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Lingering Partnership Classification Issues (Just When You Thought It Was Safe To Go Back Into the Water)

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- I. INTRODUCTION
- II. OVERVIEW OF PARTNERSHIP CLASSIFICATION PRINCIPLES
- III. LIMITED LIABILITY
 - A. *Background*
 - B. *Issues*
 - 1. *Minimal Equity Partnerships*
 - 2. *Large Equity Partnerships*
 - 3. *Use of Demand Notes*
 - 4. *Multiple Partnership Interests*
 - 5. *Absence of "Dumminess"*
 - 6. *General Partners With Tiny Interests*
 - 7. *Individuals as General Partners*
 - 8. *Capital Account Restoration Obligations*
- IV. FREE TRANSFERABILITY OF INTERESTS
 - A. *Background*
 - B. *Issues*
 - 1. *Reasonable v. Sole Discretion*
 - 2. *Limited Transfer Rights*
 - 3. *Assignments Without Substitution*
 - 4. *Multiple Mild Limitations*
 - 5. *Free Transferability for Some But Not All Partners*
 - 6. *Affiliated General and Limited Partners*
 - 7. *General Partners With Tiny Interests*
 - 8. *Consent Shopping*

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V. CONTINUITY OF LIFE

- A. *Background*
- B. *Issues*
 - 1. *Reliance on the Presumption Alone*
 - 2. *Number of Dissolution Events*
 - 3. *Weak Dissolution Events*
 - 4. *Reconstitution Provisions*
 - 5. *Affiliated General and Limited Partners*
 - 6. *General Partners With Tiny Interests*

VI. CENTRALIZED MANAGEMENT

- A. *Background*
- B. *Issues*
 - 1. *“Substantially All” Issue*
 - 2. *Capital Versus Profits Interests*
 - 3. *Removal Rights*
 - 4. *Affiliated General and Limited Partners*
 - 5. *“Exclusive Authority” Issue*
 - 6. *Managing General Partners*

VII. EXOTIC PARTNERSHIPS

- A. *Limited Liability Companies*
- B. *One-Partner Partnerships*
- C. *Business Trusts and Common Law Trusts*

VIII. CONCLUSION

I. INTRODUCTION

This article discusses the federal income tax law relating to the classification of entities as partnerships for federal income tax purposes, with a focus on the practical problems that lawyers often encounter in distinguishing partnerships from associations under the four factor test set forth in Regulations section 301.7701-2. Partnership classification issues arise with respect to both general and limited partnerships formed under state partnership statutes and certain partnership-like foreign entities. Moreover, the recent proliferation of other types of entities seeking partnership classification, such as "master limited partnerships," limited liability companies, business trusts, common law trusts and grantor trusts with partnership "fallback" positions, has focused renewed attention on those issues and raised still more classification issues.¹ The Internal Revenue Service's recent published rulings have addressed some of these issues, but a number of issues remain.

II. OVERVIEW OF PARTNERSHIP CLASSIFICATION PRINCIPLES

The question of whether an entity is a partnership for federal income tax purposes does not depend upon whether the entity is organized as a partnership under a state partnership statute.² Nor does it depend upon whether there is a written partnership agreement (or its equivalent) among the parties.³ To add further confusion, there is no comprehensive definition of the term "partnership" in the Code. Section 7701(a)(2) provides a starting point in stating that: "the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not ... a trust or estate or a corporation."⁴ Thus, an unincorporated

1. This article deals only with partnership classification issues that arise where a partnership or other juridical entity has been formed under local law. It does not deal with the more metaphysical issue of whether co-ownership of property, "participating" loans, "kicker" leases, and other types of relationships not involving a separate legal entity should be characterized as partnerships for federal income tax purposes or the special rules for "publicly traded partnerships" in section 7704. Any reference herein to a "partnership" means an entity organized as a separate legal entity under applicable state law, without regard to its characterization for federal income tax purposes, except as otherwise indicated.

2. See, e.g., *Nichols v. Commissioner*, 32 T.C. 1322, 1330 (1959), acq., 1960-2 C.B. 6; Rev. Rul. 58-243, 1958-1 C.B. 255; Regs. §§ 301.7701-1(c), -3(a).

3. See, e.g., *Seattle Renton Lumber Co. v. United States*, 135 F.2d 989, 991 (9th Cir. 1943); *Barron v. Commissioner*, T.C. Memo 1992-598, 1034, 1037 (CCH) (1992); *Nichols*, 32 T.C. at 1329; *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840, 849 (1957), acq., 1957-2 C.B. 3.

4. See also IRC § 761(a) and Regs. § 301.7701-3(a) (containing virtually identical definitions of the term "partnership").

organization⁵ that carries on a business or financial operation will be characterized as a partnership only if it is not characterized as “a trust or estate or a corporation.” Normally it is clear that an unincorporated organization that carries on a business or financial operation is not a trust or estate. However, because “corporation” as used in the Code includes not only entities formed as corporations under state laws but also unincorporated “associations,”⁶ the critical issue in characterizing an unincorporated organization normally is whether it is an “association.” If it is an association, it will be treated as a corporation. If it is not an association, it will be characterized as a partnership.

The term “association” is not defined in the Code, but it is defined in the regulations. Regulations section 301.7701-2(a)(1) states generally that an unincorporated entity will be treated as an association rather than a partnership if “the organization more nearly resembles a corporation than a partnership....” A more analytical framework is provided in Regulations section 301.7701-2(a)(3), which indicates that an unincorporated organization generally will not be classified as an association unless it has “more corporate characteristics than noncorporate characteristics,” determined without regard to the characteristics that corporations have in common with the alternative type of characterization being considered. Regulations section 301.7701-2(a)(1) states that the “major characteristics ordinarily found in a pure corporation” that may distinguish it from other types of organizations are (i) associates, (ii) an objective to carry on a business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property and (vi) free transferability of interests.⁷ Regulations section 301.7701-2(a)(2) provides that associates and an objective to carry on business are common to corporations and partnerships and, therefore, that the determination as to whether an unincorporated organization is a partnership or an association turns on whether there is continuity of life, centralized management, limited liability and free transferability of interests, each of which is discussed separately below. The determination as to whether any such characteristic exists requires an analysis of the rights and obligations of the parties based upon applicable state law and the terms of any agreement among the parties.

Under the literal language of Regulations section 301.7701-2, the four corporate characteristics that distinguish partnerships from associations are of

5. See *infra* text accompanying notes 24-27 (discussing the definition of the term “unincorporated association”).

6. IRC § 7701(a)(3); Regs. § 301.7701-1(c).

7. These factors were derived from the Supreme Court’s opinion in *Morrissey v. Commissioner*, 296 U.S. 344 (1935), which dealt with the distinction between a trust and an association and is still cited with reverence in partnership classification cases.

equal importance, and the courts have consistently rejected any attempt to weight the factors.⁸ Also, with the exception of free transferability, the four relevant corporate characteristics have been approached in all-or-nothing terms, rather than as matters of degree. Therefore, whether an entity is an association generally depends upon the purely mechanical test of whether the entity has more than two (i.e., at least three) of the four relevant corporate characteristics.

It should be noted that Regulations section 301.7701-2(a)(1) expressly states that "other factors" may be relevant in distinguishing partnerships from associations. However, only four cases have discussed the possible relevance of such "other factors" in any detail.⁹ In both *Bush* and *Outlaw*, the courts stated that such other factors were relevant to the classification issue, but in neither case did the court seem to regard them as being particularly significant. In *Larson*, the Tax Court held that the "other factors" raised by the Service were not relevant, except to the extent that they inhered in the four standard corporate characteristics.¹⁰ In *Zuckman*, the Court of Claims dismissed the other factors raised by the Service as irrelevant, since the entity in question was so clearly a partnership based on the absence of all four standard corporate characteristics. Most cases and published rulings only pay lip service to the possible relevance of "other factors," and not all of the published rulings recently issued by the Service even do that.¹¹ Thus, this potentially nettlesome issue apparently will remain dormant for the foreseeable future.

The evolution of the current association classification regulations has been a turbulent process that has been discussed at length by several

8. See, e.g., *Richlands Medical Association v. Commissioner*, 60 T.C.M. (CCH) 1572, 1579 (1990), aff'd, 953 F.2d 639 (4th Cir. 1992); *Foster v. Commissioner*, 80 T.C. 34, 186 (1983), aff'd in part and vacated in part, 756 F.2d 1430 (9th Cir. 1985), cert. denied, 474 U.S. 1055 (1986); *Larson v. Commissioner*, 66 T.C. 159, 185-86 (1976), acq., 1979-1 C.B. 1. However, the *Larson* majority did muse that it would weight the factors in favor of "practical continuity" and limited liability if it were writing the rules.

9. *Larson*, 66 T.C. at 184; *Zuckman v. United States*, 524 F.2d 729, 744 (Cl. Cl. 1975); *Outlaw v. United States*, 494 F.2d 1376, 1385 (Cl. Cl.), cert. denied, 419 U.S. 844 (1974); *Bush #1 c/o Stonestreet Lands Co. v. Commissioner*, 48 T.C. 218, 234 (1967), acq., 1968-2 C.B. 2.

10. Shortly thereafter, the Service issued a published ruling listing seven "other factors" that it would not consider as having relevance independent of their impact on the six major corporate characteristics, which factors reflected the other factors it unsuccessfully raised in *Larson*. Rev. Rul. 79-106, 1979-1 C.B. 448.

11. Recent partnership classification rulings that do not even mention the possible relevance of other factors include: Rev. Rul. 93-6, 1993-3 I.R.B. 8 (Jan. 19); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Jan. 19); Rev. Rul. 93-4, 1993-3 I.R.B. 5 (Jan. 19); Rev. Rul. 88-79, 1988-2 C.B. 361; Rev. Rul. 88-8, 1988-1 C.B. 403. Revenue Ruling 88-76, 1988-2 C.B. 360, does mention "other factors," though only in passing.

commentators.¹² However, three historical points regarding the evolution of the association classification regulations are worth mentioning at this juncture.

The first point is that the current regulations reflect a bias that the Service once had to make it difficult for unincorporated entities to achieve corporate status. That bias arose because at one time many professional service businesses operated in partnership, trust or association form, but claimed that they were taxable as corporations in order to become entitled to the favorable tax benefits that were available for corporate pension and profit-sharing plans.¹³ After losing a number of cases where it asserted that such businesses should be treated as partnerships,¹⁴ the Service promulgated Regulations section 301.7701-2 in 1960 to make it easier to achieve partnership status.¹⁵ That bias towards partnership classification has been the subject of discussion by commentators,¹⁶ and it has even been acknowledged by the courts on several occasions.¹⁷ The Service's ruling guidelines also have been liberalized considerably over the years, thereby increasing the bias in favor of partnership characterization in the ruling arena. The current ruling

12. See, e.g., 1 William S. McKee, et al., *Federal Taxation of Partnerships and Partners* ¶ 3.06(1) (2d ed. 1990); Richard A. Fisher, *Classification Under Section 7701—the Past, Present, and Prospects for the Future*, 30 *Tax Law.* 627 (1977); H. Lawrence Fox, *The Maximum Scope of the Association Concept*, 25 *Tax. L. Rev.* 311 (1970); Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 *Minn. L. Rev.* 603 (1965).

13. The taxpayers presumably believed that treatment of the entity as a corporation would not involve an onerous double tax burden based on their expectation that the taxable income of the entity could be minimized through salary payments and by the availability at the time of the tax-free liquidation provisions for corporations.

14. See, e.g., *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954); *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959).

15. T.D. 6503, 1960-2 C.B. 409. In 1965, the Service amended the original 1960 regulations by adding a special provision applicable only to unincorporated professional service businesses that would have made it virtually impossible for such professional service businesses to be treated as corporations. T.D. 6797, 1965-1 C.B. 553. That amendment was promptly held to be invalid. *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969); *O'Neill v. United States*, 410 F.2d 888 (6th Cir. 1969); *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969); *Holder v. United States*, 289 F. Supp. 160 (N.D. Ga. 1968), *aff'd per curiam*, 412 F.2d 1189 (5th Cir. 1969). The 1965 amendments were withdrawn in 1977. T.D. 7515, 1977-2 C.B. 482. Additional amendments relating to limited liability were proposed in 1980, but they also were withdrawn. See discussion *infra* in Part III(A). One additional amendment was made in 1983. T.D. 7889, 1983-1 C.B. 362. The Service has recently proposed an amendment to the continuity of life provisions of the regulations. Notice PS-7-92, 1992-32 I.R.B. 29 (Aug. 10).

16. See, e.g., Fisher, *supra* note 12, at 630.

17. See, e.g., *Kurzner*, 413 F.2d at 105; *Empey*, 406 F.2d at 169; *Foster v. Commissioner*, 80 T.C. 34, 186 (1983), *aff'd in part and vacated in part*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986); *Larson*, 66 T.C. at 186-88 (Dawson, C.J., concurring); *Zuckman*, 524 F.2d at 733, n.5.

guidelines¹⁸ reflect at least six significant changes from the prior guidelines dating from 1972.¹⁹ Given that legal environment, it should come as no surprise that the Service has lost most of the classification cases since 1960 where it was attempting to characterize as an association an entity that the taxpayer had been treating as a partnership.²⁰

The second point is that there are surprisingly few cases and published rulings on a number of basic issues that frequently arise under the association classification rules contained in Regulations section 301.7701-2, as the discussion below indicates.²¹ Indeed, the association classification law

18. The Service's current ruling guidelines are contained in: Rev. Proc. 93-3, 1993-1 I.R.B. 71 (Jan. 4); Rev. Proc. 92-88, 1992-42 I.R.B. 39 (Oct. 19); Rev. Proc. 92-87, 1992-42 I.R.B. 38 (Oct. 19); Rev. Proc. 92-35, 1992-1 C.B. 790; Rev. Proc. 92-33, 1992-1 C.B. 561; Rev. Proc. 89-12, 1989-1 C.B. 798, modified, Rev. Proc. 93-3, 1993-1 I.R.B. 71 (Jan. 4). See also Rev. Proc. 91-13, 1991-1 C.B. 477 (providing the partnership classification ruling request checklist).

19. The prior ruling guidelines were contained in Revenue Procedure 72-13, 1972-1 C.B. 735, as modified and supplemented by Revenue Procedure 74-17, 1974-1 C.B. 438. The significant liberalizing changes that were made by the current ruling guidelines include: (i) the minimum interest of the general partner need not be one percent in all cases (with as little as 0.2% now sufficing in certain cases), Rev. Proc. 89-12 at § 4.01; (ii) the minimum interest of the general partner may be subject to temporary reductions due to the requirements of sections 704(b) and 704(c) or more permanent reductions in certain years (provided that in the latter case there is a substantial interest in other years), Rev. Proc. 89-12 at § 4.01; (iii) there is no per se rule preventing the limited partners from owning more than 20% of the general partner or having an option or obligation to acquire securities issued by the general partner in the future, see Rev. Proc. 72-13 at §§ 2.01, 2.05; (iv) the general partner does not need to have a net worth equal to 10% of the capital contributions to the partnership in all cases (which was previously required even where the partnership is not relying on the absence of limited liability), see Rev. Proc. 72-13 at § 2.02; (v) the general partner's net worth for limited liability purposes may include the value of its interests in other limited partnerships, see Rev. Proc. 72-13 at § 2.03; and (vi) the partnership may generate losses in excess of the equity capital of the partners during the first two years of operations, see Rev. Proc. 74-17 at § 3.02. The only significant tightening of the ruling guidelines was the addition of the new requirement that the general partner either (x) maintain a capital account balance equal to the lesser of one percent of the aggregate positive capital accounts of all the partners or \$500,000, or (y) represent that it will provide "substantial services" and agree to a limited negative capital account restoration obligation at liquidation. Rev. Proc. 89-12 at § 4.03.

20. The Service's losses occurred in: *MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982); *Larson*, 66 T.C. 159; *Zuckman*, 524 F.2d 729; *Bush #1 c/o Stonestreet Lands Co. v. Commissioner*, 48 T.C. 218 (1967), acq., 1968-2 C.B. 2. The only Service victories were in *Richlands Medical Ass'n v. Commissioner*, 60 T.C.M. (CCH) 1572 (1990), aff'd, 953 F.2d 639 (4th Cir. 1992), and *Outlaw v. United States*, 494 F.2d 1376 (Ct. Cl. 1974).

21. The key cases on distinguishing partnerships from associations under the current regulations are: *MCA*, 685 F.2d 1099; *Kurzner*, 413 F.2d 97; *Foster*, 80 T.C. 34; *Larson*, 66 T.C. 159; *Zuckman*, 524 F.2d 729; *Outlaw*, 494 F.2d 1376; *Bush #1 c/o Stonestreet Lands Co.*, 48 T.C. 218; *Richlands Medical Ass'n*, 60 T.C.M. (CCH) 1572. The key published rulings are the revenue procedures referred to in note 18, supra, and: Rev. Rul. 93-6, 1993-3 I.R.B. 8 (Jan.

has not been the subject of a Supreme Court decision since 1935,²² which was long before the current regulations were promulgated. The leading case is the Tax Court decision in *Larson*, but even that case may be of questionable reliability.²³ Given that dearth of authority, the Service's ruling guidelines and its private letter rulings in this area have become very important sources of guidance. Only the bravest of practitioners knowingly go beyond the ruling guidelines to test the limits of the substantive law.

