301.6231(a)(7)-1(q)(2)(iii) and (iv)).

88. For purposes of forming a “five percent group” to file a petition for judicial review or appealing a judicial determination, a “five percent group” is a group of partners who for the tax year involved had profits interests which aggregated five percent or more (Code Sec. 6231(a)(11)).

89. A partnership that has made a Code Sec. 444 election to use a tax year other than the tax year required under Code Sec. 706(b) must generally make a “required payment” under Code Sec. 7519 for any tax year in which the election is in effect. The computation of the required payment in turn requires, inter alia, the computation of the partnership’s “applicable payments,” which in general are any amounts deductible in the base year that are includible, directly or indirectly, in the gross income of a taxpayer that during the base year is a partner. An amount is “indirectly includible in the gross income of a partner” if the amount is includible in partnership more than 50 percent of the profits and capital of which is owned by the aggregate by partners of the electing partnership (Temporary Reg. §1.7519-1T(b)(5)(iv)(D)(1)(iii)).

90. For purposes of determining the applicable payments of an electing partnership, any amounts deducted by a “downstream controlled partnership” are considered deducted by the electing entity. If more than 50 percent of the profits and capital interests are owned by a partnership that has made a Code Sec. 444 election, such owned partnership is considered a “downstream controlled partnership.” Furthermore, if more than 50 percent of a partnership’s profits and capital are owned by a downstream controlled partnership, such owned partnership also is considered a downstream controlled partnership (Temporary Reg. §1.7519-1(b)(5)(iv)(D)(2)(iii)).

91. In determining whether certain transfers are disregarded under Code Sec. 7704(b) in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof, transfers by one or more partners of interests representing in the aggregate 50 percent or more of the total interests in partnership capital and profits in one transaction or a series of related transactions are disregarded (Reg. §1.7704-1(e)(1)(ix)).

92. For purposes of determining whether certain transfers are disregarded under Code Sec. 7704(b) in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof, the transfer by a partner and any related persons (as defined in Code Secs. 267(b) and 707(b)(1)) in one or more transactions during any 30 calendar day period of partnership interests representing in the aggregate more than two percent of the total interests in partnership capital or profits (Reg. §1.7704-1(e)(2)).

93. For purposes of determining whether certain transfers are disregarded under Code Sec. 7704(b) in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof, in determining whether the transfer of an interest in a partnership pursuant to a redemption or repurchase agreement is disregarded, one of the alternative tests requires that the sum of the percentage interests in partnership capital or profits transferred during the tax year of the partnership (other than certain “private transfers”) does not exceed 10 percent of the total interests in partnership capital or profits (Reg. §1.7704-1(f)(3)).

94. For purposes of Code Sec. 7704(b), which disregards the transfer of an interest through a “qualified matching service” in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof, the sum of the percentage interests in partnership capital or profits transferred during the tax year of the partnership (other than certain “private transfers”) does not exceed 10 percent of the total interests in partnership capital or profits (Reg. §1.7704-1(g)(2)(viii)).

95. For purposes of Code Sec. 7704(b), interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if the sum of the percentage interests in partnership capital or profits transferred during the tax year of the partnership (excluding certain specified categories of transfers) does not exceed two percent of the total interests in partnership capital or profits (Reg. §1.7704-1(j)).
96. For purposes of Reg. §1.7704-1, in determining the total interests in partnership capital or profits, if the general partners and any person related to the general partners (within the meaning of Code Sec. 267(b) or 707(b)(1)) own, in the aggregate, more than 10 percent of the outstanding interests in partnership capital or profits at any one time during the tax year of the partnership, the total interests in partnership capital or profits are determined without reference to the interests owned by such persons (Reg. §1.7704-1(k)(1)(ii)(A)).

97. For purposes of rules relating to expatriated entities and their foreign parents under Code Sec. 7874, in determining an expanded affiliated group (EAG) that includes a foreign corporation, for purposes of the ownership percentage determination stock held by one or more members of the EAG shall be included in the denominator (but not the numerator) of the fraction that determines the ownership percentage if, inter alia, (1) before the acquisition, 80 percent or more of the capital or profits interest in the domestic entity was owned by the corporation that is the common parent of the EAG after the acquisition, and (2) after the acquisition, stock held by non-members of the EAG by reason of holding a capital or profits interest in the domestic entity does not exceed 20 percent of the stock of the foreign corporation (Reg. §1.7874-1T(c)(1)).

98. For purposes of the rules relating to Code Sec. 7874, partnership interests owned by an entity in which at least 50 percent of the capital or profits interest is owned by the partnership in question shall not be taken into account for purposes of (1) determining the percentage of ownership of an entity under Reg. §1.7874-1T(c), or (2) treating stock held by one or more members of the EAG as included in the denominator (but not the numerator) under Reg. §1.7874-1T(c) (Reg. §1.7874-1T(d)).

99. For purposes of preparing the partnership tax return, Schedule K-1 calls for reporting the percentage ownership of the partner in partnership capital and profits.

100. For purposes of determining whether the filing of a new Schedule M-3 (Form 1065) to the partnership tax return is required, the determination of whether an entity is a “reportable entity partner” turns on whether the entity owns or is deemed to own a 50 percent or greater interest in the partnership’s income, loss or capital on any day during the tax year of the partnership’s tax year on or after June 30, 2006. (Form 1065, Schedule M-3 Draft Instructions, 6/27/06 Draft, “Reportable Entity Partner Reporting Responsibilities,” pg. 2). (Note: The 50 percent Ownership reference is with respect to the partnership’s “capital, profit, or loss” on any day during the tax year of the partnership,” on Schedule M-3, Box D, and the Schedule M-3 Draft Instructions 2006, supra, “General Instructions – Who Must File,” pg. 2).

101. For purposes of determining whether the filing of a Schedule M-3 (Form 1065) to the partnership tax return is required, the owner of 50 percent or more of partnership income, loss or capital on any day of the partnership tax year is deemed to own all corporate and partnership interests owned or deemed to be owned by the partnership during the partnership tax year. (Form 1065, Schedule M-3 Draft Instructions, 6/27/06 Draft, “Reportable Entity Partner Reporting Responsibilities,” pg. 2).

102. For purposes of preparing Schedule M-3 (Form 1065), for any tax year in which the partnership has more than two “reportable entity partners,” the partnership must provide all of the information pertaining to Check Box D on page 1 of Schedule M-3 for the two reportable entity partners having the “maximum percentage of deemed ownership for the tax year of the partnership.” The latter is defined as the maximum percentage interest deemed owned (under the Schedule M-3 Instructions) by the reportable entity partner in the partnership’s capital, profit, or loss on any day during the partnership’s tax year. (Form 1065, Schedule M-3 Draft Instructions, 6/27/06 Draft, “Reportable Entity Partner Reporting Responsibilities,” pg. 3).

Appendix II. Derivative References (Incorporating PIPP and PIPC) Under Code Sec. 267(b) and/or 707(b)

The following is a partial listing of Code and regulatory provisions which derivatively incorporate PIPP and PIPC by their references to Code Sec. 267(b) and/or Code Sec. 707(b), and which in certain circumstances may have significant tax consequences, depending upon the measurement of PIPP and PIPC.

1. For purposes of determining the availability of low-income housing tax credits under Code Sec. 42 for existing buildings, the existing building must be acquired by “purchase” as defined in Code Sec. 179(d), which excludes, among other things, acquisitions from a person whose relationship to the acquiring person would result in disallowance of losses under Code Sec. 267 or 707(b), utilizing a 10 percent threshold instead of 50 percent (Code Sec. 42(d)(2)(D)(iii)(I)).

2. For purposes of determining the availability of low-income housing tax credits under Code Sec. 42 for existing buildings, the existing building must not have been previously placed in service by any person...
who was related to the taxpayer as of the time previously placed in service, where (among other things) the relationship is as specified in Code Sec. 707(b)(1), utilizing a 10 percent threshold instead of 50 percent (Code Sec. 42(d)(2)(D)(iii)(II)).

3. A low-income building can utilize a credit allocation from a prior year in certain circumstances, which include a requirement that the basis in the low-income housing project at specified times is more than 10 percent of the taxpayer’s reasonably expected basis in such project. For purposes of this determination, certain fees may be included in basis, for which purpose one of the requirements is that the fee be paid (or to be paid) to a related person be accounted for under the accrual method, where the related person must bear a relationship to the taxpayer specified in Code Sec. 267(b) or 707(b)(1) or be engaged in a trade or business under common control with the taxpayer (Reg. §1.42-6(b)(2)(iv)(E)).

4. For purposes of allocating the new markets tax credit under Code Sec. 45D, the Secretary is directed to give priority to any entity that (among other things) intends to make “qualified low-income community investments” in one or more businesses in which persons unrelated to such entity (within the meaning of Code Sec. 267(b) or 707(b)(1)(B)) hold the majority equity interest (Code Sec. 45D(i)(2)(B)).

5. Code Secs. 83(a) and (b) apply to the transfer of money or other property received if an option is sold or otherwise disposed of in an arm’s length transaction in the same manner as Code Secs. 83(a) and (b) would have applied to the transfer of property pursuant to an exercise of the option unless the sale or other disposition of the option is to a person related to the service provider, and occurs on or after July 2, 2003, where a person will be treated as related (among others) if the person and the service provider bear a relationship to each other specified in Code Sec. 267(b) or 707(b)(1), utilizing 20 percent instead of 50 percent (Reg. §1.83-7(a)(1)).

6. For purposes of the rule limiting the exclusion from gross income of an applicable policyholder as to employer-owned life insurance, “applicable policyholder” includes any person which bears a relationship which is specified in Code Sec. 267(b) or 707(b)(1) to the person that owns the life insurance contract, is engaged in a trade or business, and is directly or indirectly a beneficiary of the contract (Code Sec. 101(j)(3)(B)(ii)(I)).

7. Discharge of indebtedness income is created when a taxpayer’s debt is acquired at a discount by a related person, defined as including a person related under Code Sec. 267(b) or 707(b)(1) (Code Sec. 108(e)(4)).

8. The exclusion for certain gains on the sale of a principal residence can apply to sales or exchanges of remainder interests in the residence unless the sale or exchange is with a person who bears a relationship to the taxpayer which is described in Code Sec. 267(b) or 707(b) (Code Sec. 121(d)(8)(B)).

9. In determining whether a bond qualifies as a “qualified small issue bond,” certain issues will be aggregated based, in part, on whether the facilities financed will be used by the same person or two or more persons that bear such a relationship that would result in a disallowance of losses under Code Sec. 267 or 707(b) (Code Sec. 144(a)(3) as implemented by Code Secs. 144(a)(2)(B), 144(a)(4)(B)(ii), 144(a)(6)(A)(ii), 144(a)(6)(B) and 144(a)(10)(E)).

10. In determining whether a bond qualifies as a “qualified small issue bond,” issues where more than $250,000 of the net proceeds are used to provide depreciable farm property where the principal user is or will be the same person or two or more persons that bear such a relationship that would result in a disallowance of losses under Code Sec. 267 or 707(b) as one person (Code Sec. 144(c)(4)(D)(ii)).