The third point is that the issue of whether an entity is "incorporated" has not received much attention. The issue of whether an entity might be classified as a partnership under Regulations section 301.7701-2 is academic if one concludes that the entity is "incorporated," since a partnership by definition is not an "incorporated" organization. Presumably the drafters of section 7701(a)(2) intended the term "unincorporated organization" to mean an entity organized under a law other than an ordinary state corporate statute.²⁴ The Service has taken the position in a few private rulings that the term "incorporated" should be defined more broadly (and less precisely) based upon the common law concept of a corporation as described in the seminal *Dartmouth College* case.²⁵ In *O'Neill v. United States*, one of the few cases to confront this issue directly, the Sixth Circuit Court of Appeals also looked to the definition of the term "corporation" in the *Dartmouth College* case.²⁶ This issue has the potential to spawn a second major line of authority relating to partnership classification, which could be a real problem for limited liability companies, business trusts and certain other types of

19); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Jan. 19); Rev. Rul. 93-4, 1993-3 I.R.B. 5 (Jan. 19); Rev. Rul. 88-79, 1988-2 C.B. 361; Rev. Rul. 88-76, 1988-2 C.B. 360; Rev. Rul. 88-8, 1988-1 C.B. 403; Rev. Rul. 79-106, 1979-1 C.B. 448; Rev. Rul. 77-214, 1977-1 C.B. 408.

22. *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

23. The procedural history of *Larson* was unusual, because the Tax Court originally held against the taxpayer, but later reversed itself after the taxpayer made a motion for reconsideration. The final decision was a 7-6 split decision that spawned no less than eight separate opinions. As indicated in note 8, *supra*, the Service has acquiesced in *Larson*, 1979-1 C.B. 1, but that acquiescence was subsequently reconsidered and then allowed to stand, 1979-2 C.B. 2.

24. See *United States v. Empey*, 406 F.2d 157, 170 (6th Cir. 1969); cf. *O'Neill v. United States*, 410 F.2d 888, 895-98 (6th Cir. 1969) (discussing the definition of "corporation" under section 7701(a)(3)); Boris I. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 19 *Tax L. Rev.* 1, 25-27 (1961) (discussing definition of "corporation" under section 7701(a)(3)).

25. See *Priv. Let. Rul. 7921084* (Feb. 27, 1979) (Arizona "close corporation" does not need to be tested under Regulations section 301.7701-2 because it is an "incorporated" organization within the meaning of the common law, citing *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819)); *Priv. Let. Rul. 8426031* (Mar. 26, 1984) (same for a foreign "unlimited liability company"); G.C.M. 37127 (May 18, 1977) (same for a Texas "close corporation"); see also G.C.M. 37953 (May 14, 1979); G.C.M. 38281 (Feb. 15, 1980).

26. *O'Neill*, 410 F.2d at 895-98.

entities that bear certain similarities to ordinary corporations but are not organized under an ordinary state corporation statute. However, the Service apparently does not intend to press this issue. In fact, the Service now takes the position that foreign entities *must* be classified based upon an application of Regulations section 301.7701-2 as if they were unincorporated organizations, regardless of how closely they resemble an ordinary corporation.²⁷

III. LIMITED LIABILITY

A. Background

Regulations section 301.7701-2(d)(1) sets forth the basic rule that "an organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts or claims against the partnership." Under that rule, all partnerships organized under a state partnership statute would, of course, not have the corporate characteristic of limited liability, since all such partnerships would have at least one general partner that is personally liable for partnership liabilities. In the case of a general partnership, where all the partners have personal liability, the issue is that simple and no further inquiry is required under the regulations.

However, in the case of a limited partnership, the limited partners do not have personal liability and, therefore, the entity seems more like a corporation. In recognition of that fact, the regulations qualify the general rule for limited partnerships with a corporate general partner by providing that the entity will be deemed to have limited liability if (1) the general partner has "no substantial assets" (other than its interest in the partnership) that could be reached by creditors of the partnership *and* (2) the general partner "is merely a 'dummy' acting as the agent of the limited partners."²⁸

There are three important points that should be noted with respect to the limited liability factor. First, historically the limited liability factor was regarded by many practitioners as being more important than any of the other three corporate factors in distinguishing partnerships from associations, even though it is coequal with the other three corporate factors under the literal language of Regulations section 301.7701-2 and no case or published ruling has ever held that the limited liability factor should be given special weight.²⁹ That concern was based in part on the notion that the personal liability of a general partner represents the most meaningful difference

27. Rev. Rul. 88-8, 1988-1 C.B. 403. But see Rev. Proc. 93-3, 1993-1 I.R.B. 71 (Jan. 4), at § 4.01(47) (the Service will ordinarily not rule as to whether "what is generally known as a foreign corporation" is a partnership for federal income tax purposes).

28. Regs. § 301.7701-2(d)(2).

29. See *supra* note 8 and accompanying text.

between a partnership and a corporation and in part on the Service's prior ruling policy, as codified in Revenue Procedure 72-13, that the corporate general partner of a limited partnership always should have a certain amount of net worth, even if the partnership were not relying on the absence of limited liability to support its partnership status.³⁰ That concern reached its apogee in 1980, when the Service proposed a regulation that would have automatically treated an entity as an association if no member was personally liable for the liabilities of the entity.³¹ The proposed regulation was withdrawn in 1982 without any real explanation by the Service.³² However, the withdrawal of the proposed regulation did not dispel the concern that limited liability might be a "superfactor," since the Service's statement indicated that it planned to conduct a study of the association classification rules with a "special focus on the significance of the characteristic of limited liability"³³ and the Service subsequently announced that it would not rule on the status of limited liability companies pending completion of that study.³⁴ The concern was finally eliminated in 1988 when the Service announced that it would not insist on the absence of limited liability in all cases either as a matter of substantive law or as a ruling policy (with the result that limited liability was left coequal with the other three corporate characteristics)³⁵ and its publication of Revenue Ruling 88-76,³⁶ indicating that Wyoming limited liability companies may be treated as partnerships, without any member having personal liability, on the basis of the absence of at least two other corporate factors.

The second point regarding the limited liability factor is that there is virtually no authority on what it means for a general partner to have "substantial assets." The only gloss that Regulations section 301.7701-2(d)(2) provides is a statement to the effect that a general partner may be regarded as having substantial assets even if its assets would be "insufficient to satisfy any substantial portion of the obligations of the organization," indicating that the substantiality of the general partner's assets need not necessarily be judged by reference to the entity's liabilities. Fortunately, the Service has provided some bright-line guidance in the form of its ruling guidelines, which indicates that the Service generally will rule that a limited partnership with a corporate general partner lacks the characteristic of limited liability if the

30. See Rev. Proc. 72-13, 1972-1 C.B. 735 at § 2.02.

31. Prop. Regs. §§ 301.7701-2(a), -2(g), 45 Fed. Reg. 75,709 (1980).

32. I.R.S. News Rel. 145 (Dec. 16, 1982), 82 CCH ¶ 6851, 83 P-H ¶ 54,703.

33. *Id.*

34. See Rev. Proc. 83-22, §§ 2.01, 5.26, 1983-1 C.B. 680, and successor ruling guidelines.

35. Announcement 88-118, 1988-38 I.R.B. 26 (Sept. 2); see also Rev. Proc. 88-44, 1988-2 C.B. 634 (abandoning Service's no-ruling policy regarding limited liability companies).

36. 1988-2 C.B. 360.

net worth of the general partner (exclusive of the value of its interest in the partnership) equals at least ten percent of the total capital contributions to the partnership.³⁷ The guidelines go on to provide that the Service may rule that a partnership lacks limited liability if the general partner has a lesser amount of net worth, although “close scrutiny” will be applied in such cases.

The third point regarding the characteristic of limited liability is that the fact that a partnership has debt that is nonrecourse to the partners is not relevant. For a partnership that finances its operations solely with nonrecourse debt, the personal liability of the general partner may be relevant only for any trade creditors or tort claimants.

B. Issues

The foregoing rules raise the following special problems.

1. *Minimal Equity Partnerships.*—One issue that frequently arises under the ten percent net worth safe harbor for unlimited liability under Revenue Procedure 89-12 is whether it really means what it says when it is applied to situations where the capital contributions to the entity are minimal. In theory, one could organize a partnership or other entity with no equity capital (other than whatever *de minimis* amount of capital, if any, is required as a matter of state law) and rely solely on loans to fund the partnership’s operations. This is most likely to occur when the partnership will be conducting a service business where capital is not a material income-producing factor or will be a “securitization” vehicle that does not need significant equity. In such situations, the safe harbor would require that the general partner have net worth equal to ten percent of a *de minimis* amount, which obviously seems too good to be true, since there is no substance to personal liability in that situation. The drafters of Revenue Procedure 89-12 may have been concerned about that case, since Revenue Procedure 89-12 includes the caveat that an entity “generally” (but apparently not always) will be deemed to lack limited liability if the general partner satisfies the ten percent safe harbor.

In such situations, it would be advisable for the general partner to have a greater level of net worth such that its net worth would seem significant, perhaps by reference to the amount of debt capitalization of the entity (even though Regulations section 301.7701-2(d)(2) suggests that is not relevant) or perhaps by reference to the amount of expenses expected to be incurred by the entity on an annual basis. Given the dearth of authority on this issue, practitioners ultimately must be guided by the “smell test,” with net worth amounts in the range of \$10,000 often seeming to be the lower limit even for small partnerships. However, the net worth that is recommend-

37. Rev. Proc. 89-12, 1989-1 C.B. 798, at § 4.07.

ed for minimal equity partnerships is likely to vary inversely with the level of comfort that one has on the “dumminess” issue discussed below.³⁸

2. *Large Equity Partnerships.*—The opposite of the case posed in paragraph (1) above is the situation where the partnership has a huge amount of equity capitalization, such that the ten percent safe harbor net worth amount itself would be enormous. In such situations, it would seem that the net worth of the general partner could be regarded as “substantial” as a matter of general principles even if it fails to satisfy the ten percent safe harbor.

Historically, there was no exception to the ten percent safe harbor for partnerships with large amounts of equity capitalization.³⁹ However, Revenue Procedure 89-12 itself expressly contemplates that a favorable ruling could be granted in situations where the ten percent safe harbor is not satisfied, provided that the partnership satisfies the “close scrutiny” test that applies in such cases.⁴⁰ It goes on to provide that limited liability will be found lacking if either the general partner has “substantial assets” or the general partner “will act independently of the limited partners.” The former test, of course, reflects the Service’s new view that even for advance ruling purposes a net worth equal to ten percent of the capital contributions to the partnership may not be required.

That having been said, one is still in uncharted waters when trying to determine how far below the ten percent safe harbor one can go in the case of a large equity partnership. Thus, this issue also tends to be governed by rules of thumb, with practitioners often getting comfortable with net worth amounts that are as low as five percent of the capital contributions to the partnership (and sometimes less) where that amount would be at least five to ten million dollars on the theory that a judge would have difficulty concluding that such net worth was not substantial. Again, one’s willingness to take a risk on this issue is often directly related to his comfort on the “dumminess” issue.

3. *Use of Demand Notes.*—Assuming that one can determine the requisite amount of net worth that the general partner should have to insure that the partnership will lack limited liability, the next issue becomes how that net worth should be supplied. In many, if not most, cases the general

38. See discussion *infra* Part III(B)(5).

39. Rev. Proc. 72-13, 1972-1 C.B. 735 at § 2.02, modified, Rev. Proc. 74-17, 1974-1 C.B. 438. As indicated in note 19, the 10% net worth requirement in the old ruling guidelines applied to all partnerships, even where the partnership did not need to lack limited liability to be treated as a partnership as a matter of substantive law. In addition, the old ruling guidelines did not contemplate the possibility that a favorable ruling on limited liability could be given based on the absence of dumminess.

40. Rev. Proc. 89-12, 1989-1 C.B. 798, at § 4.07.

partner is a special purpose entity or otherwise does not have sufficient net worth to satisfy the requirement. In such cases, the usual practice is for the shareholder of the general partner to issue a demand note to the general partner with a principal amount equal to the shortfall in net worth. The demand note provides that on demand by the general partner, the shareholder will immediately pay the principal amount to the general partner.

The theory behind the use of a demand note is that such a note represents an asset of the general partner with fair market value equal to its face amount. While such a demand note normally would not be readily marketable, the creditors of the partnership could tap the value inherent in the note by obtaining a judgment against the general partner, levying on the demand note and then either making demand on the general partner's shareholder or selling the note to a third party. Thus, the only issue should be whether the general partner's shareholder has the financial wherewithal to satisfy the demand note.

The Service attempted to impose certain limitations regarding the use of demand notes in a recent General Counsel Memorandum regarding advance rulings on partnership status in situations where the general partner is capitalized with a demand note.⁴¹ Among other things, the Memorandum requires that the note be negotiable within the meaning of the applicable state version of the Uniform Commercial Code, that it be payable immediately upon demand and that it accrue interest (which compounds if not paid when due) at a "reasonable market rate."⁴²

In the abstract, these may be reasonable requirements so that the Service will have some assurance that the note is worth its face amount for purposes of advance rulings. However, as a substantive matter, such requirements do not seem to be absolutely necessary, provided that such factors are taken into account in valuing the note. For instance, it is arguable that negotiability should be irrelevant, since negotiability only affects the liquidity of the note, which would not seem to be a particularly material factor in valuing a note payable on demand. In the case of the interest requirement, it is unclear whether the Service wants the note to bear interest from the date of issuance or the date of demand.⁴³ If the former reading was

41. G.C.M. 39798 (Oct. 24, 1989).

42. *Id.* See also I.R.S. Technical Advice Memorandum 9217007 (Jan. 3, 1992), holding that a non-interest bearing demand note did not constitute good equity capital for a Netherlands Antilles finance subsidiary. Although the demand note was essentially the same in substance as the demand notes used to capitalize corporate general partners, the Service concluded that the note was a "nullity," relying in part on the failure of the note to bear interest.

43. Unfortunately, the Service's private letter rulings do not seem to resolve that ambiguity. See, e.g., Priv. Let. Rul. 8942085 (July 27, 1989); Priv. Let. Rul. 9021009 (Feb. 20, 1990). The author has been advised informally by Service officials that the Service's position is that interest should run from the date of issuance.

intended, the Service's position would not be reasonable, since it would be tantamount to either (i) requiring an increasing amount of net worth due to the mere passage of time (where the interest accrues but is not paid currently), which is not required where the general partner is capitalized with other types of assets, or (ii) requiring circular flows of cash (where the note pays interest on a current basis, in which event the cash presumably would be divided back to the shareholder), which would not add any substance to the general partner.

4. *Multiple Partnership Interests.*—Another issue that frequently arises is whether the net worth of a general partner for “substantial assets” purposes may be measured taking into account the value of its interests in other partnerships in which it is a general partner. Regulations section 301.7701-2(d)(1) expressly provides that the net worth of the general partner should be determined without regard to the value of the general partner's interest in the partnership whose status is in question. That rule is perfectly sensible, since that interest presumably would be worthless in any situation where the creditors of the partnership were seeking to collect from the general partner.⁴⁴ However, the regulations do not answer the question of whether general partner interests in *other* partnerships may be taken into account.

It is difficult to see why general partner interests in other partnerships should be disregarded for this purpose. General partner interests in other partnerships represent assets that normally could be valued and, subject to the likely absence of liquidity, may be used to satisfy the claims of creditors of the partnership. While such interests may seem pregnant with liabilities, particularly where the entity is the sole general partner, such liabilities could be taken into account in the valuation process. Certainly it is difficult in principle to distinguish the situation where the entity owns a general partner interest in another partnership that conducts an operating business from the situation where it owns the operating business directly, in which case the fair market value of the business clearly should be taken into account. In either case, the entity would have personal liability for the liabilities of the business, the only difference being that in the direct ownership case the creditors with respect to the business generally would not have to exhaust the assets used in the business before going after the entity's other assets.

44. Creditors of a partnership normally may not seek payment from a general partner in respect of a partnership liability until they have first attempted to collect from the partnership and exhausted all the partnership's assets. However, once the partnership's assets have been exhausted, the general partner's interest could not have any positive value (and it actually would represent a liability).

Historically, the Service looked askance at a general partner taking the value of its interests in other partnerships into account. The Service's long-standing ruling policy, as reflected in Revenue Procedure 72-13, was to exclude the value of such interests in determining whether the general partner satisfied the ten percent net worth test.⁴⁵ Perhaps the Service was concerned about the possibility that a general partner with interests in multiple partnerships would purport to have artificial net worth that would evaporate if all the partnerships went bankrupt. In any event, the Service seemed to relent on this point in Revenue Procedure 89-12, since the ten percent net worth test contained therein does not expressly require that the net worth be determined by excluding the value of the general partner's interests in other limited partnerships.⁴⁶

However, Revenue Procedure 89-12 was quickly followed by General Counsel Memorandum 39798,⁴⁷ which imposes limitations on counting interests in other limited partnerships in satisfying the ten percent net worth requirement for advance ruling purposes. General Counsel Memorandum 39798 imposes a twofold net worth requirement in such situations: (i) the "overall" requirement that the net worth of the general partner, taking into account the value of all its partnership interests, be equal to at least ten percent of the aggregate amount of capital contributions to all the limited partnerships and (ii) the "entity-by-entity" requirement that for each of the related limited partnerships, the general partner's net worth, exclusive of the value of its interest in that partnership but taking into account its interests in all other partnerships, be equal to at least ten percent of the aggregate amount of capital contributions to that partnership. Under that test, the general partner's net worth requirement for numerous limited partnerships may be satisfied with a single valuable interest in another partnership, provided that the general partner has sufficient net worth based on the value of its other partnership interests or its other assets to satisfy the entity-by-entity ten percent net worth requirement with respect to the partnership that issued the valuable partnership interest.⁴⁸

45. Rev. Proc. 72-13, 1972-1 C.B. 735, at § 2.03, modified, Rev. Proc. 74-17, 1974-1 C.B. 438. In fact, Revenue Procedure 72-13 literally seemed to require that such interests be disregarded, even where they represented a net liability.

46. Rev. Proc. 89-12, 1989-1 C.B. 798, at § 4.07. However, it should be noted that the Service's partnership classification ruling checklist still asks for "a description of all other partnerships in which any of the general partners has an interest." Rev. Proc. 91-13, 1991-1 C.B. 477, Appendix A, Question 21.

47. G.C.M. 39798 (Oct. 24, 1989).

48. As an illustration, suppose that a corporation ("GP Co.") is a general partner in limited partnerships A, B, C, D, and E. Suppose further that: (i) the aggregate amount of capital contributions to each of the limited partnerships was \$1,000; (ii) the value of GP Co.'s interest in each of limited partnerships A, B, C, and D is \$10; (iii) the value of GP Co.'s

5. *Absence of "Dumminess."*—As indicated above, Regulations section 301.7701-2(d)(2) provides that limited liability does not exist for a limited partnership with a corporate general partner unless (1) the general partner has no substantial assets *and* (2) the general partner is acting as the "dummy" of the limited partners. In other words, limited liability will not exist even where the general partner has absolutely no outside assets as long as it is not acting as the dummy of the limited partners. In *Larson*, the Service attempted to ignore the conjunctive language of the regulations and argue that the absence of substantial assets alone resulted in limited liability, but that reading of the regulations was rejected by the court.⁴⁹

Unfortunately, it is unclear what it means for a general partner to be acting as the "dummy" of the limited partners. The use of the term "dummy" apparently originated in the *Glensder Textile* case.⁵⁰ Intuitively, one might think that it simply means acting at the direction and control of the limited partners, which they could exert either through ownership of the general partner or through a right to remove the general partner. However, the language of Regulations section 301.7701-2(d)(2), which speaks of the general partner being "merely a 'dummy' acting as the agent of the limited partners," would suggest that it means something different if ordinary principles of statutory construction are to be given effect in this context. A possible alternative interpretation is that the term "dummy" refers to a situation where the general partner has only a nominal economic interest and is participating in the transaction solely to satisfy the requirement that there be a general partner so that none of the limited partners will have to have personal liability, regardless of whether the limited partners actually control the general partner.

The only authority on what it means to be a "dummy" of the limited partners within the meaning of the regulations is *Larson*.⁵¹ In *Larson*, a limited partner who was an individual with a 1.9% limited partner interest owned 23.1% of the stock of the corporate general partner. In determining that the general partner was not the dummy of the limited partners, the court

interest in limited partnership E is \$500; and (iv) GP Co. has \$60 of cash in a bank account. GP Co. would satisfy the net worth requirement of Revenue Procedure 89-12, as interpreted by General Counsel Memorandum 39798, even though it only has \$60 of "outside" net worth. The overall requirement would be satisfied, since the value of all of GP Co.'s assets (\$600) exceeds 10% of the aggregate amount of capital contributed to all the partnerships (\$500). The entity-by-entity requirement would easily be satisfied for limited partnerships A, B, C, and D based on the value of GP Co.'s interest in limited partnership E alone, while the entity-by-entity requirement for limited partnership E would be satisfied based upon the combined value of GP Co.'s interests in limited partnerships A, B, C, and D and its cash.

49. *Larson v. Commissioner*, 66 T.C. 159, 179-80 (1976); see also Rev. Proc. 89-12, at § 4.07 (adopting the conjunctive reading for advance ruling purposes).

50. *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176, 183 (1942), acq., 1942-1 C.B. 8.

51. *Larson*, 66 T.C. at 179-82.

noted that “a mere ‘dummy’ would be totally under the control of the limited partners.”⁵² The court concluded that “the limited partners did not use [the general partner] as a screen to conceal their own active involvement in the conduct of the business.”⁵³ Thus, the court seemed to regard a dummy as someone acting at the direction and control of, if not the alter ego of, the limited partners. That interpretation seems to be reflected in Revenue Procedure 89-12, which provides that the Service generally will rule that a partnership lacks limited liability where its general partner does not have substantial assets if the general partner “will act independently of the limited partners.”⁵⁴

If control by the limited partners is the key to dumminess, then dumminess would seem to be a fairly rare phenomenon. Thus, one might ask why corporate general partners of limited partnerships are so frequently capitalized with substantial assets at the direction of tax lawyers. The answer probably lies in the fact that there is just not yet enough authority on the meaning of the term “dummy” to warrant reliance on the absence of dumminess, except in the cleanest of cases.

It should be noted (primarily for comic relief) that *Zuckman*⁵⁵ stands for the proposition that there is a truism that makes the subtleties of the definition of the term “dummy” irrelevant. In *Zuckman*, the Service argued that a limited partnership with a sole corporate general partner had limited liability on the theory that the general partner had no substantial assets and was acting at the direction and control of a limited partner.⁵⁶ The taxpayer argued that limited liability was lacking on the ground that the limited partner’s control of the general partner made the limited partner personally liable for partnership liabilities under applicable state law, a premise that the Service contested.⁵⁷ The court did not resolve the state law question as to whether the limited partner had personal liability. Instead, it concluded that the literal language of Regulations section 301.7701-2(d) creates a truism: either the general partner is not acting as the dummy of the limited partners, in which case limited liability does not exist under the first sentence of Regulations section 301.7701-2(d)(2) based upon the mere fact that the general partner has personal liability (without regard to the substantiality of

52. *Id.* at 181.

53. *Id.*

54. Rev. Proc. 89-12, at § 4.07. It is interesting to note that Revenue Procedure 72-13, 1972-1 C.B. 735, which contains the prior ruling guidelines, does not include that rule but does require that in all cases the limited partners may not own more than 20% of the stock of the general partner or its affiliates (taking into account the section 318 constructive ownership rules).

55. *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

56. *Id.* at 740.

57. *Id.*

its assets), or the general partner is acting as the dummy of the limited partners, in which case limited liability does not exist based upon the fact that the limited partners would be deemed to have personal liability under the second sentence of Regulations section 301.7701-2(d)(2) due to their control of the general partner.⁵⁸ However, it would be surprising if the *Zuckman* analysis is ever followed by any other court, since it is tantamount to saying that all limited partnerships automatically lack limited liability without delving into the substance of the transaction.

6. *General Partners with Tiny Interests.*—Another issue in this area is whether a limited partnership should be regarded as lacking the characteristic of limited liability if the interest of the general partner is extremely small on the ground that the general partner should not be regarded as a partner for federal income tax purposes and, therefore, that no “member” has personal liability. There is ample authority in other tax contexts that de minimis things may be ignored.⁵⁹ In addition, it could be argued, based upon the cases indicating that intent is the most important factor in determining whether a person is a partner,⁶⁰ that a general partner with a tiny interest could not really intend to be a partner in the fullest sense, since it does not have a meaningful share of partnership profits and losses. On the other hand, a general partner with a tiny interest is a partner in form, would be regarded as a partner for state law purposes (with the consequence that it would be personally liable for partnership liabilities and have the other substantive rights and obligations of a general partner)⁶¹ and may actually intend to be a partner.

58. *Id.* at 741. The second sentence of Regulations section 301.7701-2(d)(2) reads as follows: “Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners.” It is unclear whether that statement was intended to be a purely tax rule or a summary of state partnership law.

59. E.g., *Mills v. Commissioner*, 331 F.2d 321 (5th Cir. 1964), rev’g 39 T.C. 393 (1962) (cash payment in lieu of fractional shares of stock does not disqualify corporate reorganization from nontaxable status under section 368(a)(1)(B)); *International Artists, Ltd. v. Commissioner*, 55 T.C. 94, 104-05 (1970) (incidental personal use of business property does not preclude section 167 deductions).

60. See, e.g., *Commissioner v. Culbertson*, 337 U.S. 733 (1949); *Estate of Smith v. Commissioner*, 313 F.2d 724 (8th Cir. 1963); *Luna v. Commissioner*, 42 T.C. 1067 (1964).

61. Although the mere fact that the general partner is a partner for state law purposes would not be determinative, the fact that the general partner holds itself out as a partner for state law purposes may be evidence of intent and it does confer on such person all the substantive rights and obligations of a general partner, including personal liability for partnership liabilities (other than those that are expressly nonrecourse), the exclusive right to manage the business of the partnership (subject to any limited partner approval rights) and a fiduciary obligation to manage the partnership based upon the best interests of the partners.

There seems to be no useful authority on this issue. The only case to expressly consider the issue was *Larson*, which parenthetically discussed the question of whether a general partner that had only a fifteen percent interest in partnership profits (with no interest in partnership capital) should not be regarded as a partner for continuity of life purposes because of the relative insubstantiality of that interest.⁶² Not surprisingly, the court decided that the general partner should be regarded as a partner. What is surprising, however, is the basis for that decision. The court's decision was not based upon the factual point that the general partner actually had a fairly significant interest; rather, it was based upon the court's rejection of the Service's legal argument that a general partner could have a sufficiently small interest to be disregarded for continuity of life purposes (and presumably limited liability purposes as well). The court found that argument to be "structurally incompatible with the regulations, which consider the substantiality of a partner's interest in the partnership only in connection with the centralization of management and transferability of interests."⁶³ However, that conclusion is of dubious reliability, since the court was not confronted with a truly *de minimis* case where general tax principles might be brought to bear and in any event its discussion of the issue seems to be dictum.

The *de minimis* interest issue was also considered in Private Letter Ruling 8139048.⁶⁴ In that ruling, a corporation and an employee of an affiliate of the corporation formed a limited partnership, with the corporation as the limited partner with a 99.999% interest and the employee as the general partner with a 0.001% interest. The Service ruled that the partnership was not a partnership for federal income tax purposes on the theory that the employee did not intend to become a partner. However, that ruling also is of limited usefulness, because the factors relied upon by the Service included not only the employee's "minuscule interest," but also the fact that the individual funded his share of the capital with a nonrecourse loan from his employer, the fact that he was fully indemnified against expense or loss by his employer and the fact that he was required to sell his interest at cost to the designee of his employer upon the termination of his employment.

Given the absence of authority, the only useful guidance is the Service's ruling guideline relating to the minimum interest that a general partner must have in order to receive a favorable ruling, even though that guideline is not by its terms tied to the limited liability factor (or any other specific provision of the substantive law for that matter). Historically, the Service's ruling guideline was that the general partner had to have at least a one

62. *Larson*, 66 T.C. at 175 n.11.

63. *Id.*

64. Priv. Let. Rul. 8139048 (June 30, 1981).

percent interest in all cases.⁶⁵ However, the Service's new ruling guideline, while adhering to the one percent standard for most partnerships, allows the general partner to have a smaller interest where the total capital contributions of the partnership exceed fifty million dollars.⁶⁶ The minimum permissible interest scales down to as little as a 0.2% interest, which applies where the total capital contributions are at least \$250 million.⁶⁷ Since that ruling guideline effectively provides a bright-line safe harbor as to the minimum percentage interest a general partner must have to be regarded as a partner, it tends to be faithfully observed in practice, as was its predecessor ruling guideline.

Assuming that the ruling guideline standard for the minimum percentage interest of a general partner is the de facto law of the land, the only remaining issue is how it applies where there are multiple general partners, i.e., whether each general partner must have that minimum interest individually or whether it is sufficient for the general partners collectively to have that minimum interest. The ruling guideline (which, as noted earlier, is not expressly tied to the limited liability factor) is clear that it applies to the aggregate interest of the general partners.⁶⁸ That does not quite finish the story, since there may be cases in which the net worth supporting the absence of limited liability resides in only one of the general partners. Until recently, the only prudent course of action in that case would seem to have been to make sure that that general partner's interest individually satisfied the minimum interest requirement of the ruling guidelines. However, Revenue Procedure 92-88, the Service's new statement on partnership "comfort" rulings, seems to indicate that the net worth requirement may be satisfied by any one general partner, even if its interest standing alone does not satisfy the minimum interest requirement.⁶⁹

7. Individuals as General Partners.—The foregoing discussion of the characteristic of limited liability has focused upon corporate general partners. However, another issue that frequently arises is whether an individual that serves as the general partner of a limited partnership must have a minimum

65. See Rev. Proc. 74-17, 1974-1 C.B. 438.

66. Rev. Proc. 89-12, 1989-1 C.B. 798.

67. Assuming that the general partner would be making a pro rata capital contribution for its interest, the effect of the ruling guideline is to require that the general partner contribute one percent of the total amount of capital contributed by all the partners where such contributions are less than \$50,000,000, \$500,000 where the total capital contributions are \$50,000,000 to \$250,000,000 and 0.2% of the total amount of capital contributed by all the partners where such contributions exceed \$250,000,000.

68. Rev. Proc. 89-12, 1989-1 C.B. 798 at § 4.01. Note also that the general partners may count any interests in the partnership that they hold as limited partners in satisfying the minimum interest test.

69. Rev. Proc. 92-88, 1992-42 I.R.B. 39 (Oct. 19), at § 4.03.

net worth for the partnership to be deemed to lack the characteristic of limited liability.

As indicated earlier, the basic rule on limited liability is that all partnerships lack the characteristic of limited liability, because all partnerships have at least one general partner that is personally liable for partnership liabilities.⁷⁰ The only qualification to that rule applies in the case of a limited partnership with a *corporate* general partner (in which case the corporate general partner must either have substantial assets or not be acting as the dummy of the limited partners). Thus, where the general partner is an individual, the regulations by their terms do not require any minimum net worth, even though the individual general partner case could involve fewer assets being at risk than the corporate general partner case.⁷¹

Nonetheless, practitioners typically have tended to make some modest inquiry to make sure that individual general partners in partnerships relying on the absence of limited liability have assets of some significance, even if that inquiry consisted of simply confirming that the individual had a reasonably august title where he was employed. However, Revenue Procedure 92-88⁷² establishes a new bright-line benchmark for the net worth of individual general partners and is likely to prompt a more formal inquiry by practitioners into whether that benchmark is satisfied. Revenue Procedure 92-88 provides that the Service will not issue a "comfort" ruling on whether a partnership that has an individual as its sole general partner lacks limited liability if the individual has net worth, exclusive of the value of his interest in the partnership, equal to the lesser of (i) ten percent of the total capital contributions to the partnership or (ii) one million dollars.⁷³

8. *Capital Account Restoration Obligations.*—A final issue that is tangentially related to the limited liability factor is whether a corporate general partner should have a certain minimum net worth even where the partnership is *not* relying on the absence of limited liability to support its partnership status. It is possible, of course, that purely business reasons would dictate that the general partner have substance. However, there also are two legal reasons why the net worth of the general partner might be a concern. The first reason, which is beyond the scope of this article, is the non-tax concern that the corporation may be more vulnerable to "veil-piercing" if it does not have any substance aside from its partnership interest.

70. See discussion *supra* Part III(A).

71. Notwithstanding the regulations, Revenue Procedure 91-13, 1991-1 C.B. 477 (providing the partnership status ruling checklist) requires that partnership status ruling requests indicate whether individual general partners have "substantial assets."

72. 1992-42 I.R.B. 39 (Oct. 19).

73. *Id.* at § 4.03(2).

The second reason is that the general partner otherwise might not have sufficient financial wherewithal to satisfy its tax-related capital contribution obligations. As indicated earlier, Revenue Procedure 89-12 requires for advance ruling purposes that the general partner either (i) maintain a capital account balance equal to the lesser of one percent of the aggregate positive capital accounts of all the partners, if any, or \$500,000 or (ii) represent that it will provide "substantial services" and agree to contribute on dissolution of the partnership an amount equal to the lesser of (a) the deficit balance, if any, in its capital account at that time or (b) the excess of 1.01% of the total amount of capital contributions by the limited partners over the amount of capital previously contributed by the general partner.⁷⁴ The purpose of that ruling guideline, of course, is to insure that the general partner has a minimum capital interest in the partnership, which the Service presumably felt was necessary for it to be comfortable that the general partner was a partner in substance. However, that ruling guideline is clearly more stringent than the substantive law, since a general partner need not have a capital interest to be regarded as a partner for tax purposes as a matter of substantive law, assuming that it has a significant profits interest.⁷⁵ Nevertheless, partnerships tend to comply with the ruling guideline to avoid any question on the issue, although often in reliance on the part applicable to general partners that provide "substantial services."⁷⁶ Whichever part of the ruling guideline is to be satisfied, it would not seem sufficient for the applicable partnership agreement simply to recite the required capital contribution obligation if the general partner does not have enough financial substance to satisfy that obligation.