11. A private activity bond is not a qualified bond if it is held by a person who is a substantial user of the facilities or by a related person of such a substantial user, where a related person includes (among others) 2 or more persons if the relationship between such persons would result in a disallowance of losses under Code Sec. 267 or 707(b) (Code Sec. 147(a)(2)(A)).

12. In certain situations, OID on a debt instrument held by a related foreign person may not be deducted until paid, for purposes of which a “related foreign person” is any person who is not a U.S. person and who is related (within the meaning of Code Sec. 267(b)) to the issuer (Code Sec. 163(e)(3)(C)).

13. The interest stripping rules of Code Sec. 163(j) may disallow the interest deduction for interest paid or accrued by a taxpayer (directly or indirectly) to a related person if no federal income tax is imposed on such interest, interest paid or accrued by a taxpayer.

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with respect to any indebtedness to a person who is not a related person if there is a disqualified guarantee of such indebtedness and no gross basis tax is imposed on such interest and interest paid or accrued by a taxable REIT subsidiary of a REIT to the REIT. For these purposes, a “related person” in general is any person who is related within the meaning of 267(b) or 707(b)(1) to the taxpayer, except that interest paid or accrued to a partnership which would be a related person (but for the exception) will not be treated as paid or accrued to a related person if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no federal income taxes are imposed on such interest (with a further exception that the exception does not apply to interest allocable to any partner of such partnership who is a related person to the taxpayer) (Code Sec. 163(j)(4)(A)).

15. With certain exceptions, an interest deduction is not allowed for interest on any indebtedness of a corporation payable in equity of the issuer or a related party or equity held by the issuer (or a related party) in any other person, where a “related party” includes a person that bears a relationship to the issuer described in Code Sec. 267(b) or 707(b) (Code Sec. 163(l)(6)).

16. A theft loss is allowed for losses reasonably estimated to have occurred on a qualified individual’s deposit in a qualified institution that went bankrupt or became insolvent. For purposes of this provision, “qualified individual” means an individual except an individual that owns at least one percent of the institution, is an officer of the institution, who has certain familial ties to such an owner or officer or who otherwise is a related person (as defined in Code Sec. 267(b)) with respect to such an owner or officer (Code Sec. 165(l)(2)).

17. No Code Sec. 167 depreciation is allowed to the taxpayer for any term interest in property for any period during which the remainder interest in such property is held (directly or indirectly) by a related person, which means any person bearing a relationship to the taxpayer described in subsection (b) or (e) of Code Sec. 267 (Code Sec. 167(e)(5)(B)).

18. For purposes of calculating Code Sec. 167 depreciation on the income forecast method or any other similar method, in the case of television and motion picture films, the income from the property shall include income from the exploitation of characters, designs, scripts, scores, and other incidental income associated with such films, but only to the extent that such income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related persons (within the meaning of Code Sec. 267(b)) to the taxpayer (Code Sec. 167(g)(5)(C)).

19. If public utility property is acquired in a carryover basis transaction or in a transfer from a related person, then the applicable 1968 method with respect to such property shall be determined by reference to the treatment in respect of such property in the hands of the transferor. For this purpose, a related person is any person that is related to another if either immediately before or after the transfer the persons are members of the same controlled group or the relationship would result in a disallowance of losses under Code Secs. 267 or 707(b) (Reg. §1.167(l)-1(e)(4)(ii)(b)(1)).

20. The bonus depreciation provided in Code Sec. 168(k) for property placed in service after September 10, 2001 and before January 1, 2005 was only available for “qualified property,” which did not include property if the user of the property (on the date of original placement in service) or a person related (within the meaning of Code Sec. 267(b) or 707(b)) to such user or the taxpayer had a written contract in effect for the acquisition of the property at any time on or before September 10, 2001 (Code Sec. 168(k)(2)(E)(iv)(I)).

21. For purposes of bonus depreciation, if, in the ordinary course of its business, a taxpayer sells fractional interests in property to unrelated third parties, each first fractional owner of the property is considered as the original user of its proportionate share of the property and if the taxpayer uses the property before all of the fractional interests of the property are sold but the property continues to be held primarily for sale by the taxpayer, the original use of any fractional interest sold to an unrelated third party subsequent to the taxpayer’s use of the property begins with the first purchaser of that fractional interest, for purposes of which persons are not related if they do not have a relationship described in Code Sec. 267(b) or 707(b) (Reg. §1.168(k)-1T(b)(3)(iv)).

22. Among other exclusions and with certain additional related rules, Section 1245 property and Section 1250 property acquired by the taxpayer after December 31, 1980 will not qualify for ACRS if the property was owned or used at any time during 1980 by the taxpayer or a related person or the property is leased by the taxpayer for more than 3 months to a person (or a person related to such person) who owned or used such property at any time during 1980, in each case where the relationship specified in Code Sec. 267(b) or 707(b)(1), utilizing 10 percent instead of 50 percent will cause two persons to be related (Reg. §1.168-4(d)(6)).

23. The rules of Reg. §1.168(h)-1 apply with respect to a direct or indirect transfer of property among related
persons if Code Sec. 1031 applied to any party to the transfer or to any related transaction and if a principal purpose of the transfer or related transaction is to avoid or limit the application of the alternative depreciation system, for purposes of which a person will be treated as related to another if they bear a relationship specified in Code Sec. 267(b) or 707(b)(1) (Reg. §1.168(h)-1).

24. Charitable contributions of future interests in personal tangible property are treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or those standing in the relationship to the taxpayer described in Code Sec. 267(b) or 707(b) (Code Sec. 170(a)(3)).

25. To satisfy the substantiation requirements for certain charitable contributions, it is necessary to obtain a qualified appraisal, which must be prepared, signed, and dated by a qualified appraiser. A qualified appraiser does not include (among others) any person related under Code Sec. 267(b) to or married to a person who is in a relationship described in Code Sec. 267(b) with the donor, the taxpayer claiming the deduction, a party to the transaction in which the donor acquired the property, the donee or an employee of any of these persons (Reg. §1.170A-13(c)(5)(iv)(E)).

26. Contributions of conservation easements where a mineral interest is retained does not qualify for a charitable contribution deduction if the minerals may be extracted by any surface mining method unless (among other things) the present owner of the mineral interest is not a person whose relationship to the owner of the surface estate is described at the time of the contribution in Code Sec. 267(b) or 707(b) (Reg. §1.170A-14(g)(4)(ii)(A)(2)).

27. For purposes of determining the value of contribution of a conservation easement, the deduction may be disallowed or reduced if the donor or a related person receives, or can reasonably expect to receive, financial or economic benefits, for purposes of which related person has the same meaning as in either Code Sec. 267(b) or 707(b) (Reg. §1.170A-14(h)(3)(i)).

28. A “convertible bond” for purposes of applying a rule regarding the determination of a holder’s basis in a convertible bond is a bond that provides the holder with an option to convert the bond into stock of the issuer, stock or debt of a related party (within the meaning of Code Sec. 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt (Reg. §1.171-1(e)(1)(iii)(C)).

29. The deduction available for Code Sec. 179 property, which (among other things) must be acquired by purchase for use in the active conduct of a trade or business, where “purchase” does not include acquisitions from persons whose relationship to the acquiring person would result in disallowance of losses under Code Sec. 267 or 707(b) (Code Sec. 179(d)(2)).

30. Taxpayers (and their related persons) may not deduct more than $100,000, over the years, in qualified clean-fuel vehicle refueling property, where “related persons” include persons who bear a relationship described in Code Sec. 267(b) or 707(b)(1) (Code Sec. 179A(b)(2)(B)).

31. The anti-churning rules as to amortization of Code Sec. 197 intangibles applies (among others) to those intangibles that were held or used at any time on or after July 25, 1991 and on or before July 25, 1991 by the taxpayer or a related person or if the taxpayer grants the right to use the intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991 and on or before July 25, 1991, in each case where the related person bear a relationship described in Code Sec. 267(b) or 707(b)(1), utilizing 20 percent instead of 50 percent, immediately before or immediately after the acquisition of the intangible involved (Code Sec. 197(f)(9)(C)).

32. For purposes of the trade-or-business rules in Reg. §1.197-2(e), assets will only be considered acquired if they are acquired by the taxpayer and persons related to the taxpayer from another person and persons related to that other person, in each case treating two persons as related only if their relationship is described in Code Sec. 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of Code Sec. 41(f)(1) (Reg. §1.197-2(e)(3)).

33. Amounts paid for qualified long-term care services provided to an individual is not treated as paid for medical care (for purposes of the Code Sec. 213 deduction) if such services is provided by an unlicensed spouse or relative or by a corporation or partnership which is related (within the meaning of Code Sec. 267(b) or 707(b)) to the individual (Code Sec. 213(d)(11)(B)).

34. The deduction for interest on education loans is not available on indebtedness owed to a person who is related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to the taxpayer (Code Sec. 221(d)(1)).

35. For purposes of determining if a holding period should be shortened by reason of positions that result in a diminished risk of loss, positions held by a party related to the taxpayer within the meaning of Code Sec. 267(b) or 707(b)(1) are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of Code Sec. 246 or Reg. §1.1092(d)-2 (Reg. §1.246-5(c)(6)).
Identifying Partners’ Interests in Profits and Capital

36. For purposes of Code Sec. 263(a) requiring capitalization of certain expenditures, references to a party other than the taxpayer include persons related to that party and persons acting for or on behalf of that party (including persons to whom the taxpayer becomes obligated as a result of assuming a liability of that party), for purposes of which persons are related only if their relationship is described in Code Sec. 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of Code Sec. 267(b) or 707(b) (Reg. §1.263(a)-4 and -5).

37. A small reseller is not required to capitalize additional Code Sec. 263A costs to personal property produced for it under contract with an unrelated person and may use the simplified resale method if the contract is entered into incident to the resale activities of the small reseller and the property is sold to its customers, for purposes of which persons are related if they are described in Code Sec. 267(b) or 707(b) (Reg. §1.263A-3(a)(3) and -3(a)(4)(iii)).

38. Distribution costs, which are not generally required to be capitalized, do not include costs incurred by a taxpayer in delivering goods to a related person and, when a taxpayer sells goods to a related person, the costs of transporting the goods are included in determining the basis of the goods that are sold, and hence in determining the resulting gain or loss from the sale, for purposes of which persons are related if they are described in Code Sec. 267(b) or 707(b) (Reg. §1.263A-3(c)(4)(vi)(A)(2)).

39. For purposes of Reg. §§1.263A-8 through 1.263A-15 (dealing with capitalization requirements as to certain expenditures, including interest), a person is related to a taxpayer if their relationship is described in Code Sec. 267(b) or 707(b) (Reg. §1.263A-8(a)(4)(ii)).