IV. FREE TRANSFERABILITY OF INTERESTS

A. Background

Regulations section 301.7701-2(e)(1) provides that an entity has the

74. Rev. Proc. 89-12, 1989-1 C.B. 798. Curiously, the one percent figure in clause (i) and the 1.01% figure in clause (ii) are not subject to reduction where the capital contributions to the partnership exceed \$50 million, even though the general partner need not have a one percent interest in profits and losses in such case under section 4.02 of Revenue Procedure 89-12. The clause (ii) amount also apparently is not reduced by any distributions to the partners that represent a return of capital.

75. See, e.g., *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840, 850-51 (1957).

76. It is unclear why the Service felt that the general partner had to be providing "substantial services" to avoid a positive capital account maintenance obligation. One cynical explanation is that the Service was looking for confessions by service partners of possible vulnerability to taxation upon receipt of their partnership interests under *Diamond v. Commissioner*, 492 F.2d 286 (7th Cir. 1974).

corporate characteristic of free transferability of interests if "those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization." The regulation goes on to provide that the key is whether a member can assign "his rights to participate in the management of the organization." Consequently, the ability of members to freely assign the economic attributes of their interests (without the transferee becoming a partner of record) is not relevant for this purpose, regardless of what additional significance there may be to becoming a partner of record. In addition, the ability of members to transfer to other members is not relevant, since the regulation looks to whether a transfer may be made to a nonmember.

Under Regulations section 301.7701-2(e)(2), if the members are subject to a transfer limitation created by the existence of a right of first offer on the part of the other members,⁷⁷ then "a modified form of free transferability" is deemed to exist. The concept of partially limited transferability stands in contrast to the all-or-nothing approach taken with the other three corporate characteristics, even though those characteristics also could easily be viewed as matters of degree. In any event, it has long been recognized that the concept of partially limited transferability is largely academic, since the existence of partially limited transferability produces the same result as the existence of completely free transferability.⁷⁸

Under Regulations section 301.7701-2(e)(1), a partnership is deemed to lack the characteristic of free transferability if a transfer of an interest would cause the entity to dissolve under local law (regardless of whether it is immediately reconstituted), even if the interests are otherwise freely transferable. As a result of that rule, general partnerships virtually always lack the characteristic of free transferability of interests.

77. The regulation describes the limitation as a situation where a member may transfer his interest "only after having offered such interest to the other members at its fair market value."

78. If the entity has only one other corporate characteristic (say, limited liability), the entity will be classified as a partnership if it has either partially limited transferability or completely free transferability, since in either case the entity will not have more than two of the four corporate characteristics. On the other hand, if the entity has two other corporate characteristics (say, limited liability and centralized management), it will be classified as an association if it has either partially limited transferability or completely free transferability, since in either case it will have more than two of the four corporate characteristics. See Regs. § 301.7701-2(a)(3) (concerning requirement of more than two corporate characteristics to be classified as an association).

B. Issues

The foregoing rules raise the following special problems.

1. *Reasonable v. Sole Discretion.*—One issue that arises is whether a partnership should be viewed as having the corporate characteristic of free transferability of interests if the limited partners must obtain the consent of the general partner to transfer their interests, but that consent may not be unreasonably withheld. The issue of what would be a reasonable basis for withholding consent must be decided on a case-by-case basis. At one extreme would be closely held partnerships where the limited partners have substantial financial obligations and participate in management, in which case the general partner presumably could reasonably be very selective in granting consent. At the other extreme would be widely held partnerships where the limited partners have no financial obligations and do not participate in management (master limited partnerships being the classic example), in which case the general partner probably could not reasonably withhold consent with respect to any proposed transferee except perhaps the Mafia.

The *Larson* case holds that if the general partner's consent to a proposed transfer may not be unreasonably withheld, the entity will be treated as having free transferability.⁷⁹ That conclusion is questionable for a number of reasons. First, the *Larson* holding seems to give no effect to the term "freely" in the Regulation, since the term "freely" would seem to indicate that there are not *any* limitations. Second, the requirement that a partner must go to another member and obtain consent before transferring provides a meaningful distinction from the truly free transferability typically associated with corporate stock, even if the consent may be withheld only for a good reason. Third, there is authority in the real estate investment trust ("REIT") area that suggests that the *Larson* holding may not be correct. Under section 856(a)(2), a REIT's shares must be "transferable," which obviously sounds like a weaker standard than the "freely transferable" standard. The REIT requirement has been interpreted to mean the absence of any limitation on share transfers, other than any limitations that are necessary to avoid violating securities laws or to prevent a loss of REIT status because of an increase in the concentration of share ownership.⁸⁰ Thus, a reasonable consent requirement would, a fortiori, seem to preclude the existence of *free* transferability. Nevertheless, *Larson* is the only authority on the issue in the partnership

79. *Larson v. Commissioner*, 66 T.C. 159, 183 (1976).

80. See Regs. § 1.856-1(d)(2); Priv. Let. Rul. 8921067 (Feb. 28, 1989); Priv. Let. Rul. 7311230330A (Nov. 23, 1973). The REIT authority on the meaning of the term "transferable" is favorable to the Service in the REIT context, but would be unfavorable to the Service as it relates to the partnership issue.

context, and, therefore, it tends to be followed.

That gloss having been established, the one remaining issue in this area is what the result is if the partnership agreement simply provides that the general partner must consent, without specifying whether such consent may be granted or denied in its sole discretion. That, in turn, leads to the nontax issue of whether there is an implied duty of reasonability under applicable state law. Since the law varies from jurisdiction to jurisdiction and reasonable people may differ as to what the law in a particular jurisdiction actually is, the only prudent course of action where the absence of free transferability is being relied upon is to specify in the partnership agreement that the general partner's consent may be granted or denied in its sole discretion.

2. *Limited Transfer Rights.*—Another issue is whether free transferability will be deemed to exist where the partners have the right to freely transfer their interests in certain limited circumstances, but in all other circumstances transfers are subject to the general partner's consent. One type of transfer provision of this nature is a provision authorizing transfers occurring as a result of certain extraordinary events, such as a provision authorizing transfers to the estate of an individual partner upon his death, a provision authorizing transfers to the bankruptcy estate of a partner upon his bankruptcy or a provision authorizing a transfer to a lender that holds a loan secured by a partnership interest upon the occurrence of a default on the loan. This issue is more pervasive than one might imagine, because applicable law often requires such transfers, regardless of whether there is any transfer restriction in the partnership agreement.⁸¹

Given the fact that such transfers are authorized only on a one-time basis upon the occurrence of an extraordinary (and typically unforeseen) event for the transferor partner, the fact that the transfer essentially is involuntary and the fact that the transfer would be made to an identified transferee that is the successor in interest to all the transferor partner's assets (not just his partnership interests), such provisions generally should not be regarded as making the interests "freely transferable." The Service has issued at least three private letter rulings to that effect.⁸² The only close question

81. See, e.g., § 541(c) of the Bankruptcy Reform Act of 1978, as amended (providing that a debtor's bankruptcy estate generally succeeds to the debtor's property, without regard to any transfer restrictions in any agreement); Del. Code Ann. tit. 6, § 17-705 (Supp. 1992) (providing for automatic transfers of interests in Delaware limited partnerships to the estates of deceased individual partners or the successors to liquidated corporate partners).

82. Priv. Let. Rul. 9253013 (Sept. 30, 1992) (ruling that partnership lacks free transferability despite the lack of a consent requirement for transfers to specified persons by will or under the laws of descent and distribution); Priv. Let. Rul. 9243018 (July 22, 1992) (ruling that foreign entity lacks free transferability despite the fact that the prohibition on transfers of shares did not apply with respect to transfers upon the death, dissolution,

in that regard involves provisions authorizing a transfer by a corporate partner to its successor in connection with a merger or liquidation transaction, since such a transfer generally is more volitional in nature than the other types of transfers described above. Even that type of provision should not cause the partnership to be viewed as having the characteristic of free transferability, however, assuming that most of the partners in the partnership are not special purpose corporations created to circumvent a general transfer limitation.⁸³

Another common transfer provision is a provision authorizing transfers at any time to related transferees, such as family members or controlled affiliates, without the consent of any partner. It seems arguable that such provisions should not cause the partnership to be deemed to have freely transferable interests, assuming that the specified class of transferees is reasonably circumscribed. The argument would be that the partners must have a right of transfer that is unfettered in all respects for the interests to be regarded as being "freely" transferable, a conclusion that is supported by the REIT authority mentioned earlier.⁸⁴ However, the term "freely" may have been intended to refer only to the freedom to transfer at any time without any consent requirement. Even if the class of potential transferees is limited, the partner does have the right to make a transferee of his choosing within that class a partner. One case to consider this issue was *O'Neill v. United States*,⁸⁵ which involved an Ohio professional association the shares in which under Ohio law could only be transferred to a person that was licensed to practice the profession and under the articles of association could only be transferred to a person who would become an employee of the association. Without much discussion, the court ruled that the association had freely transferable interests. Given the lack of clear authority on this issue, most practitioners tend to take the conservative view that such affiliate transfer rights create the corporate characteristic of free transferability.

3. *Assignments Without Substitution.*—As indicated above, Regulations section 301.7701-2(e)(1) provides that the key consideration for free

liquidation, bankruptcy or insolvency of a member); Priv. Let. Rul. 9210019 (Dec. 6, 1991) (ruling that Texas limited liability company lacks free transferability despite the lack of a consent requirement for transfers to specified persons incident to death, dissolution, divorce, liquidation, merger or termination).

83. See Priv. Let. Rul. 9243018 (July 22, 1992) and Priv. Let. Rul. 9210019 (Dec. 6, 1991), *supra* note 82. But see G.C.M. 38012 (July 13, 1979) (trust has a modified form of free transferability where corporate beneficiaries could transfer their interests in connection with a merger or consolidation with another corporation). Query also what effect the availability of a section 338 election for purchasers of the stock of the corporate partners should have on the free transferability issue.

84. See *supra* text accompanying note 80.

85. 410 F.2d 888 (6th Cir. 1969).

transferability purposes is whether a member can assign "his rights to participate in the management of the organization." Consequently, the ability of members to freely assign the economic attributes of their interests, with the transferee becoming entitled to cash distributions but not becoming a partner of record, is not relevant for this purpose. That reading of the regulations has been confirmed in a number of published rulings.⁸⁶

The irrelevance of free assignability is rather surprising as a policy matter. The assignee of a partnership interest has all the economic benefits and burdens of ownership. The only substantive indicia of ownership that the assignee lacks are that the assignee may not receive cash distributions directly from the partnership if the partnership agreement expressly provides that distributions will not be made to assignees and the assignee does not have the right to participate directly in partnership governance. However, the distribution point is not significant, since many partnership agreements authorize distributions directly to assignees and, even if the partnership agreement does not so provide, the assignor normally would function as the assignee's agent for those purposes, remitting distributions to the assignee upon receipt from the partnership. Likewise, the partnership governance point is not significant, since limited partners usually have very limited rights to participate in management and again the assignor could presumably function as the assignee's agent by sending partnership communications to the assignee, voting as directed by the assignee, etc., if the partnership continued to allow the assignor to participate in management.⁸⁷ Consequently, whether a limited partnership lacks the characteristic of free transferability is a largely formalistic question.

On the basis of the foregoing considerations, the Service has ruled that an assignee of a partnership interest that acquires substantially all dominion and control over the partnership interest should be treated as the

86. See, e.g., Rev. Rul. 88-76, 1988-2 C.B. 360 (classifying a Wyoming limited liability company as a partnership based in part on the absence of free transferability of interests where substitutions were restricted but assignments were not); Rev. Rul. 88-79, 1988-2 C.B. 361 (classifying a Missouri royalty trust as a partnership based on the same analysis); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Jan. 19) (classifying a Virginia limited liability company as a partnership based on the same analysis); Rev. Rul. 93-6, 1993-3 I.R.B. 8 (Jan. 19) (classifying a Colorado limited liability company as a partnership based on the same analysis).

87. As a general rule, under most state partnership statutes, the assignor would cease to have the right to participate in partnership governance after the assignment, unless the partnership agreement provided otherwise. See, e.g., Del. Code Ann. tit. 6, § 17-702(a)(4) (Supp. 1992). Of course, if the partnership agreement contemplated that cash distributions would be made directly to assignees and it permitted assignees to participate in partnership management, there would not be any substantive distinction whatsoever between an assignee and a partner of record and, therefore, the partnership should be treated as having free transferability of interests if the interests therein were freely assignable.

partner for federal income tax purposes.⁸⁸ Thus, not only does the assignee have the substantive benefits and burdens of being a partner, but he also enjoys the tax attributes as well. That leads to the seemingly anomalous result that a partnership may be treated as lacking free transferability even though both economic and tax ownership is freely transferable by assignment. However, it is interesting to note that most tax practitioners have regarded that conclusion as being simply too good to be true when applied to “master limited partnerships” where what trades are assignee interests (or depository units representing assignee interests) that do not result in the automatic substitution of the transferee as a partner of record.⁸⁹

One argument that can be made as to why free assignability should not matter for purposes of determining whether a partnership has freely transferable interests is that it may be impossible for a partnership to prevent assignments of interests. The reason is that the law in many states is (or may be) that restrictions on the transfer of partnership interests that are contained in a partnership agreement, regardless of how absolute, are unenforceable as between a transferor and a transferee of a partnership interest.⁹⁰ Hence, even though the partnership would not recognize the transfer, the transferor could still confer the substantive benefits and burdens of ownership on the transferee in essentially the same manner as where assignments are specifically authorized under the partnership agreement. Thus, if the ability to assign were the key to free transferability, partnerships in such states might have a real problem where partnership status depended upon the absence of free transferability.

4. *Multiple Mild Limitations.*—As indicated above, a transfer limitation is not sufficient to cause an entity to be treated as not having the corporate characteristic of free transferability of interests if all it does is require the general partner’s reasonable consent to a proposed transfer, restrict

88. See Rev. Rul. 77-137, 1977-1 C.B. 178; G.C.M. 36960 (Dec. 20, 1976) (discussing Rev. Rul. 77-137); Priv. Let. Rul. 8743083 (July 30, 1987); Priv. Let. Rul. 8642050 (July 18, 1986); Priv. Let. Rul. 8636019 (June 3, 1986); Priv. Let. Rul. 8602062 (Oct. 17, 1985); Priv. Let. Rul. 8524070 (Mar. 20, 1985); Priv. Let. Rul. 8520105 (Feb. 21, 1985); Priv. Let. Rul. 8440081 (July 6, 1984); Priv. Let. Rul. 8434047 (May 21, 1984); Priv. Let. Rul. 8427073 (Apr. 3, 1984); Priv. Let. Rul. 8350033 (Sept. 9, 1983); and Priv. Let. Rul. 8229034 (Apr. 20, 1982); cf. *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971) (holding a transferor of his entire interest in partnership to no longer be a partner for federal income tax purposes).

89. See, e.g., the prospectuses for: *De Laurentiis Film Partners L.P.* (dated Feb. 27, 1987); *EQK Green Acres, L.P.* (dated Aug. 20, 1986); *Falcon Cable Systems Company* (dated Dec. 23, 1986). The tax opinions for these master limited partnerships did not seem to rely on the absence of free transferability.

90. See, e.g., *Trubowitch v. Riverbank Canning Co.*, 182 P.2d 182 (Cal. 1947) and *Rosenthal v. Landau*, 202 P.2d 810 (Cal. Dist. Ct. App. 1949) for California authority limiting the enforceability of restrictions on assignments of contract rights.

the class of eligible transferees or impose a right of first offer.⁹¹ That leads to the obvious question of whether the imposition of more than one such mild transfer limitation would cause the entity to be treated as not having the corporate characteristic of free transferability of interests.

Surprisingly, there is virtually no authority or even commentary on this issue. The *Larson* case involved two mild limitations—a reasonable consent requirement and a very limited right of first offer—but the former only applied to transfers of profits interests and the latter only applied to transfers of capital interests.⁹² Thus, the court easily concluded that the partnership had the characteristic of free transferability of interests.

This issue also was addressed in a recent private letter ruling.⁹³ The ruling involved a German Gesellschaft mit beschränkter Haftung (“GmbH”) whose shares could not be transferred without the transferor first offering them for sale to the other members and, if they chose not to purchase the shares, obtaining their consent to the transfer (which could not be unreasonably withheld). The Service ruled that the GmbH lacked free transferability of interests because of that double limitation, even though neither limitation individually would have been sufficient.

Finally, the REIT authority discussed earlier⁹⁴ would seem instructive, as it would suggest that any mild transfer limitation and, *a fortiori*, a combination of mild transfer limitations would cause the interests to not be regarded as “transferable,” much less “freely transferable.”

5. *Free Transferability for Some But Not All Partners.*—As noted earlier, free transferability of interests exists if persons holding “substantially all” the interests in the entity may freely transfer their interests. Hence, an entity will not be deemed to have the corporate characteristic of free transferability of interests as long as the interests of persons subject to transfer limitations are sufficiently significant that the interests of the other persons are not regarded as “substantially all” the interests.

Unfortunately, there is virtually no authority as to what the standard of significance is for this purpose. The only directly relevant authority is the Service’s recent ruling guideline set forth in Revenue Procedure 92-33,⁹⁵ which states that the question of whether “substantially all” the interests are freely transferable depends upon all the relevant facts and circumstances, with no particular percentage being controlling. However, it goes on to provide a

91. See *supra* text accompanying note 77 (regarding treatment of imposition of right of first offer requirement as creating modified form of free transferability).

92. *Larson v. Commissioner*, 66 T.C. 159, 182-83 (1976).

93. Priv. Let. Rul. 9010028 (Dec. 7, 1989).

94. See *supra* text accompanying note 80.

95. 1992-1 C.B. 782.

safe harbor by indicating that the Service generally will rule that a partnership lacks the characteristic of free transferability of interests if the partnership agreement restricts the transferability of partnership interests that represent “more than 20% of all interests in partnership capital, income, gain, loss, deduction, and credit.”

There are two interesting aspects of this ruling guideline. First, Revenue Procedure 92-33 states that the Service “generally” (but apparently not always) will rule favorably if the twenty percent test is satisfied. Although there is no indication as to why that qualification was included, it probably reflects the Service’s concern regarding whether transfer limitations should be respected where the general and limited partners are affiliated, as discussed in Part IV(B)(6) below.

Second, the twenty percent test apparently must be satisfied separately with respect to the interests in each of partnership capital, income, gain, loss, deduction and credit. That raises the issue of how the twenty percent test applies where the partners’ interests in capital, income, gain, loss, deduction or credit vary over time. The ruling guideline could be interpreted as referring either to partnership interests that always represent at least twenty percent of partnership capital, income, gain, loss, deduction and credit or to partnership interests that are expected to receive twenty percent of such items on a present value basis. For instance, in a typical real estate or venture capital partnership, the limited partners put up all the equity capital and cash profits are distributed first to the limited partners to pay a preferred return on their capital and then, say, fifty percent to the limited partners and fifty percent to the general partner. Under the former reading of the ruling guideline, forty percent of the limited partners’ interests would have to be restricted, whereas under the latter reading something substantially less than forty percent should suffice. The “all interests” language in the ruling guideline suggests that the former reading was intended, as does a recent private letter ruling.⁹⁶

One final observation on this issue is that it may be possible for a partnership that restricts the transferability of some but not all of its interests to provide all its partners with effective free transferability. The reason is that, as noted earlier, the free transferability factor turns on whether the members may substitute for themselves someone that is *not a member*, which means that it is not necessary to restrict transfers to *other members*. Suppose, for example, that a partnership agreement provided that twenty-five percent of the interests in the partnership could be transferred to third parties only with the consent of the general partner (but could be freely transferred to existing partners without consent) and that the remaining seventy-five percent

96. See Priv. Let. Rul. 9306008 (Nov. 10, 1992) (describing the partnership interests not subject to transfer limitations as representing less than 80% of partnership capital, income, gain, loss, deduction and credit “throughout the life” of the partnership).

of the interests could be freely transferred to anyone. The partnership would seem to lack free transferability based on the ruling guideline in Revenue Procedure 92-33. However, the holders of the restricted interests could transfer their interests to third parties without consent by first arranging for the transferee to acquire a small unrestricted interest, which would make the transferee a partner and thereby vitiate the consent requirement for the transfer of the restricted interest. Because this potential to "unlock" restricted interests is inherent in the free transferability rules, it does not seem too disturbing, except possibly in the case where all the partners regard the transfer limitation as a subterfuge and partners routinely transfer restricted interests through this two-step process.

6. *Affiliated General and Limited Partners.*—In some partnerships, the general partner is closely affiliated with some or all of the limited partners. In such situations, the issue arises as to whether the entity could be deemed to have freely transferable interests, even if transfers are subject to the general partner's consent, on the theory that the general partner would never refuse to grant its consent to a proposed transfer by its affiliate. The first hint of this issue as a real concern came in Revenue Ruling 75-19,⁹⁷ in which the Service ruled that a general partnership formed under a Uniform Act statute by four corporate subsidiaries of the same corporation was a partnership for federal income tax purposes. The ruling held that the entity should be classified as a partnership on the basis of the absence of limited liability, continuity of life and centralized management, but there was an ominous silence as to whether the entity had free transferability of interests.⁹⁸ The issue then surfaced in *Zuckman*,⁹⁹ where the Service argued that the interest of the largest limited partner in a partnership, which could not be transferred without the general partner's consent, was effectively freely transferable because that limited partner indirectly owned the general partner. The court seemed to accept that argument, although it went on to conclude that free transferability was lacking because the general partner's own sixty-two percent interest could not be transferred without the consent of all the limited partners.

This issue gained much more prominence two years later when the Service promulgated Revenue Ruling 77-214.¹⁰⁰ Revenue Ruling 77-214

97. 1975-1 C.B. 382.

98. *Id.*; see also Rev. Rul. 83-156, 1983-2 C.B. 66 (assuming, in a section 721 ruling involving a general partnership formed between a first-tier and second-tier subsidiary of the same corporation, that the partnership was a partnership for federal income tax purposes).

99. 524 F.2d at 742-44.

100. 1977-1 C.B. 408. It probably is not a coincidence that Revenue Ruling 77-214 was promulgated the same year as Revenue Ruling 77-316, 1977-2 C.B. 53, which disallowed

involved a German GmbH owned by two wholly owned U.S. subsidiaries of a U.S. corporation. Since under German law a GmbH has the corporate characteristics of limited liability and centralized management, the classification issue depended upon whether the GmbH lacked free transferability of interests and continuity of life. Although the "memorandum of association" for the GmbH provided that neither member could transfer its interest without the other's consent and that the GmbH would be dissolved upon the death, insanity or bankruptcy of either member, the Service nevertheless ruled that the GmbH had freely transferable interests and continuity of life and, therefore, that the entity was an association for federal income tax purposes. On the free transferability of interests issue, the Service simply stated that "it is apparent that the controlling parent could make all the transfer decisions for its wholly owned subsidiaries."¹⁰¹ In other words, any time one of the members desired to transfer its interest, it would be acting at the direction of, or at least with the approval of, the common parent, which would not then turn around and direct the other member to withhold its consent to the transfer. Revenue Ruling 77-214 was immediately criticized by commentators.¹⁰²

The issue resurfaced shortly thereafter in *MCA, Inc. v. United States*.¹⁰³ That case involved a number of different foreign entities, each of which was owned ninety-five percent by a Dutch corporation (which, in turn, was owned forty-nine percent by MCA, forty-nine percent by Paramount Pictures and two percent by an employee trust created for the benefit of the Dutch corporation's key employees) and five percent by the employee

deductions for insurance premium payments by a corporation to its "captive" insurance company on the theory that there could be no risk shifting because they were in the same "economic family."

101. Rev. Rul. 77-214, 1977-1 C.B. 408, 409. On the continuity of life issue, the Service first stated that the GmbH would not dissolve upon the occurrence of a dissolution event as to one member unless the other member affirmatively acted to force dissolution (since dissolution was not automatic under German law) and then concluded that there were no "separate interests" that would compel dissolution should a dissolution event occur. The lack of "separate interests" rubric used in analyzing the continuity of interest issue is really just an alternative way of stating the Service's concern with respect to the free transferability issue. For more discussion of the continuity of life aspect of Revenue Ruling 77-214, see Part V(B)(5) below.

102. See, e.g., Tax Section, New York State Bar Ass'n, Report on Foreign Entity Characterization for Federal Income Tax Purposes, reprinted in 35 Tax. L. Rev. 169, 206-15 (1980). The main criticism of the single economic interest theory is that:

if followed through to its logical conclusion, it would apply to three out of the four characteristics which the regulations specify as distinguishing partnerships from corporations.... It would be impossible for a corporate group to operate a foreign partnership if its full ownership is channelled through a single corporate parent at any point in its structure.

Id. at 206.

103. 685 F.2d 1099 (9th Cir. 1982).

trust.¹⁰⁴ The parties stipulated that the foreign entities had limited liability and centralized management,¹⁰⁵ so that, as in Revenue Ruling 77-214, the classification issue turned on whether the entities had freely transferable interests and continuity of life. Although transfers of interests required the consent of the other member and the entities would dissolve upon the bankruptcy of a member or the occurrence of certain other events,¹⁰⁶ the Service argued that the entities had freely transferable interests and continuity of life because the Dutch corporation and the employee trust were under common control¹⁰⁷ and constituted a “single economic interest” such that they could not act independently.¹⁰⁸ The court held that the entities should be classified as partnerships, rejecting the Service’s position on the theory that the owners were different persons that potentially could have conflicting interests, despite the general commonality of their business interests.¹⁰⁹ Although the court acknowledged that there was common control of the members, it dismissed that concern based upon the fact that the board of trustees of the employee trust had a fiduciary duty to exercise its authority in good faith based upon the best interests of the beneficiaries.¹¹⁰

Revenue Ruling 77-214 was recently reconsidered by the Service in Revenue Ruling 93-4.¹¹¹ While, as discussed below, the Service purported to eliminate Revenue Ruling 77-214 as a problem for continuity of interest purposes,¹¹² the Service essentially reaffirmed it for free transferability purposes. However, the Service did add certain refinements. First, the Service expressly stated the question in terms of whether “the possibility of an impediment to transfer” exists, which sounds like the narrow approach taken by the court in *MCA*. Second, the Service made the surprising statement that if the “memorandum of association” for the GmbH had either prohibited transfers of interests or provided for an automatic dissolution of the GmbH upon the occurrence of a transfer, then the GmbH would have been viewed

104. *Id.* at 1100.

105. *Id.* at 1102.

106. The opinion states that dissolution occurred “because the organizational documents and local laws provide for dissolution.” *Id.*

107. The same persons controlled the board of directors of the Dutch corporation and the board of trustees of the employee trust. *Id.* at 1100-01.

108. *Id.* at 1102.

109. The court concluded that, although the Dutch corporation and the employee trust “are likely, as a practical matter, always to act in concert in their management of the [entities], we cannot conclude as a matter of law that their interests will never diverge.” *Id.* at 1104.

110. *Id.*

111. 1993-3 I.R.B. 5 (Jan. 19).

112. See discussion *infra* Part V(B)(5).

as lacking free transferability of interests.¹¹³

Before turning to the free transferability issues raised by the Service's "single economic interest" theory, it is instructive to note two points. First, despite the potentially sweeping nature of the Service's argument, the authority for its position is actually quite narrow. The only favorable authorities, *Zuckman*¹¹⁴ and Revenue Ruling 77-214, involved the extreme cases of a partnership principally owned by an individual and his wholly owned second tier subsidiary and a partnership between sister subsidiaries, respectively. Moreover, both the *MCA* opinion, which was sympathetic to the Service's legal argument but rejected it as applied to the facts of the case, and Revenue Ruling 93-4 stated the legal issue in terms of whether there was any possibility that the members could have divergent interests that could result in the transfer limitation having substance, which is a relatively easy test to satisfy.¹¹⁵ Second, the Service apparently has never asserted the "single economic interest" theory in the context of classifying an entity organized under domestic law.¹¹⁶ In fact, the Service has not even consistently applied the theory in the foreign context.¹¹⁷ However, there is no reason in principle why the theory should not apply in the domestic context for free transferability purposes, and a Service official recently stated publicly that the theory could be applied in the domestic context.¹¹⁸

113. That aspect of Revenue Ruling 93-4 was foreshadowed by Private Letter Ruling 9243018 (July 22, 1992) and Private Letter Ruling 9253029 (Oct. 2, 1992), in which foreign entities owned by sister companies that prohibited transfers of interests were held to lack free transferability.

114. 524 F.2d 729 (Ct. Cl. 1975).

115. *MCA*, 685 F.2d at 1104.

116. For an example of a recent private letter ruling that presents this issue in the domestic context, see Private Letter Ruling 9248021 (Aug. 31, 1992) (classifying partnership between S corporations with a common owner as a partnership based upon the lack of free transferability and continuity of life without mentioning Revenue Ruling 77-214).

117. See, e.g., Priv. Let. Rul. 7934096 (May 24, 1979) (classifying French *Société en Nom Collectif* between sister companies as a partnership based on the absence of limited liability, free transferability of interests, continuity of life, and centralized management without mentioning Revenue Ruling 77-214); Priv. Let. Rul. 8439037 (June 26, 1984) (classifying foreign partnership owned by parent and subsidiary as a partnership based upon the absence of limited liability and free transferability of interests without mentioning Revenue Ruling 77-214); Priv. Let. Rul. 9253029 (Jan. 1, 1993) (same ruling for unspecified foreign entity owned by sister companies). See also the continuity of life rulings, *infra* note 128, although those rulings may have been given in each case because local law seemed to provide for an automatic dissolution if certain dissolution events occurred.

118. See NYSBA Tax Section Copes with Regulatory Lull, reprinted in *Tax Notes Today* (Jan. 29, 1993) (LEXIS, FEDTAX library, TNT file, elec. cit. 93 TNT 21-11). See also letter to the editor from Susan Pace Hamill, Attorney Advisor in the Office of Assistant Chief Counsel (Passthroughs and Special Industries), *Tax Notes* (Mar. 8, 1993) at 1385.

The "single economic interest" issue, which is often overlooked, frequently arises in three contexts. The first is the context of partnerships between members of the same corporate group. That fact pattern presents the issue in its starkest form, since there are no adverse interests involved in a corporate group where there is 100% common ownership. Revenue Rulings 77-214 and 93-4 obviously reflect the Service's view on that fact pattern.¹¹⁹ It is difficult to quarrel with that view. Thus, the only interesting issue is what amount of divergent ownership is required to create sufficiently separate economic interests for a consent requirement for transfers of interests to be considered meaningful. Needless to say, there is not yet any authority on that issue.

The second context in which this issue frequently arises involves tiered partnership structures where an upper-tier limited partnership owns, say, ninety-nine percent of a lower-tier limited partnership and the two limited partnerships have a common general partner owning a one percent interest in each. In those situations, a transfer of the upper-tier partnership's interest in the lower-tier partnership would be initiated by the general partner of the upper-tier limited partnership, which would then have to consent to the transfer in its capacity as the general partner of the lower-tier partnership. That structure is often employed by master limited partnerships¹²⁰ or partnerships seeking to insulate their assets from the liabilities relating to a particular part of their business.¹²¹ The "single economic interest" theory of Revenue Ruling 77-214 should also apply to this situation, subject to the question of what degree of divergent ownership at either level would produce sufficiently separate economic interests (and, therefore, potentially conflicting fiduciary duties of the general partner) for the transfer restrictions to be respected.

119. Rev. Rul. 93-4, 1993-3 I.R.B. 5 (Jan. 19); Rev. Rul. 77-214, 1977-1 C.B. 408. For subsequent private letter rulings expressly applying the Revenue Ruling 77-214 theory in that context, see: Priv. Let. Rul. 8401001 (June 16, 1983); Priv. Let. Rul. 8114095 (Jan. 12, 1981); Priv. Let. Rul. 8023029 (Mar. 11, 1980); Priv. Let. Rul. 7936050 (June 8, 1979); Priv. Let. Rul. 7841008 (June 20, 1978); Priv. Let. Rul. 7831021 (May 3, 1978). But see the rulings, *supra* note 117.

120. For examples of this structure, see the prospectuses for: Apache Petroleum Company (dated Aug. 22, 1985); Burger King Investors Master L.P. (dated Feb. 20, 1986); IP Timberlands, Ltd. (dated Mar. 7, 1985). The tax opinions as to the status of the lower-tier partnership in these transactions did not seem to rely on the absence of free transferability.

121. For example, a real estate partnership might form one or more special purpose limited partnerships to hold individual properties. The parent partnership would be a 99% limited partner in the special purpose partnerships and its general partner would be a one percent general partner in the special purpose partnerships. Thus, if one of the special purpose partnerships incurs a liability in an amount in excess of the value of its assets, the creditor may not reach any of the other assets of the parent partnership (although the creditor could go after the general partner).