40. If, pursuant to the matching and acceleration rules of Reg. §1.1502-13(c) and (d) as implemented by Reg. §1.267(f)-1(c)), a member of a controlled group that sold property to another member of that controlled group takes into account a loss or deduction as a result of the other member’s transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under Code Sec. 267(b) or 707(b) (among other times), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer (Reg. §1.267(f)-1(c)(1)(iii)).

41. For purposes of determining whether a foreign corporation is a stapled foreign corporation, the Commissioner may, at his discretion, treat interests that otherwise would be stapled interests as not being stapled if the same person or related persons (within the meaning of Code Sec. 267(b) or 707(b)) hold stapled interests constituting more than 50 percent of the beneficial ownership of both corporations, and a principal purpose of the stapling of those interests is the avoidance of U.S. income tax (Reg. §1.269B-1(b)(2)).

42. In determining the extent to which Code Sec. 274(e)(2) will limit an entertainment expense deduction, individuals who are subject to the requirements of Code Sec. 16(a) of the Securities Exchange Act of 1934 with respect to the taxpayer or a related person to the taxpayer or would be so subject if the taxpayer (or such related person) were an issuer of equity securities referenced in Code Sec. 16(a), where “related person” includes persons that bear a relationship described in Code Sec. 267(b) or 707(b) (Code Sec. 274(e)(2)(B)(ii)).

43. For purposes of determining the portion of travel that will be allocable to business activity in determining the portion of the travel expenses that may be deducted, any individual who travels on behalf of his employer under a reimbursement or other expense allowance arrangement shall be considered not to have had substantial control over the arranging of his business trip and thus to have such trip fully allocable to business activity, provided the employee is not (among others) related to his employer within the meaning of Code Sec. 267(b), but for this purpose the percentage referred to in Code Sec. 267(b)(2) shall be 10 percent (Reg. §1.274-4(f)(5)(i)(b)).

44. For purposes of determining the amount of qualified business use to determine whether Code Sec. 280F will act to limit or deny deductions for lease payments or depreciation, certain uses by certain persons cannot be included. For this purpose, “related person” means any person related to the taxpayer (within the meaning of Code Sec. 267(b)) (Code Sec. 280F(d)(6)(D)(ii)).

45. In a Code Sec. 304 acquisition where the acquiring corporation is a foreign corporation, the only earnings and profit taken into account for purposes of Code Sec. 304(b)(2)(A) are those which are attributable to stock owned by a corporation which is a U.S. shareholder of the acquiring corporation for purposes of subpart F and the transferor (or a person who bears a relationship to the transferor described in Code Sec. 267(b) or 707(b)) and which were accumulated during the period such stock was owned by such person while the acquiring corporation was a CFC (Code Sec. 304(b)(5)(A)).

46. The rule specifying that where a corporation that issues preferred stock, which may be redeemed under certain circumstances at a price higher than the
issue price, the difference (the redemption premium) is treated under Code Sec. 305(c) as a constructive distribution (or series of constructive distributions) of additional stock on preferred stock that is taken into account under principles similar to the principles of Code Sec. 1272(a) will not apply if (among other considerations) the issuer’s obligation to redeem or the holder’s ability to require the issuer to redeem is subject to a contingency that is beyond the legal or practical control of either the holder or the holders as a group (or through a related party within the meaning of the code Sec. 267(b) or 707(b)), and that, based on all of the facts and circumstances as of the issued date, renders remote the likelihood of redemption (Reg. §1.305-5(b)(2)).

47. The rule described in #46 above will apply if the issuer has the right to redeem the stock but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur. A redemption pursuant to an issuer’s right to redeem is not treated as more likely than not to occur if (among other things) the issuer and the holder are not related within the meaning of Code Sec. 267(b) or 707(b), utilizing 20 percent instead of 50 percent (Reg. §1.305-5(b)(3)(ii)(A)).

48. For purposes of the consistency rules under Code Sec. 338(e) and (f), the consistency period is extended to include any continuous period that ends on, or begins on, any day of the consistency period during which a purchasing corporation, or any person related, within the meaning of Code Sec. 267(b) or 707(b)(1), to a purchasing corporation, has an arrangement to purchase stock of target or to own an asset to which the carryover basis rules of Reg. §1.338-8 apply, taking into account the extension (Reg. §1.338-8(j)(1)).

49. The 12-month acquisition period, for purposes of determining whether a qualified stock purchase has been made, is extended if, pursuant to an arrangement, a corporation acquires by purchase stock of another corporation satisfying the requirements of Code Sec. 1504(a)(2) over a period of more than 12 months. For purposes of determining whether an arrangement exists, one factor considered is the participation of a person related within the meaning of Code Sec. 267(b) or 707(b)(1) (Reg. §1.338-8(j)(5)).

50. Preferred stock is nonqualified preferred stock under Code Sec. 351(g) if the holder has the right to require the issuer or a related person to redeem or purchase the stock, the issuer or a related person is required to redeem or purchase such stock, the issuer or a related person has the right to redeem or purchase the stock in certain circumstances, or the dividend rate varies in whole or part (directly or indirectly) with reference to certain types of indices. In each case, a person is related to another person if they bear a relationship to such other person described in Code Sec. 267(b) or 707(b) (Code Sec. 351(g)(3)(B)).

51. For purposes of applying the rules of Code Sec. 355(d), which provides that a spin-off is disqualified if, after the spin-off, any person owns 50 percent or more of the stock of either the distributing or controlled corporation and that stock is so-called “disqualified stock,” a person and all persons related to such person (within the meaning of Code Sec. 267(b) or 707(b)(1)) are treated as one person (Code Sec. 355(d)(7)(A)).

52. The exception to the disqualified investment company rules of Code Sec. 355(g) for investment assets used in the active conduct of lending or finance businesses, banking businesses or insurance businesses only applies if substantially all of the income of the business is derived from persons who are not related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to the person conducting the business (Code Sec. 355(g)(2)(B)(iii)).

53. Where there is a later direct or indirect disposition of intangible property transferred under circumstances triggering Code Sec. 367(d), in general, deemed annual license payments will continue if a transfer is made to a related person, while gain must be recognized immediately if the transfer is to an unrelated person, for purposes of which persons are considered related if they are partners or partnerships described in Code Sec. 707(b)(1) of the Code (Reg. §1.367(d)-1(b)(1)).

54. For purposes of determining whether an ownership change occurs, an option is treated as exercised on the date of its issuance or transfer if, on that date, the option satisfies three tests, one of which (the control test) requires (among other things) the holder of the option and any persons related to the option holder have, in the aggregate, a direct and indirect ownership interest in the loss corporation of more than 50 percent, treating persons as related if they bear a relationship specified in Code Sec. 267(b) or 707(b) or if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock, within the meaning of Reg. §1.382-3(a)(1)(i) (Reg. §1.382-4(d)(4)(ii)(A)(2)).

55. For purposes of determining whether indebtedness is qualified indebtedness under Code Sec. 382(l)(5), indebtedness ownership periods will tack in certain circumstances, including upon transfers between parties who bear a relationship to each other described in Code Sec. 267(b) or 707(b), utilizing 80 percent instead of 50 percent (Reg. §1.382-9(d)(5)(ii)(A)).
56. A plan to which Code Sec. 1042 applies and an eligible worker-owned cooperative (within the meaning of Code Sec. 1042(c)) shall provide that no portion of the assets of the plan or cooperative attributable to (or allocable in lieu of) employer securities acquired by the plan or cooperative in a sale to which Code Sec. 1042 applies may accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of Code Sec. 401(a)) during the nonallocation period, for the benefit of (among others) any individual who is related to the taxpayer (within the meaning of Code Sec. 267(b)) (Code Sec. 409(n)(1)(A)(ii)).

57. Code Sec. 409A does not apply to an amount deferred under an arrangement between a service provider and service recipient with respect to a particular trade or business in which the service provider participates, if during the service provider's tax year in which the service provider obtains a legally binding right to the payment of the amount deferred the service provider is actively engaged in the trade or business of providing services, other than as an employee or as a director of a corporation, service provider provides significant services to two or more service recipients to which the service provider is not related and that are not related to one another (for purposes of which persons are related if they bear a relationship specified in Code Sec. 267(b) or 707(b)(1), utilizing 20 percent instead of 50 percent) and service provider is not related to the service recipient (for purposes of which persons are related if they bear a relationship specified in Code Sec. 267(b) or 707(b)(1), utilizing 20 percent instead of 50 percent) is deemed to be providing significant services to two or more service recipients to which the service provider is not related and that are not related to one another (for purposes of which persons are related if they bear a relationship specified in Code Sec. 267(b) or 707(b)(1), without the aforementioned modification). For purposes of the “significant services” portion of the foregoing, a service provider who provides services to two or more service recipients to which the service provider is not related and that are not related to one another (for purposes of which persons are related if they bear a relationship specified in Code Sec. 267(b) or 707(b)(1), utilizing 20 percent instead of 50 percent) is deemed to be providing significant services to two or more of such service recipients for a given tax year, if the revenues generated from the services provided to any service recipient or group of related service recipients during such tax year do not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services. (Proposed Reg. §1.409A-1(f)(3)).

58. A notional principal contract definitionally requires payments calculated by reference to a specified index, which includes an interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons. If a taxpayer, either directly or through a related person, reduces risk with respect to a notional principal contract by purchasing, selling, or otherwise entering into other notional principal contracts, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods provided in Reg. §1.446-3(f)(2)(iii) and (v). There is also a consistency rule regarding estimations of a specified index among the taxpayer and parties related to the taxpayer that are parties to the notional principal contract. For purposes of these rules, A related person is a person related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to one of the parties to the notional principal contract or a member of the same consolidated group (as defined in Reg. §1.1502-1(h)) as one of the parties to the contract (Reg. §1.446-3(c)(4)(ii)).

59. The installment sale rules do not apply to transfers of depreciable property to related persons, where related persons includes 2 or more partnerships having a relationship to each other described in Code Sec. 707(b)(1)(B) (Code Sec. 453(g)(3)).

60. For purposes of the rules relating to accounting for long-term contracts (including, for example, determining the contract commencement date), a related party is a person whose relationship to a taxpayer is described in Code Sec. 707(b) or 267(b), with certain modifications relevant to Code Sec. 267(b) only (Reg. §1.460-1(b)(4)).

61. To obtain a deduction in the year of payment on a contested, asserted liability, the payment must satisfy certain requirements. Payment to a person (other than the person asserting the liability) of any stock of the taxpayer or of any stock or indebtedness of a person related to the taxpayer (as defined in Code Sec. 267(b)) will not qualify (Reg. §1.461-2(c)(1)(iii)(E)).

62. Amounts borrowed from any person who has an interest in an activity or from a related person to a person (other than the taxpayer) having such an interest are not considered at risk with respect to an activity, where “related person” includes persons bearing a relationship specified in Code Sec. 267(b) or 707(b)(1), utilizing 10 percent instead of 50 percent (Code Sec. 465(b)(3)(C)).

63. For purposes of determining the amount that a taxpayer has at-risk in an activity, amounts which are borrowed from (among others) a person with a relationship to the taxpayer specified within any one of the paragraphs of Code Sec. 267(b) shall be treated in the same manner as amounts borrowed for which the taxpayer has no personal liability and for which no security is pledged. (Proposed Reg. §1.465-20(a)(2)).
64. Except for purposes of determining whether a Section 467 rental agreement is a leaseback within the meaning of Reg. §1.467-3(b)(2), two persons are related persons for purposes of regulations under Code Sec. 467 if they either have a relationship to each other that is specified in Code Sec. 267(b) or 707(b)(1) or are related entities within the meaning of Code Secs. 168(h)(4)(A), (B), or (C) (Reg. §1.467-1(h)(11)).

65. For purposes of determining whether a payment is a qualified payment and whether a fund is a designated settlement fund in Code Sec. 468B, certain rules reference related persons. For example, as to qualified payments, amounts which may be transferred to the taxpayer or any related person or transfers of stock or indebtedness of the taxpayer or any related person will not qualify. As to designated settlement funds, among other things, the fund must be established for the principal purpose of resolving and satisfying present and future claims against the taxpayer (or any related person or formerly related person) arising out of personal injury, death, or property damage and, under the terms of the fund, the taxpayer (or any related person) may not hold any beneficial interest in the income or corpus of the fund. For these purposes, a “related person” means a person related to the taxpayer within the meaning of Code Sec. 267(b) (Code Sec. 468(d)(3)).

66. For purposes of the segregation requirement as to qualified settlement funds under Reg. §1.468B-1(c)(3) and (h), a related person is any person who is related to the transferor within the meaning of Code Sec. 267(b) or 707(b)(1) (Reg. §1.468B-1(d)(2)).

67. Providing debt of a related person (within the meaning of Code Sec. 267(b) or 707(b)(1)) does not constitute economic performance (which is delayed until principal payments are made on such debt), despite the rules providing that a transfer to a disputed ownership fund to resolve or satisfy a liability will constitute such economic performance (Reg. §1.468B-9(d)(2)(i)).

68. Passive activity losses may be deducted in the tax year in which a taxpayer disposes of his entire interest in the passive activity in a taxable transaction unless the acquiring party and the taxpayer bear a relationship to each other described in Code Sec. 267(b) or 707(b)(1), in which case the loss may only be deducted in the tax year in which such interest is so acquired by another person who does not bear such relationship to the taxpayer (Code Sec. 469(g)(1)(B)).

69. Except as otherwise provided in Reg. §1.469-4T(j)(3)(iii)(B), a person's ownership percentage in a pass-through entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related to such person owns (determined without regard to Reg. §1.469-4T(j)(3)(iii)) in such pass-through entity or in such undertaking, treating persons as related if the relationship of such persons is described in Code Sec. 267(b) or 707(b)(1) (Reg. §1.469-4T(j)(3)(iii)(C)). (Note: Only applicable for tax years ending on or before May 10, 1992.)

70. To determine whether the mark-to-market accounting method is available, the taxpayer must be a dealer in securities, where securities includes notes, bonds, debentures or other evidences of indebtedness and such terms do not include nonfinancial customer paper. Nonfinancial customer paper is a receivable which is a note, bond, debenture or other evidence of indebtedness, arises from the sale of nonfinancial goods or services by a person the principal activity of which is selling or providing such goods or services and is held by such person (or a person who bears a relationship to such person described in Code Sec. 267(b) or 707(b)) at all times since issue (Code Sec. 475(c)(4)(B)(iii)).

71. A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship described in Code Sec. 707(b)(1)(A) or (B) held by a dealer in securities are per se held for investment within the meaning of Code Sec. 475(b)(1)(A) and are deemed to be properly identified as such for purposes of Code Sec. 475(b)(2) (Reg. §1.475(b)-1(b)(i)).

72. Gains or losses from certain sales, exchanges or other dispositions of certain Brownfield properties are not unrelated business taxable income. In particular, the Brownfield property must be acquired from an unrelated person and must be sold, exchanged or disposed of to an unrelated person. In both cases, a person is treated as related if such person bears a relationship to such other person described in Code Sec. 267(b) (with one exception) or 707(b)(1), utilizing 25 percent instead of 50 percent with an additional requirement if such other person is a nonprofit organization (Code Sec. 512(b)(19)(J)).

73. While “acquisition indebtedness” for purposes of the unrelated business income tax does not generally include indebtedness to acquire or improve real property, this exception to the definition of “acquisition indebtedness” does not apply (among other times) if the real property is at any time after the acquisition leased to any person that bears a relationship described in Code Sec. 267(b) or 707(b) to the person selling the property to the qualified organization (Code Sec. 514(c)(9)(B)(iii)).
74. If a corporation acquires the assets of a large bank (among other ways) in any direct or indirect acquisition of a significant portion of a large bank’s assets if, after the acquisition, the transferor large bank owns more than 50 percent (by vote or value) of the outstanding stock of the acquirer, the acquiring corporation (the acquirer) is treated as a large bank for any tax year ending after the date of the acquisition in which it is an institution described in Reg. §1.585-1(b)(1)(i) or (ii). For purposes of the foregoing test, stock of the acquirer is treated as owned by a transferor bank if the stock is owned by (among others) any related party within the meaning of Code Sec. 267(b) or 707(b). The acquirer is treated as a large bank, under the foregoing rule, if the acquisition is any direct or indirect acquisition of substantially all of a large bank’s assets if the transferor large bank and the acquirer are related parties (within the meaning of Code Sec. 267(b) or 707(b)) before or after the acquisition and a principal purpose of the acquisition is to avoid treating the acquired assets as those of a large bank (Reg. §1.585-5(b)(2)).

75. In determining the maximum amount of depletion a taxpayer may take under 613A, the depletable oil quantity is must be allocated among corporations, trusts and estates owned by the same or related persons, where related persons includes persons that bear a relationship that would result in disallowance of losses under Code Sec. 267 or 707(b) (Code Sec. 613A(c)(8)(D)(ii)).

76. The rule allowing certain transfers of coal or iron ore to be treated as a gain or loss on the sale of the coal or iron ore does not apply to disposals to a person whose relationship to the disposing person would result in disallowance of losses under Code Sec. 267 or 707(b) (Code Sec. 631(c)).

77. Code Sec. 643(i), which deems certain loans of cash or marketable securities by foreign trusts to be distributions by such trust to the grantor or beneficiary, only applies to loans directly or indirectly to any U.S. grantor or beneficiary or to any U.S. person that is related to a U.S. grantor or beneficiary, where the relationship between the U.S. person and the U.S. grantor or beneficiary would result in disallowance of losses under Code Sec. 267 or 707(b) (Code Sec. 643(i)(2)(B)(ii)).

78. For purposes of Reg. §1.643(h)-1, relating to distributions by certain foreign trusts through intermediaries, a United States person is related to a grantor of a foreign trust if the United States person and the grantor are “related” for purposes of Code Sec. 643(i)(2)(B), while for purposes of Code Sec. 267 and 707(b)(1) utilizing “at least 10 percent” instead of “more than 50 percent.” (Reg. §1.643(h)-1(e)).

79. For purposes of determining whether a “qualified gratuitous transfer” has occurred under the rules for charitable remainder trusts, if any portion of the assets of an ESOP attributable to securities acquired by the ESOP in a qualified gratuitous transfer are allocated to the account of (among others) any person who is related to the decedent (within the meaning of Code Sec. 267(b)), the ESOP shall be treated as having distributed (at the time of such allocation) to such person or shareholder the amount so allocated (Code Sec. 664(g)(5)).

80. A transfer by a U.S. person to a foreign trust through an intermediary will be treated as an indirect transfer by that U.S. person to the foreign trust if such transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of United States tax, which will be deemed to exist if (among other things) the U.S. person is “related” to a beneficiary of the foreign trust, or has another relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the U.S. transferor would make a transfer to the foreign trust, where such relationship meets the requirements of Code Sec. 643(i)(2)(B), while for purposes of Code Sec. 267 and 707(b)(1) utilizing “at least 10 percent” instead of “more than 50 percent.” (Reg. §1.679-3(c)).

81. The term “qualified funeral trust” does not include any trust (treating all trusts having trustees that are related persons as one trust) which accepts aggregate contributions by or for the benefit of an individual in excess of $7,000. For purposes of this test, related persons include persons whose relationship is described in Code Sec. 267 or 707(b) (Code Sec. 685(c)(2)(A)).

82. The deficit-restoration-obligation and liquidation-in-accordance-with-positive-capital-account-balances requirements for the economic effect safe harbor under Code Sec. 704(b) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of Code Sec. 267(b) (without modification by Code Sec. 267(e)(1)) or Code Sec. 707(b)(1), to a partner) pursuant to an agreement negotiated at arm’s length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the fundamental principles of the economic effect safe harbor (Reg. §1.704-1(b)(2)(ii)(b)).

83. For purposes of the Code Sec. 704(b) regulations, the partnership agreement includes agreements with a person related, within the meaning of Code Sec. 267 or 707(b) (Code Sec. 685(c)(2)(A)).
Sec. 267(b) (without modification by Code Sec. 267(e)(1)) or 707(b)(1), to such partner or partnership, utilizing “80 percent or more” instead of “more than 50 percent” (Reg. §1.704-1(b)(2)(ii)(h)).

84. The transition rule, which allows partnerships to apply the provisions of Reg. §1.704-1(b) as if they had not been amended regarding the allocations of foreign tax expenditures if the partnership agreement was entered into before April 21, 2004 until any subsequent material modification to the partnership agreement occurs, does not apply if, as of April 20, 2004, persons that are related to each other (within the meaning of Code Sec. 267(b) and 707(b)) collectively have the power to amend the partnership agreement without the consent of any unrelated party (Reg. §1.704-1(b)(1)(ii)(b)(2)).

85. Interests of disregarded foreign partners are not ignored for purposes of determining a partnership’s tax year if each partner that is not a disregarded foreign partner (a “regarded partner”) holds less than a 10 percent interest, and the regarded partners, in the aggregate, hold less than a 20 percent interest in the capital or profits of the partnership, treating each regarded partner as owning any interest in the partnership owned by partners that are related within the meaning of Code Sec. 267(b) or 707(b), utilizing “10 percent” instead of “50 percent” (Reg. §1.704-1(b)(6)(iii)).

86. For purposes of the disguised sale of partnership interest rules under Code Sec. 707(a)(2)(B), an increase in a partner’s share of a partnership liability may be treated as a transfer of consideration by the partner to the partnership, notwithstanding any other rule in Reg. §1.707-7, if within a short period of time after the partnership incurs or assumes the liability or another liability, one or more partners of the partnership, or related parties to a partner (within the meaning of Code Sec. 267(b) or 707(b)), in substance bears an economic risk for the liability that is disproportionate to the partner’s interest in partnership profits or capital; and the transactions are undertaken pursuant to a plan that has as one of its principal purposes minimizing the extent to which the partner is treated as making a transfer of consideration to the partner that may be treated as part of a disguised sale of partnership interests. (Proposed Reg. §1.707-7(j)(8)).