The third context in which this issue frequently arises is the family partnership area, where the general partner is a family member or is a corporation that is owned by one or more family members and the limited partners are family members. One simple case would be a partnership between a husband and a wife where neither could transfer without the other's consent. The Service recently ruled that a partnership with a corporation owned by the husband as general partner and the husband and wife as limited partners lacked free transferability of interests.¹²² Since differences obviously can arise among any family members, it seems highly unlikely that the Revenue Ruling 77-214 theory could be successfully applied in any family partnership context.¹²³

In any of the above situations where the affiliations among the partners mean that a consent requirement may be disregarded, there is still the possibility based on Revenue Ruling 93-4 that free transferability of interests may be defeated by simply prohibiting transfers of interests or providing for an automatic dissolution of the partnership upon the occurrence of a transfer. As noted above, Revenue Ruling 93-4 indicates that free transferability would be found lacking in any such situation. However, that seems a little too good to be true, since a partner that desired to transfer its interest could arrange to do so by causing the partnership agreement to be amended prior to the proposed transfer to permit that particular transfer.¹²⁴

7. *General Partners with Tiny Interests.*—If a general partner has a tiny interest, a variation on the limited liability issue discussed in Part III(B)(6) above may arise, i.e., whether the general partner's interest is so small that the general partner should not be regarded as a partner for tax purposes. If the general partner's interest is so small that it would be disregarded, any general partner consent requirement for transfers of interests would not seem to be relevant for free transferability purposes, since Regulations section 301.7701-2(e) looks to whether the consent of another *member* is required. Accordingly, for the reasons discussed in Part III(B)(6),

122. Priv. Let. Rul. 9239014 (June 25, 1992).

123. Compare *David Metzger Trust v. Commissioner*, 76 T.C. 42 (1981), aff'd, 693 F.2d 459 (5th Cir. 1982), cert. denied, 463 U.S. 1207 (1983), and the cases cited therein on the issue of when family hostility can break attribution of ownership among family members under section 318. See also Revenue Ruling 93-12, 1993-7 I.R.B. 13 (Jan. 26), on the issue of valuing the stock of a corporation owned by family members.

124. Such an amendment, in and of itself, should not cause the partnership to have freely transferable interests, since it would only authorize a transfer of a specific interest to a specific person on a specific date and it may not involve "substantially all" the interests. However, if the partners had an agreement from the outset that transfers could be effected in that manner upon request or they routinely did transfer their interests in that manner, the Service obviously could take the position that the transfer limitation was illusory.

it would be prudent for the general partner's interest to satisfy the Service's ruling guideline regarding the minimum size of a general partner's interest.

8. *Consent Shopping*.—A final free transferability issue arises where the partnership agreement provides that a transferee partner will not be admitted as a substitute limited partner without consent, but the consent need not be the consent of any particular partner. That issue can arise where the partnership has multiple general partners and any one general partner may give the consent, and it can arise where the consent of a particular percentage (say, twenty-five percent) of all the non-transferring partners is required. Although Regulations section 301.7701-2(e) literally would be satisfied (since the consent of a member is required for the transferee to be admitted), many tax practitioners tend to have a visceral feeling that this type of transfer limitation generally is not sufficient to avoid the corporate characteristic of free transferability. The only provision of this nature that has been held to defeat free transferability is a provision requiring a majority of all the members to consent to a proposed transfer.¹²⁵

V. CONTINUITY OF LIFE

A. Background

If the limited liability factor could be regarded as the most meaningful corporate characteristic, continuity of life is surely the most ephemeral. Regulations section 301.7701-2(b)(1) sets forth the general rule that "an organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization." The term "dissolution" means a dissolution under applicable state law,¹²⁶ rather than a termination in the section 708(b)(1)(A) sense of ceasing to be engaged in business. Whether the entity will automatically dissolve on a date certain or will dissolve on the occurrence of an event other than the six specified dissolutions events is irrelevant for that purpose. The partner whose death, bankruptcy, etc. would cause a dissolution of the partnership does not have to be the partner that has personal liability where the partnership is relying on the lack of limited liability or the partner whose consent is required for a transfer where the partnership is relying on the absence of free transferability.¹²⁷

The regulations add two special rules. The first special rule is set forth in Regulations section 301.7701-2(b)(3), which states that general

125. See Rev. Rul. 88-79, 1988-2 C.B. 360.

126. Regs. § 301.7701-2(b)(2).

127. See Regs. § 301.7701-2(b)(1).

partnerships organized under a statute “corresponding” to the Uniform Partnership Act and limited partnerships organized under a statute “corresponding” to the Uniform Limited Partnership Act lack continuity of life. While it is not clear what it means for a statute to “correspond” to a Uniform Act, the Service recently issued a ruling indicating that the limited partnership statutes of thirty-two states “correspond” to the Uniform Limited Partnership Act.¹²⁸ As discussed below, the regulation flatly and without qualification states the conclusion that a partnership formed under a statute that corresponds to a Uniform Act lacks continuity of life, but that statement arguably should be regarded more as a favorable presumption because of certain continuity issues that may arise even for Uniform Act partnerships.

Second, the regulation, in attempting to state the converse of the basic rule stated above, adds a caveat regarding the possible continuation of the entity after the occurrence of a dissolution event: “If the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership, *unless the remaining general partners agree to continue the partnership or unless all remaining members agree to continue the partnership*, continuity of life does not exist.”¹²⁹ As discussed below, that provision opens the door to the possibility that reconstitution mechanisms could cause an entity to be deemed to have continuity of life even if the governing

128. Those states are: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Iowa, Kansas, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Jersey, Ohio, Oklahoma, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin and Wyoming. See Revenue Ruling 93-2, 1993-1 I.R.B. 8 (Jan. 4), which provides a consolidated listing of all the state limited partnership statutes that have been determined to correspond to the Uniform Limited Partnership Act in prior revenue rulings (which rulings are superseded by Revenue Ruling 93-2). Thus, eighteen states currently lack comfort on this issue, which states are: Alaska, Hawaii, Indiana, Kentucky, Louisiana, Maine, Nevada, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota and Vermont. It should be cautioned that the approval of Revenue Ruling 93-2 is expressly based upon the partnership law of the applicable state as in effect on the date specified in the Revenue Ruling, which means that any subsequent changes in such law potentially could render the approval inapplicable. For example, the approval of the New Jersey statute as in effect on January 1, 1985, may be obsolete because that statute was extensively amended in 1988. See N.J. Stat. Ann. § 42:2A (West Supp. 1992); Priv. Let. Rul. 9046037 (Aug. 21, 1990) (noting that the New Jersey statute, as amended, does not materially correspond to the Uniform Limited Partnership Act for purposes of classification criteria set forth in Regulations section 301.7701-2).

129. Regs. § 301.7701-2(b)(1) (emphasis added). It is curious that this part of the regulation refers to only three of the six relevant dissolution events. One possible explanation is that it was intended to be only an illustration of the converse of the general rule. In any event, the Service’s recently issued proposed amendment to Regulations section 301.7701-2(b) would clarify that the reconstitution rule applies in the case of a dissolution triggered by any of the six events. See *infra* text accompanying note 151.

agreement provides that there is a dissolution for state law purposes on the occurrence of one or more of the six dissolution events.

B. Issues

The foregoing rules raise the following special problems.

1. *Reliance on the Presumption Alone.*—A threshold issue that arises with respect to any partnership organized under a statute “corresponding” to the Uniform Act is whether the partnership may rely on the statement in Regulations section 301.7701-2(b)(3) that partnerships organized under such statutes lack continuity of life, regardless of what the partnership agreement specifically provides regarding dissolution. At first blush, it would seem that the unqualified nature of the statement means that it may be relied upon without further inquiry. In fact, the Service has recently issued two revenue procedures indicating that it generally will not issue rulings on continuity of life if the partnership is organized under a Uniform Act statute on the ground that such rulings constitute “comfort” rulings.¹³⁰

Nevertheless, there are some grounds for concern on this issue. Specifically, when the statement regarding Uniform Act partnerships is read in context, one cannot help but notice that it is preceded by a lengthy discussion of the substantive aspects of continuity of life.¹³¹ As will be seen below, there could be a serious question as to whether a Uniform Act partnership lacks continuity of life in substance because of the inclusion of certain reconstitution provisions,¹³² affiliations between the general and limited partners¹³³ or other reasons. In addition, the Service’s ruling guidelines provide that it will not rule favorably on the continuity of life of a Uniform Act limited partnership if less than a majority of the limited partners can continue the partnership after the removal of the general partner.¹³⁴ Thus, it may be more prudent to treat the statement on Uniform Act partnerships as being more in the nature of a favorable presumption that would control in what might otherwise be a close case on continuity of life.¹³⁵

130. Rev. Proc. 92-88, 1992-42 I.R.B. 39 (Oct. 19), at §§ 3.03 and 4.02; Rev. Proc. 92-87, 1992-42 I.R.B. 38 (Oct. 19).

131. Regs. § 301.7701-2(b).

132. See discussion *infra* Part V(B)(4).

133. See discussion *infra* Part V(B)(5).

134. Rev. Proc. 89-12, 1989-1 C.B. 798, at § 4.05.

135. The leading partnership commentators seem to agree with that conclusion. See 1 John R. Bonn, *Taxation of Partnerships* ¶ 3:46 (1987) (a Uniform Act partnership “ordinarily lacks” continuity of life); McKee, *supra* note 12, at 3-60 (a Uniform Act partnership is “probably immune” from continuity of life attacks based on substance). But see 1 Arthur B. Willis, et al., *Partnership Taxation* ¶ 34.05 (4th Ed. 1989) (no hedging language in describing

The only case to consider this issue has held that the rule on Uniform Act partnerships is absolute, even if there are provisions in the relevant partnership agreement that would raise questions as to whether the partnership lacked continuity of life in substance. In *Zuckman*,¹³⁶ the Service took the position that a partnership formed under a state limited partnership statute that admittedly corresponded to the Uniform Act had continuity of life on the grounds that (i) it had a special purpose corporate general partner, (ii) the partnership agreement provided that the partnership would not voluntarily be dissolved and (iii) the general partner agreed not to file for bankruptcy. The court held that it was “inescapable” that continuity of life would have to be found lacking under a literal reading of the statement in the regulations regarding Uniform Act partnerships.¹³⁷ However, the court did go on to analyze the continuity of life issue as if the statement did not apply and concluded that continuity of life was lacking in substance.¹³⁸

2. *Number of Dissolution Events.*—The literal language of Regulations section 301.7701-2(b)(1)—which refers to “the death, insanity, bankruptcy, retirement, resignation, or expulsion” as causing a dissolution—raises the grammatical issue of whether it means that all of those six events (rather than any one such event) must be capable of causing a dissolution for an entity to lack continuity of life, since that language could be read either way. However, the remaining portion of Regulations section 301.7701-2(b), particularly the language relating to the reconstitution of a partnership after the occurrence of a dissolution event, makes reasonably clear that it is sufficient that any one such event causes a dissolution.¹³⁹ Certainly that is the way the regulation is universally applied in practice by both the Service and by taxpayers. As an illustration, the partnership at issue in *Larson* was determined to lack continuity of life even though the only pertinent dissolution event was the bankruptcy of the general partner.¹⁴⁰ The issue of whether all six dissolution events were required was not even raised by the Service.¹⁴¹

the lack of continuity of life of Uniform Act partnerships).

136. *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975).

137. *Id.* at 734.

138. *Id.* at 734-37. See also *Foster v. Commissioner*, 80 T.C. 34, 187-88 (1983), *aff'd in part and vacated in part*, 756 F.2d 1430 (9th Cir. 1985), *cert. denied* 474 U.S. 1055 (1986) (general partnership determined to lack continuity of life based on an analysis of the substance after noting that it was formed under a Uniform Act statute).

139. See also Regs. § 301.7701-3(b)(2) (examples of partnerships that apparently lack continuity of life on the basis of only three dissolution events). It also may be instructive to note that the seminal pre-regulation case on continuity of life—*Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942), *acq.* 1942-1 C.B. 8—held that a partnership lacked continuity of life where the only dissolution events were death, retirement, and insanity.

140. *Larson v. Commissioner*, 66 T.C. 159, 173-76 (1976).

141. *Id.*

3. *Weak Dissolution Events*.—Assuming that continuity of life may generally be avoided by providing that any one of the six stated dissolution events will cause a dissolution of the partnership, the next issue is whether the dissolution event that is specified may be one that is highly unlikely to occur. Likelihood for this purpose is, of course, a relative concept, as the likelihood that any of the six dissolution events would occur for the typical partnership is very low.

Presumably it would be going too far to rely on death, insanity or retirement as the dissolution event where the general partner is a corporation for which those concepts have no relevance, except due to the possibility that it might later transfer its partnership interest to an individual. A closer question is whether a partnership may rely on expulsion as the dissolution event where the general partner may not be expelled unless it commits a wrongful act and/or a supermajority vote of the limited partners is required. Another issue is whether a partnership may rely on bankruptcy as the dissolution event where the general partner covenants not to voluntarily file a bankruptcy petition, with the result that bankruptcy would occur only if the general partner's creditors file an involuntary petition or the general partner breaches its covenant. A similar issue is whether a partnership may rely on withdrawal as the dissolution event where the general partner covenants not to withdraw. In all those situations, the provision that would be relied upon to break continuity of life would not have much substance given the remote possibility that the applicable dissolution event would occur.

Two of the foregoing situations were addressed in *Zuckman*,¹⁴² which, as noted earlier,¹⁴³ considered whether a partnership lacked continuity of life where the partnership agreement provided that the general partner would not voluntarily dissolve the partnership and the general partner separately agreed not to file for bankruptcy. The court held that such agreements would not cause the partnership to have continuity of life on the ground that the regulations look solely to whether the general partner has the *power* to cause a dissolution, not whether the general partner has agreed not to do so or whether the general partner would be liable for damages if it did so.¹⁴⁴ That theory would suggest that continuity of life would also be found lacking in the expulsion case where the general partner could be expelled without cause, but presumably not where cause is required, since the existence of the power to dissolve the partnership would be contingent on the occurrence of wrongful behavior by the general partner.

142. *Zuckman*, 524 F.2d at 734-37.

143. See *supra* text accompanying notes 136-38.

144. *Zuckman*, 524 F.2d at 734-37.

4. *Reconstitution Provisions.*—Another issue is whether a so-called reconstitution provision in a partnership agreement may cause the partnership to be treated as having continuity of life. Under such a provision, if a stated dissolution event occurs, a technical dissolution may occur under state law, but the partnership will be reconstituted and continued by the remaining members if a specified proportion of the members agree to so reconstitute the partnership.¹⁴⁵ For example, it is common for the partnership agreement of a limited partnership with multiple general partners to provide that, upon the occurrence of a dissolution event with respect to any one general partner, the remaining general partners may elect to reconstitute and continue the partnership. Such reconstitution provisions can test the boundaries of the continuity of life factor, because they can cause the consequences of the occurrence of a dissolution event to be formalistic at best. Indeed, as a federal income tax matter, the partnership would not even be viewed as terminating, since the business of the partnership would be continued.¹⁴⁶

As noted above,¹⁴⁷ Regulations section 301.7701-2(b)(1) indicates that a partnership that otherwise would be treated as lacking continuity of life will nevertheless be treated as having continuity of life if the partnership may be continued, upon the occurrence of a dissolution event, by less than all the remaining members of the partnership. The language of the regulation indicates that unanimous consent must be required for reconstitution if continuity of life is to be found lacking, and the only case on point involved a unanimous consent provision.¹⁴⁸ Unanimous consent obviously would be extremely difficult to obtain where the partnership is widely held. Fortunately, the Service's 1989 ruling guidelines indicated that a partnership agreement providing for reconstitution based on a simple majority vote of the remaining members after the *removal* of the general partner would not result in continuity of life,¹⁴⁹ but left unaddressed the issue of whether such a majority vote was allowable after the occurrence of any other type of dissolution event. A further advance was made in 1992 in Revenue Procedure 92-35,¹⁵⁰ in which the Service announced that it would not take the position that a partnership has continuity of life if at least fifty percent of the members

145. Under Revised Uniform Limited Partnership Act statutes, the partnership is not even dissolved as a matter of state law if the vote to continue the partnership occurs within 90 days of the date on which the dissolution event occurs. See, e.g., Del. Code Ann. tit. 6, § 17-801(3) (Supp. 1992).

146. See IRC § 708(b)(1)(A); Regs. § 1.708-1(b)(1)(i).

147. See *supra* text accompanying note 129.

148. *Larson v. Commissioner*, 66 T.C. 159, 165; see also Priv. Let. Rul. 9010027 (Dec. 7, 1989) (limited liability company determined to have continuity of life because of a majority vote reconstitution provision).

149. Rev. Proc. 89-12, 1989-1 C.B. 798 at § 4.05.

150. 1992-1 C.B. 790.

must vote to reconstitute the partnership upon the bankruptcy *or* removal of the general partner, but that still left the issue as to whether a majority vote was allowable after the occurrence of any of the four other dissolution events. This issue would finally be put to bed by the Service's recently issued proposed amendment to Regulations section 301.7701-2(b),¹⁵¹ which would make clear as a matter of substantive law that a partnership will not be deemed to have continuity of life as a result of a provision in its partnership agreement that allows the partnership to be reconstituted based on a majority vote after the occurrence of any dissolution event.

The most extreme example of a reconstitution provision would be one which provides that upon the occurrence of a dissolution event, the partnership would automatically be reconstituted and continued. At first glance, that would seem to insure the entity had continuity of life. However, even that result is not perfectly clear. First, the occurrence of a dissolution event may have non-tax significance under the partnership statutes in certain states, since the dissolution event may cause a technical dissolution of the partnership as a matter of state law, with the consequence that the reconstituted partnership would be regarded as a new partnership for state law purposes.¹⁵² Second, it is arguable that the requirement that all the partners agree to reconstitute has been satisfied, based either on the theory that all the partners effectively agreed in advance to reconstitute upon the occurrence of a dissolution event by becoming parties to a partnership agreement providing for such reconstitution or on the theory that all the partners agreed to agree to reconstitute the partnership in that event. Third, if the partnership was formed under a Uniform Act statute, the statement in Regulations section 301.7701-2(b)(3) that Uniform Act partnerships do not have continuity of life would seem to insure that continuity of life would be found lacking.¹⁵³ Notwithstanding such arguments, it would not seem wise to include an automatic reconstitution provision in a partnership agreement where partnership status depends upon lack of continuity of life (even if the partnership is organized under a Uniform Act statute), since such a provision would make the consequences of the occurrence of a dissolution event merely formalistic.

151. Notice PS-7-92, 1992-32 I.R.B. 27 (Aug. 10). It is interesting to note that Notice PS-7-92 was issued only three months after Revenue Procedure 92-35. The proposed amendment also would clarify that a partnership may be reconstituted by the remaining general partner(s), without a limited partner vote, where a partnership has more than one general partner and a dissolution event occurs with respect to one of them.

152. This would not be true under most state statutes, since most states have adopted some version of the Revised Uniform Limited Partnership Act. See *supra* note 145.

153. In fact, as noted earlier, the applicability of Regulations section 301.7701-2(b)(3) would prevent the taxpayer from being able to obtain a "comfort" ruling on that issue. See *supra* text accompanying note 130.

5. *Affiliated General and Limited Partners.*—In situations where the general partner is closely affiliated with some or all of the limited partners, a continuity of life issue analogous to that discussed earlier with respect to free transferability may arise.¹⁵⁴ Specifically, the Service might take the position, as it did in Revenue Ruling 77-214¹⁵⁵ and *MCA*,¹⁵⁶ that the entity has continuity of life even if the partnership agreement provides that the entity will dissolve upon the occurrence of one or more dissolution events on the theory that there are no “separate interests” that would seek to enforce the dissolution provision or, alternatively, that there are no “separate interests” that might prevent the reconstitution of the partnership.¹⁵⁷

While the considerations discussed earlier in the context of free transferability apply in this context, there is an important additional consideration that may change the result for continuity of life purposes. That consideration is the fact that the state statute under which the entity is organized may provide that the entity must dissolve upon the occurrence of one or more dissolution events (subject to the possibility of it reconstituting and continuing). Thus, dissolution may occur automatically as a matter of law, rather than as a result of the enforcement of a contractual provision by the members. That consideration, of course, explains why Regulations section 301.7701-2(b)(3) contains a flat statement that partnerships organized under a Uniform Act statute lack continuity of life. Thus, historically it has been reasonably safe to rely on the absence of continuity of life where the entity has closely affiliated members but is organized under a Uniform Act statute. There was less certainty for entities organized under other types of statutes providing for automatic dissolution. However, there was only a glimmer of hope in the Service’s seemingly aberrational rulings in the foreign context that certain foreign entities owned by members of a single corporate group lack continuity of life, which could only be explained on the basis that local law provided for automatic dissolution.¹⁵⁸

154. See *supra* Part IV(B)(6).

155. 1977-1 C.B. 408.

156. *MCA, Inc. v. United States*, 685 F.2d 1099 (9th Cir. 1982).

157. But see I.R.S. T.A.M. 8533003 (May 7, 1985) (single beneficiary trust held to lack continuity of life because the beneficiary could revoke the trust).

158. See, e.g., Priv. Let. Rul. 9237021 (June 12, 1992) (*Société en Nom Collectif* between sister companies classified as a partnership based on the absence of continuity of life and limited liability without mentioning Revenue Ruling 77-214 or discussing free transferability); Priv. Let. Rul. 9131057 (May 8, 1991) (same for a *Société en Nom Collectif* between sister companies); Priv. Let. Rul. 9122074 (Mar. 6, 1991) (same for a *Société en Nom Collectif* between sister companies organized in an undisclosed country); Priv. Let. Rul. 9103033 (Oct. 23, 1990) (same for a *Société en Nom Collectif* between parent and subsidiary organized in undisclosed country); Priv. Let. Rul. 8512024 (Dec. 21, 1984) (foreign partnership organized in undisclosed country treated as a partnership based on the absence of continuity of life and limited liability without mentioning Revenue Ruling 77-214 or discussing free

In Revenue Ruling 93-4,¹⁵⁹ the Service purported to eliminate the lack of “separate interests” concern with respect to continuity of life. As noted earlier,¹⁶⁰ Revenue Ruling 93-4 reconsidered the Service’s treatment of the GmbH at issue in Revenue Ruling 77-214. Without any explanation, it proclaims that “the presence of separate interests is not relevant to the determination of whether an entity possesses continuity of life.”¹⁶¹ It then concludes that the GmbH at issue should have been treated as a partnership, since the memorandum of understanding provided for dissolution upon the bankruptcy of either member (which would occur automatically under German law without any further action by the members).

Although the sweeping language in Revenue Ruling 93-4 would seem to put this continuity of life issue to bed, two concerns still remain. The first concern is whether Revenue Ruling 93-4’s rejection of the relevance of separate interests applies in situations where the dissolution of the entity would not happen automatically under local law, but, rather, would require the affirmative action of one or more of the members. That could be the case, for example, with a partnership organized under a non-Uniform Act statute that did not provide for the automatic dissolution or with an entity such as a trust where the dissolution is required purely as a contractual matter.¹⁶² In such cases, the occurrence of a dissolution event would have absolutely no consequence at the entity level, *unless* a member enforced the dissolution provision. Since the affiliated partners presumably would choose not to enforce the dissolution provision upon the occurrence of a dissolution event, the dissolution provision would have no substance.¹⁶³ Hence, in the face of the Service’s reaffirmation of the lack of separate interests theory for free

transferability); Priv. Let. Rul. 8243193 (July 29, 1982) (German Offence Handelsgesellschaft between sister companies classified as a partnership based on the absence of limited liability, continuity of life and centralized management without mentioning Revenue Ruling 77-214 or discussing free transferability); Priv. Let. Rul. 8222012 (Feb. 25, 1982) (foreign partnership organized in undisclosed country classified as a partnership based on the absence of continuity of life and limited liability without mentioning Revenue Ruling 77-214 or discussing free transferability); Priv. Let. Rul. 7934096 (May 24, 1979) (same for a French Société en Nom Collectif between sister companies).

159. 1993-3 I.R.B. 5 (Jan. 19).

160. See *supra* text accompanying notes 111-13.

161. Rev. Rul. 93-4, 1993-3 I.R.B. 5 (Jan. 19). As indicated, *supra* text accompanying notes 111-13, Revenue Ruling 93-4 preserves the lack of “separate interests” theory for free transferability purposes.

162. The trust case is discussed in more detail *infra* at Part VII(C).

163. This was the Service’s reasoning on the continuity of life issue in Revenue Ruling 77-214, 1977-1 C.B. 408. Revenue Ruling 93-4, 1993-3 I.R.B. 5 (Jan 19), simply recognizes that “separate interests” were not necessary for the dissolution provision to have significance under the facts of that ruling, because the GmbH would dissolve automatically under German law upon the occurrence of a dissolution event.

transferability of interests purposes, it would not seem prudent to rely on the absence of continuity of life where the dissolution provision is purely a contractual matter or otherwise requires the affirmative action of the members.

The second concern is whether a partnership with affiliated partners could be deemed to have continuity of life where there is automatic dissolution under local law but the partnership agreement contains a reconstitution provision that would permit continuation of the partnership upon the occurrence of a dissolution event. Since the partners presumably would always vote to reconstitute, the dissolution provision would not really have any substance, other than the nuisance of forcing an affirmative vote to continue the entity. In the case of a Uniform Act partnership, the partnership normally would not even dissolve as a matter of state law after the occurrence of a dissolution event.¹⁶⁴ Nevertheless, the unequivocal declaration in Revenue Ruling 93-4¹⁶⁵ that the separate interests theory is not relevant for continuity of life purposes, when coupled with the favorable presumption in the regulations on Uniform Act partnerships¹⁶⁶ and the *Zuckman* case,¹⁶⁷ should result in Uniform Act partnerships among affiliated partners being treated as lacking continuity of life.¹⁶⁸ For other types of entities with affiliated members, there actually may be a dissolution of the entity under local law that the entity could rely on to prove that the dissolution provision had some significance. In any event, Revenue Ruling 93-4 and, by analogy, the treatment of Uniform Act partnerships, would seem to insure that such other types of entities also should be treated as lacking continuity of life.

6. *General Partners with Tiny Interests.*—If a general partner has a tiny interest, a continuity of life issue, analogous to the limited liability issue discussed in Part III(B)(6) above may arise, i.e., whether the general partner's interest is so small that the general partner should not be regarded as a member for federal income tax purposes. If so, the effect of a general partner's bankruptcy, death, withdrawal, etc. would not seem to be relevant for continuity of life purposes, since Regulations section 301.7701-2(b) looks to whether the bankruptcy, death, withdrawal, etc., of a *member* would cause a dissolution. Thus, for the reasons discussed in Part III(B)(6), it would seem prudent for the general partner's interest to satisfy the Service's ruling

164. See *supra* note 145. The entity would dissolve, however, if the partners failed to vote to reconstitute the partnership within the statutory period (usually 90 days) for reconstitution without dissolution.

165. 1993-3 I.R.B. 5 (Jan. 19). See also Rev. Rul. 75-19, 1975-1 C.B. 382.

166. Regs. § 301.7701-2(b)(3).

167. *Zuckman v. United States*, 524 F.2d 729 (Ct.Cl. 1975), which is discussed *supra* text accompanying notes 136-38.

168. That conclusion is also supported by the complete absence of any authority holding that Uniform Act partnerships among affiliated partners lack continuity of life.

guideline regarding the minimum size of a general partner's interest. However, even if the ruling guideline were not satisfied, there would still be the issue discussed in Part V(B)(1) above as to whether the continuity of life rule for entities formed under a Uniform Act statute is really absolute.

VI. CENTRALIZED MANAGEMENT

A. Background

Regulations section 301.7701-2(c)(1) states the general rule that an entity has the characteristic of centralized management "if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed." The fact that a third party is appointed to run the day-to-day operations of the entity is not relevant, since the regulations look to the management responsibilities undertaken by the owners.

The regulations expressly provide that a general partnership formed under a statute corresponding to the Uniform Partnership Act always lacks centralized management because of the "mutual agency relationship" that exists among all the partners, meaning the authority of each partner to bind the partnership vis-a-vis third parties.¹⁶⁹

One might be tempted to conclude that all limited partnerships have centralized management, given the concentration of management authority in the general partner. However, Regulations section 301.7701-2(c)(4) states that limited partnerships organized under a statute "corresponding" to the Uniform Limited Partnership Act "generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners." The theory apparently is that centralized management should not be deemed to exist where the general partner has a sufficiently large economic interest that it would be acting for its own account in managing the business of the partnership, rather than acting in a representative capacity like the board of directors of a corporation.¹⁷⁰ Of course, that theory only goes so far, since a general partner has a fiduciary duty under state law to manage the partnership based upon the best interests of the limited partners, no matter

169. Regs. § 301.7701-2(c)(4).

170. This theory is based on *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942), acq. 1942-1 C.B. 8, which held that a limited partnership where the general partners owned 42% of the interests lacked centralized management because "[t]hey were acting in their own interest as hitherto ... and not merely in a representative capacity for a body of persons having a limited investment and a limited liability." *Id.* at 185.

what the size of its interest.¹⁷¹ In addition, the general partner may be further constrained by limited partner consent rights.

Regulations section 301.7701-2(c)(4) goes on to state that if all or any group of the limited partners may remove the general partner, then "all the facts and circumstances must be taken into account in determining whether the partnership possesses centralized management." The theory apparently is that if the general partner may easily be removed by the limited partners, then the general partner's interest may not be sufficiently vested to motivate it to act for its own account in managing the partnership, thereby relegating it to acting in a representative capacity.

B. Issues

The foregoing rules raise the following special problems.

1. *"Substantially All" Issue.*—The most obvious centralized management question is how substantial an interest the general partner must have for the entity to be deemed to lack centralized management. As indicated above, the specific legal issue under Regulations section 301.7701-2(c)(4) is whether "substantially all" the interests in the partnership are owned by the limited partners.¹⁷² Until 1989, there was no useful authority on what the term "substantially all" means for this purpose, other than an example in the regulations indicating that centralized management would exist where the general partner holds only a 5.7% interest.¹⁷³

In 1989, the Service promulgated a ruling guideline indicating that it would not rule that a partnership lacks centralized management unless the general partners own at least twenty percent of the "total interests" in the partnership (including any interests held as a limited partner).¹⁷⁴ That ruling guideline, which codified what apparently had previously been an informal ruling policy, is likely to occupy the field until there is more definitive authority.

2. *Capital Versus Profits Interests.*—Another issue is whether a partnership would be deemed to have centralized management if the general partner contributes little or no capital to the partnership but has a sizable

171. For Delaware authority see, e.g., Del. Code Ann. tit. 6, § 17-403 (Supp. 1992); *In re USA Cafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991).

172. The *Larson* court rephrased the issue in terms of whether the general partners have "a meaningful proprietary interest." *Larson v. Commissioner*, 66 T.C. 159, 177 (1976) (citation omitted).

173. Regs. § 301.7701-3(b)(2) (Example 1).

174. Rev. Proc. 89-12, 1989-1 C.B. 798 at § 4.06.

interest in partnership profits. That situation apparently would fail to satisfy the ruling guidelines, since the ruling guideline test is whether the general partner has twenty percent or more of the "total interests" in the partnership.

The only case to consider that issue is *Larson*,¹⁷⁵ which involved a limited partnership where the general partner had a twenty percent interest in partnership profits after a return of the limited partner's capital.¹⁷⁶ The court did not seem to regard that subordination of the general partner's interest as being per se fatal on the centralized management issue. However, the court did hold that centralized management existed, since the court regarded the general partner's interest as being very speculative on the facts and it was concerned about the right of the limited partners to remove the general partner at any time with a sixty percent vote.¹⁷⁷

It would seem that at some point a general partner's interest in partnership profits could be sufficiently large that it would be managing the partnership more as a principal than in a representative capacity, even if it had little or no interest in partnership capital. Thus, the theory underlying the centralized management regulations would dictate that the partnership should not be regarded as being centrally managed. In addition, authorities on the meaning of the term "substantially all" for other tax purposes would support that result.¹⁷⁸ To venture a guess, it would seem that an interest in partnership profits in the thirty to forty percent range should be sufficient to preclude centralized management, assuming that such interest is not subordinated to a return on the capital invested by the other partners. A higher percentage might be necessary, depending on the facts, if the general partner's interest were subordinated to a return on capital.

3. *Removal Rights*.—As indicated above, under Regulations section 301.7701-2(c)(4), centralized management may be deemed to exist if the limited partners have the power to remove the general partner.¹⁷⁹ The presence of a removal right throws the centralized management question into a facts and circumstances test with no further guidance from the regulations.

The obvious issue in this regard is when centralized management will be deemed to exist under the facts and circumstances test where the general

175. 66 T.C. 159 (1976).

176. The amount of capital to which the general partner's interest was subordinated was actually only half the amount of cash actually contributed by the limited partners, and the limited partners were deemed to receive a return of their capital through both cash distributions and tax benefits.

177. *Larson*, 66 T.C. at 176-79.

178. See, e.g., Rev. Proc. 77-37, 1977-2 C.B. 568 ("substantially all" the assets of a party to a triangular merger means 90% of its net assets and 70% of its gross assets).

179. See discussion supra Part VI(A). This aspect of the regulations was added in 1983 by Treasury Decision 7889, 1983-1 C.B. 362.

partner has a substantial interest but is subject to a removal right. Unfortunately, there is absolutely no authority on this issue. While it may seem like an issue of only academic significance, it is in fact of real practical significance. The reason is that many partnership agreements have express removal rights that apply where the general partner has acted wrongfully, and state law may supply such a removal right where the partnership agreement does not.

There are two aspects of removal provisions that seem most relevant to the facts and circumstances inquiry. The first is when the removal right can be exercised. If the removal right can be exercised only when the general partner commits a wrongful act, it is difficult to see why the general partner should be treated as acting in a representative capacity, since the general partner should regard its interest as sufficiently vested to be motivated to act for its own account. In addition, it would be absurd as a policy matter for the partnership tax law to encourage limited partners to give up legitimate remedies against general partners that have acted wrongfully in order to avoid centralized management. In recognition of those considerations, Regulations section 301.7701-2(c)(4) quite sensibly provides that: “[a] substantially restricted right of the limited partners to remove the general partner (e.g., in the event of the general partner’s gross negligence, self-dealing, or embezzlement) will not itself cause the partnership to possess centralized management.” That having been said, there is still the lingering issue of whether removal rights tied to a simple negligence standard or the failure of the general partner to satisfy a financial performance test (without regard to fault) would be deemed to be a “substantially restricted right.” Presumably such removal rights would be regarded as substantially restricted, except in the case of removal rights based on a financial performance test if the parties expected that the test would not be satisfied.