87. For purposes of the allocation of liabilities among partners under Code Sec. 752, a person is related to a partner if the person and the partner bear a relationship to each other that is specified in Code Sec. 267(b) or 707(b)(1), utilizing “80 percent or more” instead of “more than 50 percent” and with certain additional rules where a person is related to more than one partner (Reg. §1.752-4(b)(1)).

88. Basis adjustments as the result of Code Sec. 734(b) may not be made to stock of a corporation if that corporation is a partner of the partnership in which the basis adjustment is being made or if a person related to the corporation is a partner in that partnership, where the related person has a relationship with the corporation described in Code Sec. 267(b) or 707(b)(1) (Code Sec. 755(c)).

89. For purposes of determining whether a segregated asset account that is a real property account is adequately diversified during its start-up period to obtain annuity, endowment, or life insurance contract treatment, amounts transferred to the account from a diversified account (determined without regard to this rule) or as a result of an exchange pursuant to Code Sec. 1035 in which the issuer of the contract received in the exchange is not related in a manner specified in Code Sec. 267(b) to the issuer of the contract transferred in the exchange are not treated as amounts attributable to contracts entered into more than one year before such date or amounts attributable to contracts entered into more than five years before such date (Reg. §1.817-5(c)(2)(iv)).

90. To obtain look-through treatment for REITs, RICs, partnerships or grantor trusts for purposes of adequate diversification rule to obtain annuity, endowment, or life insurance contract treatment, the beneficial ownership must satisfy a test and public access to such REIT, RIC, partnership or trust must be limited. As to the beneficial ownership test, investments that meet certain requirements and are held by the general account of a life insurance company or a corporation related in a manner specified in Code Sec. 267(b) to a life insurance company or are held by the manager, or a corporation related in a manner specified in Code Sec. 267(b) to the manager, of the REIT, RIC, partnership, or trust (Reg. §1.817-5(f)(3)).

91. A significant purpose to impede the assessment or collection of tax exists for purposes of disregarding a transfer of a noneconomic residual interest under Code Sec. 860E if the transferee, at the time of the transfer, either knew or should have known (had “improper knowledge”) that the transferee would be unwilling or unable to pay taxes due on its share of the taxable income of the REMIC. A transferor will be presumed not to have improper knowledge if (among other things) the transfer satisfies the asset test or the formula test. For purposes of meeting the asset test, obligations of related persons are disregarded, where a related person is any person that bears a relationship to the transferee enumerated in Code Sec. 267(b) or 707(b)(1), utilizing
20 percent instead of 50 percent, or is under common control with the transferee (Reg. §1.860E-1(c)(6)(ii)).

92. If, in apportioning interest expense on the basis of assets for purposes of computing US and foreign income, the taxpayer uses the fair market value of its assets, then the taxpayer and its related persons must continue to use such method unless expressly authorized by the Commissioner to change methods, for purposes of which “related persons” means two or more persons in a relationship described in Code Sec. 267(b) (Reg. §1.861-8T(c)(2)).

93. In apportioning research and experimentation deductions for purposes of computing US and foreign income, the residual amount is apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions that the amount of sales from the product category (or categories) that resulted in such gross income within the statutory grouping (or statutory groupings) and in the residual grouping bear, respectively, to the total amount of sales from the product category (or categories). For purposes of this determination, the sales from the product category (or categories) by each party uncontrolled by the taxpayer of particular products involving intangible property that was licensed or sold by the taxpayer to such uncontrolled party shall be taken fully into account both for determining the taxpayer’s apportionment and for determining the apportionment of any other member of a controlled group of corporations to which the taxpayer belongs if the uncontrolled party can reasonably be expected to benefit directly or indirectly (through any member of the controlled group of corporations to which the taxpayer belongs) from the research expense connected with the product category (or categories) of such other member, for purposes of which “uncontrolled party” means a party that is not (among others) a person with a relationship to the taxpayer specified in Code Sec. 267(b) (Reg. §1.861-17(c)(2)(i)).

94. In classifying transfers of computer programs for purposes of subchapter N of chapter 1 of the Internal Revenue Code, Code Secs. 367, 404A, 482, 551, 679, 1059A, chapter 3, chapter 5, Code Secs. 842 and 845 (to the extent involving a foreign person), and transfers to foreign trusts not covered by Code Sec. 679, a transferee of a computer program shall not be considered to have the right to distribute copies of the program to the public if it is permitted to distribute copies of the software to only either a related person (within the meaning of Code Sec. 707(b)(1) and certain parts of Code Sec. 267(b), utilizing 10 percent instead of 50 percent), or to identified persons who may be identified by either name or by legal relationship to the original transferee (Reg. §1.861-18(g)(3)(ii)).

95. Code Sec. 864(f)(5)(A) allows certain financial corporations, which would not be included within the affiliated group under Code Sec. 864(f)(4), to be included in the worldwide affiliated group for purposes of allocating certain expenses among the group. For purposes of Code Sec. 864(f) (as effective for tax years beginning after December 31, 2008), the term “financial corporation” is defined as any corporation if at least 80 percent of its gross income is “financial services income” (within the meaning of Code Sec. 904(d)(2)(D)(ii)) which is derived from transactions with persons who are not related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to the corporation (Code Sec. 864(f)(5)(B)).

96. For certain purposes, if a person acquires (directly or indirectly) a trade or service receivable from a related person, any income (including any stated interest, discount or service fee) derived from the trade or service receivable shall be treated as if it were interest received on a loan to the obligor under the receivable, for purposes of which a “related person” is a person who is a related person within the meaning of Code Sec. 267(b) and the regulations thereunder; a United States shareholder (as defined in Code Sec. 951(b)); or a person who is related (within the meaning of Code Sec. 267(b) and the regulations thereunder) to a United States shareholder (Reg. §1.864-8T(b)(2)).

97. As an anti-abuse rule, if a taxpayer recognizes loss with respect to personal property and the taxpayer (or any person described in Code Sec. 267(b) (after application of Code Sec. 267(c)), 267(e), 318 or 482 with respect to the taxpayer) holds (or held) offsetting positions with respect to such property with a principal purpose of recognizing foreign source income and United States source loss, the loss shall be allocated and apportioned against such foreign source income (Reg. §1.865-1(c)(6)(ii); see similar rule as to stock in Reg. §1.865-2(b)(4)(ii)).

98. Portfolio interest does not include interest that is determined with reference to receipts, sales, cash flow, income, profits, change in value of property, dividends, partnership distributions or similar payments of the debtor or a person related to the debtor within the meaning of Code Sec. 267(b) or 707(b)(1) (Code Sec. 871(h)(4)(B)).

99. In certain circumstances, the IRS may disregard, for purposes of Code Sec. 881, the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities.
For this purpose, if two (or more) financing transactions involving two (or more) related persons would form part of a financing arrangement but for the absence of a financing transaction between the related persons, the district director may treat the related persons as a single intermediate entity if he determines that one of the principal purposes for the structure of the financing transactions is to prevent the characterization of such arrangement as a financing arrangement. In addition, stock in a corporation (or a similar interest in a partnership or trust) will constitute a financing transaction only if (among other things) the owner of the stock or similar interest has the right to require a person related to the issuer (or any other person who is acting pursuant to a plan or arrangement with the issuer) to acquire the stock or similar interest or make a payment with respect to the stock or similar interest. In both situations, “related” means related within the meaning of Code Sec. 267(b) or 707(b)(1), or controlled within the meaning of Code Sec. 482 (Reg. §1.881-3(a)(2)(v)).

100. As an example of certain activities of a foreign corporation engaged in the international operation of ships or aircraft that are so closely related to the international operation of ships or aircraft that they are considered incidental to such operation, and thus deemed to be income derived from the international operation of ships or aircraft, the provision (either by subcontracting or otherwise) for the carriage of cargo preceding or following the international carriage of cargo under a through bill of lading, airway bill or similar document through a related corporation or through an unrelated person (and the rules of Code Sec. 267(b) shall apply for purposes of determining whether a corporation or other person is related to the foreign corporation) (Reg. §1.883-1(g)(4)(iv)(B)(2)).

102. The one-time exemption for Canadian corporations from the branch profits tax is reduced by the amount of any exemption that reduced the dividend equivalent amount of an associated foreign corporation with respect to the same or a similar business, for purposes of which an “associated foreign corporation” includes a foreign corporation related to the foreign corporation for purposes of Code Sec. 267(b) (Reg. §1.884-1(g)(4)(iv)(B)(2)).

103. For purposes of the rules relating to payments by related foreign interest holders to reverse hybrid entities under Reg. §1.894-1(d)(2)(ii)(B), a person will be treated as related to a reverse hybrid entity if it is related by reason of the ownership requirements of Code Sec. 267(b) or 707(b)(1), utilizing “at least 80 percent” instead of “more than 50 percent” (Reg. §1.894-1(d)(2)(ii)(B)(4)).

104. If a domestically controlled qualified investment entity’s distribution would be treated as gain from the sale or exchange of a U.S. real property interest but for the disposition of the interest in such entity by the taxpayer during the 30-day period preceding the ex-dividend date and if the foreign person or a person related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to the foreign person acquires the interest during the 61-day period beginning with the 1st day of the 30-day period preceding the ex-dividend date, the taxpayer will still be treated as having gain from the sale or exchange of a U.S. real property interest as to such distribution (Code Sec. 897(h)(5)(B)).

105. Any interest which is paid or accrued by a United States–owned foreign corporation during any tax year, is paid or accrued to a United States shareholder (as defined in Code Sec. 951(b)) or a related person (within the meaning of Code Sec. 267(b) or 707(b)(1)) to such a shareholder, and is properly allocable (under regulations) to income of such foreign corporation for the tax year from sources within the United States, shall be treated as derived from sources within the United States (Code Sec. 904(h)(3)).

106. Financial services income for purposes of the limitations on the foreign tax credit means certain income serviced by a financial services entity. A “financial services entity” means an individual or entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business (actively financing business) for any tax year, i.e., if at least 80 percent of its gross income fits the income categories for financial services income. For purposes of that test, gross income includes all income realized by an individual or entity, whether includible or excludible.
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from gross income under other operative provisions of the Code, but excludes gain from the disposition of stock of a corporation that prior to the disposition of its stock is related to the transferor within the meaning of Code Sec. 267(b) (Reg. §1.904-4(e)(3)(ii)).

107. Code Sec. 907(c)(2) does not apply as to “foreign oil related income” for purposes of the foreign tax credit adjustment of Code Sec. 907(b) if neither that person nor a related person has foreign oil and gas extraction income (other than directly related income) or foreign oil related income (other than directly related income) or less than 50 percent of that person’s gross income from sources outside the United States which is related exclusively to the performance of services and from the lease or license of certain property is attributable to services performed for (or on behalf of), leases to, or licenses with related persons. For both purposes, a person will be treated as a related person if that person would be so treated within the meaning of Code Sec. 954(d)(3) (as applied by substituting the word “corporation” for the word “controlled foreign corporation”) or that person is a partnership or partner described in Code Sec. 707(b)(1) (Reg. §1.907(c)-1(g)(4)).

108. Certain portions of the calculations relevant to determining the possession tax credit under Code Sec. 936 are made without regard to transactions with related persons, where the relationship must be among a controlled group of corporations or as specified in Code Sec. 267(b) or 707(b)(1), utilizing 10 percent instead of 50 percent (Code Sec. 936(h)(3)(D)).

109. Certain investments in certain Caribbean Basin countries will qualify as investment in Puerto Rico so long as (among other things) the investment is in active business assets, which includes capital expenditures for the acquisition, construction, rehabilitation (including demolition associated therewith), improvement, or upgrading of qualified assets. “Qualified assets” includes rights to intangible property that is a patent, invention, formula, process, design, pattern, know-how, or similar item, or rights under a franchise agreement, provided that such rights (among other things) are not rights acquired by the qualified recipient from a related person (within the meaning of Code Sec. 267(b), using “10 percent” instead of “50 percent” in the places where it appears) to the qualified recipient (Reg. §1.936-10(c)(4)(iii)(C)(3)).

110. The income of two or more controlled foreign corporations (“CFCs”) shall be aggregated and treated as the income of a single corporation if a principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to prevent income from being treated as foreign base company income or insurance income under the de minimis test. Two or more CFCs are presumed to have been organized, acquired or maintained to prevent income from being treated as foreign base company income or insurance income under the de minimis test if the corporations are related persons and the corporations satisfy other requirements, including that the corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership that is a related person (as described in Code Sec. 267(b)(10)) with respect to each such CFC (Reg. §1.954-1(b)(4)(iii) and Reg. §4.954-1(b)(4)(iii)).

111. If a dollar election is made for an eligible qualified business unit (“electing QBU”), then the dollar shall be the functional currency of any related person (regardless of when such person became related to the electing QBU) that is an eligible qualified business unit, or any branch of any such related person that is an eligible qualified business unit, for purposes of which the term “related person” means any person with a relationship defined in Code Sec. 267(b) to the electing QBU (or to the United States or foreign person of which the electing QBU is a part) (Reg. §1.985-2(d)(3)(ii)).

112. Each person that is related to the taxpayer on the last day of any tax year for which an election to apply Reg. §1.985-3 to open tax years is effective and that would have been eligible to elect United States dollar approximate separate transactions method of accounting (“DASTM”) must also apply these rules to that year and all subsequent years. In determining whether a qualified business unit (“QBU”) meets the thresholds for qualifying for the use of the small QBU DASTM allocation, a QBU shall be treated as owning all of the assets of each related QBU having its residence in the QBU’s country of residence. Once the election has been made to use the small QBU DASTM allocation, each QBU of any related person that satisfies the threshold requirements shall be deemed to have made the election. For purposes of these rules, the term “related person” means any person with a relationship to the QBU (or to the United States or foreign person of which the electing QBU is a part) that is defined in Code Sec. 267(b) or 707(b) (Reg. §1.985-3(e)(2)(vi)).

113. For purposes of applying Code Sec. 988(c)(1)(E), which exempts certain forward contracts, futures contracts, options and similar financial instruments from the definition of “Code Sec. 988 transactions” (on which gains or losses are characterized in certain circumstances as ordinary income) in the case of qualified funds, interests in a partnership held by persons related to each other (within the meaning of
Code Sec. 267(b) or 707(b)(1)) are treated as held by one person (Code Sec. 988(c)(1)(E)(vi)(I)).

114. If a debt instrument denominated in a nonfunctional currency (or the payments of which are determined with reference to a nonfunctional currency) is entered into between related persons as defined in Code Secs. 267(b) and 707(b), and the instrument is disposed of or otherwise terminated prior to maturity in a transaction in which exchange gain or loss would be recognized, the District Director or the Assistant Commissioner (International) may defer such gain or loss if he determines that the debt has in effect been replaced with other debt denominated in a different currency (replacement debt) entered into with the same or another related person (regardless of whether the replacement debt is denominated in, or determined by reference to, the taxpayer's functional currency. (Proposed Reg. §1.988-2(b)(14)(ii)).

115. For purposes of integrating certain nonfunctional currency debt instruments and certain hedges or integrating certain qualified payments and certain hedges, one requirement is that none of the parties to the hedge have relationships defined in Code Sec. 267(b) or 707(b) (Reg. §1.988-5(a)(5)(iii) and Proposed Reg. §1.988-5(d)(2)(ii)(D)).

116. Certain executory contracts that requires payment in a nonfunctional currency and certain hedges may be integrated and, if they are so integrated, if an executory contract is between related persons as defined in Code Secs. 267(b) and 707(b) and if the taxpayer disposes of the hedge or terminates the executory contract prior to the accrual date, the Commissioner may redetermine the timing, source, and character of gain or loss from the hedge or the executory contract if he determines that a significant purpose for disposing of the hedge or terminating the executory contract prior to the accrual date was to affect the timing, source, or character of income, gain, expense, or loss for Federal income tax purposes (Reg. §1.988-5(b)(4)(iii)(C)). A similar rule has been proposed as to integrated qualified payments and hedges (Proposed Reg. §1.988-5(d)(3)(iii)(C)(1)).

117. If a taxpayer elects the mark to market method of accounting of Reg. §1.988-5(f), each person who is related to the taxpayer within the meaning of Code Sec. 267(b) or 707(b) (whether or not such person uses U.S. GAAP) shall be deemed to make such election (Reg. §1.988-5(f)(4(i))).

118. For purposes of the regulations under Code Sec. 993, a “related person” means a person who is related to another person if either immediately before or after a transaction the relationship between such persons would result in a disallowance of losses under Code Sec. 267 or 707(b) or using a modified controlled group definition (Reg. §1.993-1(a)(6)).

119. For purposes of the debt modification rules of Reg. §1.1001-3, an option is unilateral (which could allow its exercise to avoid triggering a modification) only if, under the terms of an instrument or under applicable law there does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to the issuer; the exercise of the option does not require the consent or approval of the other party, a court or arbitrator or a person who is related to that party (within the meaning of Code Sec. 267(b) or 707(b)(1)), whether or not that person is a party to the instrument; and the exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information (as defined in §1.446-3(c)(4)(iii)) (Reg. §1.1001-3(c)(3)).

120. The nonrecognition rule provided by Code Sec. 1031 is not available in certain circumstances if a taxpayer exchanges property with a person bearing a relationship to the taxpayer described in Code Sec. 267(b) or 707(b)(1) (Code Sec. 1031(f)).

121. For purposes of the deferred exchange rules under Reg. §1.1031(k)-1, a “disqualified person” includes any person that bears a relationship to the taxpayer described in either Code Sec. 267(b) or 707(b), utilizing 10 percent instead of 50 percent, or any person that bears a relationship to certain agents of the taxpayer described in either Code Sec. 267(b) or 707(b), utilizing 10 percent instead of 50 percent (Reg. §1.1031(k)-1(k)(3) and (4)).

122. The nonrecognition rule provided by Code Sec. 1033 as to involuntary conversion is not available to (among others) partnerships in which one or more C corporations own, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership at the time of the involuntary conversion if the replacement property or stock is acquired from a person that bears a relationship to the acquiring person described in Code Sec. 267(b) or 707(b)(1) (Code Sec. 1033(i)).

123. Certain information requirements are imposed on 10 percent owners of an entity that transfer interests in such entity if, in connection with the transfer, such owner (or a person who is related within the meaning of Code Sec. 267(b) or 707(b)(1) to such owner) enters into an employment contract, covenant...
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not to compete, royalty or lease agreement or other agreement with the transferee (Code Sec. 1060(e)).

124. The partial exclusion for gains from certain small business stock is not applicable to stock acquired by a taxpayer if, at any time during the four-year period beginning on the date two years before the issuance of such stock, the issuing corporation purchased (directly or indirectly) any of its stock from the taxpayer or a person related (within the meaning of Code Sec. 267(b) or 707(b)) to the taxpayer (Code Sec. 1202(c)(3)(A)).

125. The partial exclusion for gains from certain small business stock is not applicable if the taxpayer has an offsetting short position with respect to such stock, with one exception. The determination of whether there is an offsetting short position and whether the exception applies is made treating the taxpayer and any person related within the meaning of Code Sec. 267(b) or 707(b) to the taxpayer as one person (Code Sec. 1202(j)).

126. If an obligation is issued at a discount by a corporation and if (among other things) at the time of original issue there was no intention to call the obligation before maturity, the gain realized upon the sale or exchange of the obligation (if held more than one year) is treated as long-term capital gain. Examples of evidence that there was no understanding at the time of original issue to redeem the obligation before maturity include the original purchaser and the issuer are not related within the meaning of Code Sec. 267(b) or 707(b) to the taxpayer as one person (Code Sec. 1202(j)).

127. The provision transforming certain transfers of patents into long-term capital gains is inapplicable to transfers, directly or indirectly, between persons specified within Code Sec. 267(b) (with certain modifications) or 707(b), utilizing “25 percent or more” instead of “more than 50 percent” (Code Sec. 1235(d)).

128. Gain for the sale of depreciable property between a person and (among others) all partnerships more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person or any entity which is a related person to such person under paragraph (3), (10), (11), or (12) of Code Sec. 267(b) is re-characterized as ordinary income (Code Sec. 1239(c)).

129. Code Sec. 1245 costs are properly chargeable to property if (among other times) the property is an operating or a nonoperating mineral interest held by a taxpayer if a party related to the taxpayer (within the meaning of Code Sec. 267(b) or 707(b)) held an operating mineral interest in the same tract or parcel of land that terminated (in whole or in part) without being disposed of (e.g., a working interest which terminated after a specified period of time or a given amount of production), but only if there exists between the related parties an arrangement or plan to avoid recapture under Code Sec. 1254. In such a case, the taxpayer’s Code Sec. 1254 costs with respect to the property include those of the related party (Reg. §1.1254-1(b)(2)(iv)(A)(4)).

130. Code Sec. 1259 requires recognition of gain on any constructive sale or appreciated financial position. In determining whether a taxpayer has an appreciated financial position, the taxpayer may ignore straight debt that is not convertible (directly or indirectly) into the stock of the issuer or any related person. In determining whether a constructive sale occurs, the transactions of the taxpayer and related persons are relevant, which is then taken into account as to other appreciated financial positions. For purposes of these determinations as to related persons, the transaction must be entered into with a view toward avoiding the purpose of Code Sec. 1259 and the persons must bear a relationship described in Code Sec. 267(b) or 707(b) (Code Sec. 1259(c)(4) as implemented by Code Sec. 1259(b)(2)(A)(iii), 1259(c)(1) and 1259(e)(1)).

131. For purposes of Code Sec. 1272, an option is ignored if it is an option to convert a debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of Code Sec. 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt (Reg. §1.1272-1(e)).

132. The issue price of a debt instrument includes any amount paid for an option to convert the instrument into stock (or another debt instrument) of either the issuer or a related party (within the meaning of Code Sec. 267(b) or 707(b)(1)) or into cash or other property in an amount equal to the approximate value of such stock (or debt instrument) (Reg. §1.1273-2(j)).

133. The discount rate for any debt instrument, given in consideration for the sale or exchange of any property (where, pursuant to a plan, the transferor or any related person leases a portion of such property after such sale or exchange), as used under Code Sec. 1274(b)(2)(B) or 483(b) shall be 110 percent of the AFR, compounded semiannually, and Code Sec. 1274A does not apply to any such debt instrument (Code Sec. 1274(e)),. For purposes of these rules, a “related person” means a person related to the transferor within the meaning of Code Sec. 267(b) or 707(b)(1) (Reg. §1.1274-4(a)(2)(ii)).
134. A debt instrument does not provide for contingent payments for purposes of the contingent payment debt instrument rules merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of Code Sec. 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt (Reg. §1.1275-4(a)(4)).

135. For purposes of determining whether a debt instrument is a variable rate debt instrument, an objective rate (which is required under certain circumstances) does not include a rate based on information that is within the control of the issuer (or a related party within the meaning of Code Sec. 267(b) or 707(b)(1)) or that is unique to the circumstances of the issuer (or a related party within the meaning of Code Sec. 267(b) or 707(b)(1)) (Reg. §1.1275-5(c)(1)(i)).

136. With certain exceptions, a qualifying debt instrument and a Reg. §1.1275-6 hedge are an integrated transaction if (among other things) none of the parties to the Reg. §1.1275-6 hedge are related within the meaning of Code Sec. 267(b) or 707(b)(1), and, if the parties are related, the party providing the hedge uses, for federal income tax purposes, a mark-to-market method of accounting for the hedge and all similar or related transactions (Reg. §1.1275-6(c)(1)(iii)).

137. The circumstances under which the Commissioner may require integration of a qualifying debt instrument and a Reg. §1.1275-6 hedge include among others a taxpayer issues or acquires a qualifying debt instrument and a related party (within the meaning of Code Sec. 267(b) or 707(b)(1)) enters into the §1.1275-6 hedge and a taxpayer issues or acquires a qualifying debt instrument and enters into the §1.1275-6 hedge with a related party (within the meaning of Code Sec. 267(b) or 707(b)(1)) (Reg. §1.1275-6(c)(2)).

138. With certain exceptions, the use of stock of a Section 1291 fund as security for the performance of an obligation of a direct or indirect shareholder (or of a person related within the meaning of Code Sec. 267(b) to that shareholder), in connection with a loan, guarantee, margin account, or otherwise (a pledge of stock), is a transaction that results in a disposition of the stock of the Section 1291 fund (Reg. §1.1291-3(d)(1)).

139. For purposes of determining the empowerment zone employment credit, any amount paid or incurred by an employer which is includable from the gross income of an employee under Code Sec. 127 will be treated as wages, but only to the extent paid or incurred to a person not related to the employer, where a person will be treated as related to the employer if the person and the employer are engaged in trades or businesses under common control or the person bears a relationship to the employer specified in Code Sec. 267(b) or 707(b)(1), utilizing 10 percent instead of 50 percent (Code Sec. 1397(a)(2)).

140. The exclusion for certain capital gains from the sale or exchange of certain District of Columbia Enterprise Zone assets does not apply to capital gains attributable, directly or indirectly, in whole or in part, to a transaction with a person related to the disposing person if such persons are described in Code Sec. 267(b) or 707(b)(1) (Code Sec. 1400B(e)(5)).

141. The credit allowable for first-time homebuyers in the District of Columbia is not available if the home is acquired from a person whose relationship to the acquiring person would result in the disallowance of losses under Code Sec. 267 or 707(b) (Code Sec. 1400C(e)(2)(A)(ii)).

142. For withholding under Code Sec. 1441, a withholding agent may rely on documentation furnished by a customer for an account held at another branch location of the same withholding agent or at a branch location of a person related (within the meaning of Code Sec. 267(b) or 707(b)) to the withholding agent if the withholding agent and the related person are part of a universal account system that uses a customer identifier that can be used to retrieve systematically all other accounts of the customer (Reg. §1.1441-1(e)(4)(ix)(A)(2)).

143. If a member of a consolidated group, M, would otherwise recognize gain on a qualified disposition of the stock of the parent of such consolidated group (P), then immediately before the qualified disposition, M is treated as purchasing the P stock from P for fair market value with cash contributed to M by P (or, if necessary, through any intermediate members). For purposes of this rule, a “qualified disposition” must (among other things) include M transferring the stock immediately to a nonmember that is not related, within the meaning of Code Sec. 267(b) or 707(b), to any member of the group, pursuant to a plan (Reg. §1.1502-13(i)(f)(iii)(B)).

144. The amount of loss disallowed under Reg. §1.1502-20(a)(1) and the amount of basis reduction under Reg. §1.1502-20(b)(1) with respect to a share of stock shall not exceed the sum of the extraordinary gains, the positive investment adjustments and the duplicate losses, the first two of which are not reduced or eliminated by reason of an acquisition of the share from a person related within the meaning of Code Sec. 267(b) or 707(b)(1), utilizing 10 percent instead of 50 percent, even if the share is not transferred basis.
A transaction is a reportable transaction as one with contractual protection if it is a transaction for which the taxpayer or a related party (as described in Code Sec. 267(b) or 707(b)) has the right to a full or partial refund of fees if all or part of the intended tax consequences from the transaction are not sustained (Reg. §1.6011-4(b)(4)(i)).

151. The book-tax difference type of reportable transaction only applies to taxpayers that are reporting companies under the Securities Exchange Act of 1934 (15 U.S.C. 78a) and related business entities (as described in Code Sec. 267(b) or 707(b)); or business entities that have $250 million or more in gross assets for book purposes at the end of any financial accounting period that ends with or within the entity's tax year in which the transaction occurs, for purposes of which the assets of all related business entities (as defined in Code Sec. 267(b) or 707(b)) must be aggregated (Reg. §1.6011-4(b)(6)(ii)(A)).

152. The reporting requirements imposed on domestic corporations that are 25 percent foreign owned include information requirements regarding persons who are related (within the meaning of Code Sec. 267(b) or 707(b)) to the reporting corporation or to a 25 percent foreign shareholder of the reporting corporation (Code Sec. 6038A(b)).

153. A U.S. person that transfers cash to a foreign corporation in certain types of transfers must report the transfer if (among other things) the amount of cash transferred by such person or any related person (determined under Code Sec. 267(b)(1) through (3) and (10) through (12)) to such foreign corporation during the 12-month period ending on the date of the transfer exceeds $100,000 (Reg. §1.6038B-1(b)(3)).

154. The reporting requirements under Code Sec. 6038B are imposed on transfers of property by U.S. persons to foreign partnerships in a contribution described in Code Sec. 721 if immediately after the transfer, the U.S. person owns, directly, indirectly, or by attribution, at least a 10 percent interest in the partnership, as defined in Code Sec. 6038(e)(3)(C) and the regulations thereunder; or the value of the property transferred, when added to the value of any other property transferred in a Code Sec. 721 contribution by such person (or any related person) to such partnership during the 12-month period ending on the date of the transfer, exceeds $100,000. In complying with the reporting requirements imposed under Code Sec. 6038B, the names and address of persons related to the transferee during that tax year must be disclosed. For purposes of these rules, a person is related if they bear a relationship described in Code Sec. 707(b)(1)(B) or certain portions of Code Sec. 267(b) (Reg. §1.6038B-2(i)(4)).
155. For purposes of determining whether the information reporting requirements of Code Sec. 6050H apply, interest received from a seller or a person related to a seller within the meaning of Code Sec. 267(b) or 707(b)(1) on a payor of record’s mortgage is not interest received on a mortgage (Reg. §1.6050H-1(e)(3)(ii)).

156. Reporting is specifically required under Code Sec. 6114 (among other times) if a taxpayer takes the position that a treaty exempts from tax, or reduces the rate of tax on, fixed or determinable annual or periodical income subject to withholding under Code Sec. 1441 or 1442 that a foreign person receives from a U.S. person, but only if (among other times), with respect to a treaty that contains a limitation on benefits article, the treaty exempts from tax, or reduces the rate of tax on income subject to withholding (as defined in Reg. §1.1441-2(a)) that is received by a foreign person (other than an individual or a State, including a political subdivision or local authority) that is the beneficial owner of the income and the beneficial owner is related to the person obligated to pay the income within the meaning of Code Secs. 267(b) and 707(b), and the income exceeds $500,000 and a foreign person (other than an individual or a State, including a political subdivision or local authority) meets the requirements of the limitation on benefits article of the treaty (Reg. §301.6114-1(b)(4)(ii)(C)).

157. An error or delay in performing a ministerial or managerial act will be taken into account for purposes of abating underpayment interest only if no significant aspect of the error or delay is attributable to the taxpayer involved or to a person related to the taxpayer within the meaning of Code Sec. 267(b) or 707(b)(1) (Reg. §301.6404-2(a)(2)).

158. For an advisor’s opinion to be used to establish a reasonable cause defense to certain penalties, among other things, the advisor must not be a material advisor that participates in the organization, management, promotion or sale of the transaction or that is related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to any person who so participates (Code Sec. 6664(d)(3)(B)(iii)(I)).

159. The prohibition on the Secretary utilizing summons proceedings to obtain tax-related computer software source code does not apply to (among other things) any such code acquired or developed by the taxpayer or a related person primarily for internal use by the taxpayer or such person rather than for commercial distribution or any communications between the owner of such code and the taxpayer or related persons, in each case where the relationship would cause the persons to be related under Code Sec. 267 or 707(b) (Code Sec. 7612(b)(2)(B) and (C)).

160. For purposes of a transition rule under Reg. §301.7701-2, a rule eliminating grandfathered status on a Code Sec. 708(b)(1)(B) termination will not apply if the sale or exchange of interests in the entity is to a related person (within the meaning of Code Secs. 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity (Reg. §301.7701-2(d)(3)(ii)).
### Appendix III. Partnership Percentage Interest Thresholds (Partial Listing)

<table>
<thead>
<tr>
<th>Percentage Threshold</th>
<th>Source—Code Sec. or Reg. §</th>
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</table>
| Any capital or profits interest | 267(e)(1)(B)(i) and (C)  
1.267(a)-2T(c), Answer 2  
25.2701-2(b)(5)(iii) |
| Less than 1% of profits | 6223(b)(1) |
| 1% or more of capital or profits | 1.61-21(i)(5)(iv) |
| More than 1% of capital or profits | 1.416-1, T-16 |
| 2% or less of capital of profits | 1.7704-1(j) |
| More than 2% of capital or profits | 1.7704-1(e)(2) |
| Less than 5% of capital and profits | 267(e)(5)(A)(i) and (B) |
| 5% or less of profits | 1.46-3(f)(2)(iii) |
| 5% or more of capital and profits | 1.367(a)-3(c)(5)(viii)(B) |
| 5% or more of capital or profits | 1.61-21(g)(8)(i)(C)  
1.414(c)-3(d)(2)(iii)  
1.414(c)-4(b)(2)  
613A(d)(3)(B)  
706(b)(3)  
1563(e)(2) |
| 5% or more of profits | 6223(b)(2) |
| More than 5% of capital or profits | 1.29(c)(3)  
127(b)(3)  
1.414(q)-1T, Q&A-8  
1.416-1, T-17  
1.514(c)-2(k)(2)(i)(A) |
| Less than 10% interest in capital and profits | 163(j)(4)(B)(i)  
1.706-1(b)(6)(iii)  
1.861-9T(e)(4)(i) and (ii)  
1.904-5(h)(4)  
1.1374-4(ii)(5)(i) |
| 10% or less interest in capital or profits | 1.7704-1(f)(3) and (g)(2)(vii) |
| 10% or more of capital or profits | 1.643(h)-1(e)*  
1.679-3(c)*  
4975(e)(2)(i)* |
| 10% or greater interest | 1.861-9T(e)(2) and (3) |
| 10% or more interest in capital and profits | 1.904-5(h)(4) |
| 10% or more interest in capital or profits or deductions or losses | 1.6038-3(b)(3) |
| 10% or more interest in profits and losses | 465(c)(7)(D)(iii)(II) |
| More than 10% of capital or profits | 42(d)(2)(D)(iii)(I)  
42(d)(2)(D)(iii)(II)  
1.168-4(d)(6)  
401(c)(3)(D)  
465(b)(3)(i)(C)  
1.706-1(b)(6)(iii)  
1.861-18g)(3)(ii)  
936(h)(3)(D)  
1.1031(k)-1(k)(3) and (4)  
1397(a)(2)  
1.1502-20(c)(2) and -35(d)(4)(ii)(A)  
1.1504-4(c)(3)  
1.7704-1(k)(iii)(A) |
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<tr>
<th>Percentage Threshold</th>
<th>Source—Code Sec. or Reg. §</th>
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<td>More than 10% of profits</td>
<td>4951(e)(4)(C)(ii)</td>
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<td>Less than 20% interest in capital and profits</td>
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<td>1.731-2(e)(4)(ii)</td>
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<td>20% or less of profits</td>
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<td>20% or less of capital</td>
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<td>20% or more of profits or capital</td>
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<td>20% or more of capital</td>
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<td>6166(b)(1)(B)(i)</td>
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<td>20% or more of the partner’s highest interest in any item of loss or deduction</td>
<td>1.752-4(b)(2)(iv)(A)(2) and (B)(1)</td>
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<td>More than 20% of capital or profits</td>
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<td>25% or more of capital and profits</td>
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<td>25% or more of capital or profits</td>
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<td>954(c)(4)(B)</td>
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<td>1235(d)*</td>
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<td>30% or more of capital</td>
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<td>35% or less of profits</td>
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<td>More than 35% of profits</td>
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<td>50% or less of capital and profits</td>
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<td>50% or more of capital or income or loss</td>
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### Percentage Threshold

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<td>707(b)(2)(A) and (B)</td>
</tr>
<tr>
<td>1.737-1(c)(1)</td>
</tr>
<tr>
<td>755(c)*</td>
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<td>1.817-5(c)(2)(iv)*</td>
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<tr>
<td>1.817-5(f)(3)*</td>
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<td>1.861-8T(c)(2)*</td>
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<tr>
<td>1.861-17(c)(2)(i)*</td>
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<tr>
<td>Percentage Threshold</td>
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<tr>
<td>More than 50% of capital or profits (cont’d)</td>
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### Percentage Thresholds

<table>
<thead>
<tr>
<th>Percentage Threshold</th>
<th>Source—Code Sec. or Reg. §</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than 50% of capital or profits or deductions or losses</td>
<td>1.6038-3(b)(2)</td>
</tr>
<tr>
<td>More than 50% of profits</td>
<td>301.6231(a)(7)-1(e)(4) and (f)(2)(iv)</td>
</tr>
<tr>
<td>70% or more of capital</td>
<td>2057(e)(1)(B)(ii)(II) and (3)(A)(ii)</td>
</tr>
<tr>
<td>80% or more of capital and profits</td>
<td>163(j)(6)(D)(ii)</td>
</tr>
<tr>
<td></td>
<td>775(b)(3)</td>
</tr>
<tr>
<td>80% or more of capital or profits</td>
<td>1.52-1(d)(2)(iii)</td>
</tr>
<tr>
<td></td>
<td>1.382-9(d)(5)(ii)(A)*</td>
</tr>
<tr>
<td></td>
<td>1.414(c)-2(b)(2)(i)(C)</td>
</tr>
<tr>
<td></td>
<td>1.704-1(b)(2)(ii)(h)*</td>
</tr>
<tr>
<td></td>
<td>1.752-4(b)(1)*</td>
</tr>
<tr>
<td></td>
<td>1.894-1(d)(2)(ii)(B)(4)*</td>
</tr>
<tr>
<td></td>
<td>1.864-16(d)</td>
</tr>
<tr>
<td></td>
<td>1.7874-1T(c)(1)</td>
</tr>
<tr>
<td>90% or more of capital</td>
<td>2057(e)(1)(B)(ii)(III) and (3)(A)(ii)</td>
</tr>
<tr>
<td>In accordance with partner's capital interest</td>
<td>704(e)(1)</td>
</tr>
<tr>
<td></td>
<td>743(b)(2)</td>
</tr>
<tr>
<td></td>
<td>1.761-2(b)(2)(b)(ii)(b)</td>
</tr>
<tr>
<td></td>
<td>1.856-3(g)</td>
</tr>
<tr>
<td>In accordance with partner's general profits interest</td>
<td>1.46-3(f)(2)</td>
</tr>
<tr>
<td>In accordance with partner's interest in profits</td>
<td>1.752-3(a)(3)</td>
</tr>
<tr>
<td>In accordance with partner's interest in capital or income</td>
<td>613A(c)(7)(D)</td>
</tr>
<tr>
<td>In accordance with capital or profits, whichever is greater</td>
<td>25.2701-6(a)(3)</td>
</tr>
<tr>
<td>Taking into consideration the percentage of capital and profits interests</td>
<td>301.6231(a)(3)-1(c)(4)(iii)</td>
</tr>
<tr>
<td>Taking into consideration the amount of the partner’s profits interest</td>
<td>301.6231(a)(7)-1(q)(2)(iii)</td>
</tr>
<tr>
<td>In connection with the maximum percentage interest deemed owned in capital or profit or loss</td>
<td>Form 1065 Schedule M-3 (Draft Instructions), 2006, pgs. 3, 8</td>
</tr>
<tr>
<td>In accordance with the largest profits interest</td>
<td>301.6231(a)(7)-1(m)(2)</td>
</tr>
<tr>
<td>In accordance with the partner’s percentage interest in overall profits</td>
<td>1.707-4(b)(2)(i)</td>
</tr>
</tbody>
</table>

* Contains derivative references (incorporating PIPP and/or PIPC) under Code Sec. 267(b) and/or 707(b).

## Appendix IV. Dual Stock/Partnership Thresholds

The following illustrative Code and regulations provisions are among those summarized in chart form in Appendix V.

1. For purposes of the interest stripping rules, the term “controlling interest” means at least 80 percent of the total voting power and value of all classes of stock of a corporation, or 80 percent of the profits and capital interests in any other entity (Code Sec. 163(j)(6)(D)(iii)).

2. For purposes of identifying related persons under Section 267(b), a corporation and a partnership are related if the same persons own (i) more than 50 percent in value of the outstanding stock of the corporation and (ii) more than 50 percent of the capital or profits interest in the partnership (Code Sec. 267(b)(10)).

3. For purposes of treating gain from sale of depreciable property between certain related taxpayers as ordinary income rather than capital gain, the term “controlled entity” is defined to include, with respect to any person, (i) a corporation more than 50 percent of the value of the outstanding stock is owned by or for such person, and (ii) a partnership more than 50 percent of the capital or profits interest is owned by or for such person (Code Sec. 1239(c)(1)).

4. For purposes of meeting the requirements of Section 501(q) for the tax exemption for certain credit counseling organizations, the organization must not own more than 35 percent of (i) the total combined voting power of any corporation or (ii) the profits interest of any partnership, which is in certain specified trades or businesses (Code Sec. 501(q)(1)(E)).

5. For purposes of determining the excise tax on a private foundation’s excess business holdings in a business enterprise, the permitted holdings of the private foundation (i) in an incorporated business enterprise is 20 percent of the voting stock reduced by the percentage of voting stock owned by all disqualified persons and (ii) in an unincorporated business enterprise is 20 percent of the profits interests reduced by the percentage of profits interests owned by all disqualified persons (Code Sec. 4943(c)(2)(A) and (c)(3)(A)).
Appendix V. Dual Stock/Partnership Analogues: Selected Provisions

The following illustrative Code and regulations provisions are organized by the nature of the relevant corporate stock attributes that create “relatedness” for purposes of the operative Code provision. (This list is not intended to be comprehensive.)

<table>
<thead>
<tr>
<th>Percentage Stock</th>
<th>Partnership Interest</th>
<th>Code Sec. or Reg. §</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Combined Voting Power</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Not more than 35%</td>
<td>Total combined voting power</td>
<td>Profits</td>
</tr>
<tr>
<td>At least 10%</td>
<td>Total combined voting power</td>
<td>Capital or profits</td>
</tr>
<tr>
<td><strong>2. Value of Stock</strong></td>
<td></td>
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</tr>
<tr>
<td>More than 50%</td>
<td>Value of the outstanding stock</td>
<td>Capital or profits</td>
</tr>
<tr>
<td>More than 50%</td>
<td>Value of the outstanding stock</td>
<td>Capital or profits</td>
</tr>
<tr>
<td>More than 50%</td>
<td>Value of the outstanding stock</td>
<td>Capital and profits</td>
</tr>
<tr>
<td><strong>3. Voting Power or Value</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At least 50%</td>
<td>Vote or value of the stock</td>
<td>Capital or profits</td>
</tr>
<tr>
<td>At least 80%</td>
<td>Vote or value of the stock</td>
<td>Capital or profits</td>
</tr>
<tr>
<td>At least 80%</td>
<td>Total combined voting power or value of shares of all classes</td>
<td>Capital or profits</td>
</tr>
<tr>
<td>More than 50%</td>
<td>Value of the stock or total voting power of all classes of stock</td>
<td>Value</td>
</tr>
<tr>
<td><strong>4. Voting Power and Value</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At least 80%</td>
<td>Total voting power and value of all classes</td>
<td>Profits and capital</td>
</tr>
<tr>
<td><strong>5. Percentage of Voting stock</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20% maximum</td>
<td>Percentage of the voting stock</td>
<td>Profits</td>
</tr>
<tr>
<td><strong>6. Percentage of All Shares</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20% maximum</td>
<td>Percentage of all outstanding shares (voting and nonvoting)</td>
<td>Capital</td>
</tr>
</tbody>
</table>

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