The second aspect of a removal provision that should be relevant is what consideration, if any, the general partner would be entitled to receive as a result of a removal. If the general partner would be entitled to a payment equal to the fair market value of its interest or its interest would be converted into a limited partner interest with the same economic attributes as before, it is arguable that the general partner should not be regarded as acting in a representative capacity despite the presence of the removal right, since the general partner would always have the economic incentive to manage the partnership as it saw fit to maximize the value of its interest. There is some support for that position in *Larson*, which involved a removal right pursuant to which the general partner would receive a cash payment equal to the fair market value of its interest if it were removed. The court indicated that such payment requirement created “a vested proprietary interest to protect,” although it ultimately concluded that centralized management existed because

the interest had only speculative value.¹⁸⁰

4. *Affiliated General and Limited Partners.*—Where the general and limited partners of a partnership are affiliated, special centralized management concerns may come into play. The most important concern applies where the limited partners actually control the general partner, namely, whether centralized management could be deemed to exist, even if the general partner has a substantial interest in the partnership, on the theory that the general partner would always be directed to represent the interests of the limited partners. Revenue Procedure 89-12¹⁸¹ contains a warning in this regard, stating that “the Service will consider all the facts and circumstances, including limited partner control of the general partners (whether direct or indirect), in determining whether the partnership lacks centralized management.”¹⁸²

Unfortunately, there is no definitive authority as to what degree of control by the limited partners will result in centralized management. On the one hand, the fact that a single limited partner with a small interest in a partnership with many partners has a minority interest in the general partner obviously should not be a problem. On the other hand, a limited partner’s complete control of a general partner in a two-partner partnership would raise a serious centralized management problem.

It should be noted that there is a paradox with respect to the centralized management concern raised by limited partners controlling the general partner. The paradox arises because the centralized management concern becomes more acute as the degree of control by the limited partners increases, yet, if the limited partners actually served as the general partners, there clearly would be no centralized management.

A related issue is whether the Service could extend its lack of “separate interests” theory, which it historically has applied only for free transferability¹⁸³ and continuity of life purposes,¹⁸⁴ to this area. The argument would be that a general partner that is closely affiliated with (but not controlled by) the limited partners naturally would protect the interests of the limited partners and presumably would be beholden to the same ultimate owners, thereby creating a sort of functional centralized management. Fortunately, there is no evidence that the Service has ever made that argument.

5. *“Exclusive Authority” Issue.*—Another centralization of management issue is whether a limited partnership that has a general partner with a

180. *Larson*, 66 T.C. at 178.

181. 1989-1 C.B. 798.

182. *Id.* at § 4.06.

183. See discussion *supra* Part IV(B)(6).

184. See discussion *supra* Part V(B)(5).

small economic interest could be determined to lack centralized management because of management rights granted to the limited partners. As noted earlier, Regulations section 301.7701-2(c)(1) provides that centralized management exists where “continuing *exclusive* authority to make the management decisions necessary to the conduct of the business” (emphasis added) resides with members having a small interest.

The partnership agreement for the typical limited partnership provides that the limited partners must consent to certain extraordinary transactions, such as selling substantially all the partnership’s assets or admitting new partners. Such approval rights often are quite extensive, particularly for limited partnerships formed under Revised Uniform Limited Partnership Act statutes because of the freedom those statutes give to limited partners to participate in management without losing their limited liability.¹⁸⁵ In some cases, the limited partners may be represented by a management or advisory committee that actively monitors the partnership’s business and routinely passes on general partner actions. Thus, in the real world, general partners have varying degrees of control over partnership businesses, but they seldom have truly “exclusive” control. Arguably such limited partner rights could cause a partnership to lack the characteristic of centralized management.

6. *Managing General Partners.*—One final centralized management issue arises for limited partnerships that have multiple general partners, one of whom is delegated the exclusive responsibility for managing day-to-day business of the partnership (and is usually referred to as the “managing general partner”). The question is whether the centralized management issue should be judged solely by reference to the size of the interest held by the managing general partner on the theory that the managing general partner has the “exclusive authority” to manage the partnership. It is doubtful that the Service would prevail if it were to take that position. First, even though the managing general partner of a partnership actually runs the partnership on a day-to-day basis, all the general partners would at least have the authority to bind the partnership vis-a-vis third parties, which is all that seems to be relevant under Regulations section 301.7701-2(c).¹⁸⁶ Second, that position would require disregarding the language of Regulations section 301.7701-2(c) and the Service’s 1989 ruling guideline on centralized management, both of which divide the world into the two generic categories of general partners and limited partners.

This issue conceivably could be reopened, however, in light of the Service’s publication of Revenue Ruling 93-6.¹⁸⁷ Revenue Ruling 93-6

185. See, e.g., Del. Code Ann. tit. 6, § 17-303 (Supp. 1992).

186. See McKee, *supra* note 12 at ¶ 3.06[4][b].

187. 1993-3 I.R.B. 8 (Jan. 19). That ruling is discussed in more detail *infra* Part

involved a Colorado limited liability company with five members, each of whom was designated as a "manager" to run the business. The ruling held that the limited liability company had centralized management, because the members were managing in a representative capacity (i.e., as "managers") rather than in their capacity as members. It would not be a huge leap for the Service to attempt to apply that rationale to limited partnerships with managing general partners and claim that the status of managing general partner is a representative position. Nevertheless, the Service should not prevail even with Revenue Ruling 93-6 under its belt, since the fact that all the general partners of a partnership have the authority to bind the partnership in their capacities as partners still provides a critical distinction between the limited partnership case and the situation in Revenue Ruling 93-6 where none of the members had any authority to bind the limited liability company in their capacities as members.

VII. EXOTIC PARTNERSHIPS

The following discussion analyzes some of the peculiar partnership classification issues raised by certain types of entities (other than ordinary partnerships) that may qualify as partnerships for federal income tax purposes.

A. *Limited Liability Companies*

Since the issuance of Revenue Ruling 88-76,¹⁸⁸ a growing interest has developed in the use of limited liability companies as vehicles that can offer the enviable combination of limited liability and partnership tax treatment.¹⁸⁹ There has been a flurry of legislative activity on limited liability companies at the state level, often led by accounting firms and other professional service businesses seeking to obtain some type of liability protection for their owners. Currently, eighteen states (including Delaware) have enacted limited liability company statutes,¹⁹⁰ and at least fourteen

VII(A).

188. 1988-2 C.B. 360. The first favorable private letter ruling concerning a limited liability company actually was issued in 1980. Priv. Let. Rul. 8106082 (Nov. 18, 1980) (classifying a limited liability company as a partnership based on the absence of free transferability of interests and continuity of life).

189. It normally would be possible, of course, to replicate those attributes using (i) a limited partnership with a special purpose corporate general partner, (ii) a foreign corporation (which would have to be organized in a tax haven jurisdiction to avoid foreign tax) or (iii) a trust (as discussed *infra* Part VII(C)) assuming in such case that the steps necessary to achieve partnership status were taken.

190. Those states (and the year their respective statutes were enacted) are: Arizona (1992); Colorado (1990); Delaware (1992); Florida (1982); Illinois (1992); Iowa (1992);

others are actively considering their own legislation.¹⁹¹ While tax lawyers can scarcely contain their enthusiasm for this new creature,¹⁹² the actual use of limited liability companies has been fairly limited to date. That limited use is due in large part to concerns as to whether limited liability companies really offer limited liability both within and outside their state of organization.¹⁹³ It is also due to concerns as to how limited liability companies will be taxed in the states (such as New York) that have not yet spoken on the issue or the unfavorable treatment of limited liability companies relative to partnerships in certain states that have spoken on the issue.¹⁹⁴

Kansas (1990); Louisiana (1992); Maryland (1992); Minnesota (1992); Nevada (1991); Oklahoma (1992); Rhode Island (1992); Texas (1991); Utah (1991); Virginia (1991); West Virginia (1992) and Wyoming (1977).

191. Those states include: California; Georgia; Hawaii; Indiana; Michigan; Mississippi; Missouri; Nebraska; New Hampshire; New Jersey; New York; Ohio; Pennsylvania and South Carolina. In addition, the Conference of Commissioners for Uniform State Laws is drafting a uniform limited liability company act.

192. See, e.g., Alan G. Lederman, *Miami Device: The Florida Limited Liability Company*, 67 *Taxes* 339 (1989); Edward J. Roche, Jr., et al., *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 *J. Tax'n* 248 (1991); Francis J. Wirtz & Kenneth L. Harris, *The Emerging Use of the Limited Liability Company*, 70 *Taxes* 377 (1992); Curley, *Limited Liability Companies: Emerging Classification Rules and Issues* (Jan. 25, 1993) (unpublished paper delivered at the Tax Club in New York City). Limited liability companies definitely are one of the major topics on the tax lecture circuit. Congress has taken note of all the limited liability company hoopla, as reflected by the fact that the limited liability companies are on the 1993 agenda for the House Ways and Means Subcommittee on Select Revenue Measures. See *Ways and Means Select Revenues Subcommittee, Report on Referred Tax Issues*, reprinted in *Tax Notes Today* (Feb. 3, 1993) (LEXIS, FEDTAX library, TNT file, elec. cit. 93 TNT 25-22).

193. The primary concern is that it is unclear what choice of law principle will apply where a limited liability company formed in one state does business and incurs liabilities in another state. See Robert R. Keatinge, et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 *Bus. Law.* 375, 447-56 (1992). If the second state does not look to the first state's law to determine the characteristics of the limited liability company (due to comity considerations or otherwise), it would apply its own law, which may result in the limited liability company being treated like a partnership for liability purposes in the second state. *Id.* A secondary concern, which would arise even if the limited liability company did business only in the state where it was organized or it could assume that the other states where it did business would look to its home state's law on liability questions, is whether and to what extent judicial exceptions to the statutory limitation on liability will be created, perhaps by analogy to established "veil piercing" exceptions in the corporate area. *Id.* at 442-46.

194. For commentary on New York's struggle with the taxation issue, see Lee A. Sheppard, *New York Contemplates the Cost of Limited Liability Companies*, *News Analysis*, 57 *Tax Notes* 1481 (Dec. 14, 1992); Lee A. Sheppard, *The Dark Side of Limited Liability Companies*, *News Analysis*, 55 *Tax Notes* 1441, 1443-44 (June 15, 1992). New York State Bar Association Tax Section Task Force on New York Tax Treatment of Limited Liability Companies, *Outline of Issues and Alternatives* (Jan. 26, 1993) (report submitted to Governor Cuomo) (LEXIS, FEDTAX library, TNT file, elec. cit. 93 TNT 56-24).

The classification of limited liability companies as partnerships is based upon a fairly straightforward application of Regulations section 301.7701-2. However, since a limited liability company purports to offer limited liability, partnership classification must be based on the absence of at least two of the other three corporate characteristics.¹⁹⁵ And it obviously must achieve that result without relying on the favorable presumptions in Regulations section 301.7701-2 for Uniform Act partnerships or the key ruling guidelines set forth in Revenue Procedure 89-12.¹⁹⁶ Set forth below is a brief summary of how Regulations section 301.7701-2 generally applies to limited liability companies, with a focus on the special issues that may arise because of the unique characteristics of limited liability companies.

Limited liability company statutes typically provide that a limited liability company will dissolve on the bankruptcy, death, expulsion, dissolution or retirement of a member, subject to any reconstitution provision in the governing instrument.¹⁹⁷ Such statutes also typically provide that the governing instrument may provide for the automatic continuation of the limited liability company if one or more of those events occur.¹⁹⁸ Thus, a limited liability company generally should lack continuity of life, unless the governing instrument provides for automatic continuance in the event that a dissolution event occurs or the governing instrument provides for an impermissible reconstitution provision. Limited liability companies face a problem with respect to reconstitution provisions, since they may not rely on the favorable presumption in Regulations section 301.7701-2(b)(3) for Uniform Act partnerships and, as noted earlier, Regulations section 301.7701-2(b)(1)

195. In theory, of course, a limited liability company could lack limited liability on the basis of a member's contractual assumption of the limited liability company's liabilities. However, if lack of limited liability were necessary to achieve partnership tax treatment, there presumably would be no reason not to organize the entity as a plain vanilla limited partnership (and during this initial period of uncertainty regarding the legal and tax aspects of limited liability companies, that would be the preferred approach).

196. Although the introductory part of Revenue Procedure 89-12, 1989-1 C.B. 798 states that it applies generally to all types of entities seeking partnership classification, a careful reading reveals that section 4, which contains the key ruling guidelines, applies only to limited partnerships. It should be noted that the Service's proposed 1993 business plan includes issuing a revenue procedure to provide ruling guidelines for limited liability companies. See Treasury Department, Treasury, IRS Release Proposed 1993 Business Plan, reprinted in Tax Notes Today, (Jan. 19, 1993) (LEXIS, FEDTAX library, TNT File, elec. cit. 93 TNT 12-20). If the current interest in limited liability companies continues to build, the Service sooner or later will be asked to consider amending Regulations section 301.7701-2 to provide favorable presumptions for limited liability companies analogous to those for Uniform Act partnerships.

197. See, e.g., Del. Code Ann. tit. 6, § 18-801(4) (Supp. 1992); see also Rev. Rul. 88-76, 1988-2 C.B. 360 (applying a similar provision of the Wyoming Limited Liability Company Act); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Jan. 19) (Virginia limited liability company); Rev. Rul. 93-6, 1993-1 I.R.B. 8 (Jan. 19) (Colorado limited liability company).

198. See, e.g., Del. Code Ann. tit. 6, § 18-801(4) (Supp. 1992).

seems to require that a reconstitution provision require unanimous partner approval.¹⁹⁹ Thus, unless and until Proposed Regulations section 301.7701-2(b) is adopted in final form, limited liability companies will tend to require unanimous member consent to reconstitute after the occurrence of a dissolution event.²⁰⁰

Limited liability company statutes also typically provide that interests are freely assignable, subject to whatever restrictions are contained in the governing instrument. However, unless all the members consent to the transfer or the governing instrument provides otherwise,²⁰¹ the assignee stands in essentially the same position as the unadmitted assignee of a partnership interest, with the right to receive distributions from the limited liability company but no right to participate in management. Thus, as in the case of an ordinary partnership, a limited liability company generally should lack free transferability, unless there is no consent requirement (or only a reasonable consent requirement) for the admission of assignees. Since the paradigm case involves free assignability, the distinction between assignments and substitutions in Regulations section 301.7701-2(e)(2)²⁰² is critical for limited liability companies. However, the Service has respected that distinction in its three published rulings on limited liability companies.²⁰³

Limited liability company statutes vary somewhat as they relate to centralized management. The prevailing pattern seems to be to provide that the members of a limited liability company may either delegate management responsibilities to one or more "managers" (which may be members) that would function like the general partners of a limited partnership or they may retain management responsibilities for themselves, similar to the general partners in a general partnership ("Discretionary Delegation Statutes").²⁰⁴

199. See *supra* Part V(B)(4) (discussing reconstitution provisions).

200. Note that the reconstitution provisions for the limited liability companies at issue in each of the three published rulings referred to in note 197, *supra*, all required unanimous member approval. See also Priv. Ltr. Rul. 9010027 (Dec. 7, 1989) (limited liability company determined to have continuity of life because of a majority vote reconstitution provision). However, the wave of the future may be represented by a very recent private letter ruling holding that a limited liability company lacked continuity of life where the entity could be reconstituted by a majority vote of its "managing directors" and a majority in interest and number of the remaining members. Priv. Ltr. Rul. 9308027 (Nov. 27, 1992).

201. See, e.g., Del. Code Ann. tit. 6, § 18-702 (Supp. 1992); see also Rev. Rul. 88-76 (applying a similar provision of the Wyoming Limited Liability Company Act).

202. See *supra* Part IV(B)(3).

203. See Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyoming limited liability company with freely assignable interests held to lack free transferability because assignees were not admitted without unanimous member approval); Rev. Rul. 93-6, 1993-3 I.R.B. 8 (Jan. 19) (same result for a Colorado limited liability company); Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Jan. 19) (same result for a Virginia limited liability company).

204. See, e.g., Del. Code Ann. tit. 6, § 18-402 (Supp. 1992); Rev. Rul. 88-76, 1988-

Certain other statutes, however, contemplate management solely by designated managers, which may be members ("Mandatory Delegation Statutes").²⁰⁵

At first blush, one might be tempted to conclude by analogy to the result under Regulations section 301.7701-2(c) in the plain vanilla partnership context²⁰⁶ that the centralized management issue for a limited liability company organized under either type of statute would turn on whether the persons that manage the business have a meaningful proprietary interest, regardless of whether they manage in the capacity as designated managers or in the capacity as members. However, the Service has made two important distinctions in analyzing the centralized management issue in the limited liability company context in two recent published rulings.²⁰⁷

First, in Revenue Ruling 93-6²⁰⁸ the Service expressly indicated that centralized management *always* will be present with a limited liability company *unless* the limited liability company is organized under a Discretionary Delegation Statute *and* the articles of organization for the limited liability company do not delegate management authority to managers (even if such managers are members). Revenue Ruling 93-6 involved a Colorado limited liability company with five members. The Colorado statute is a Mandatory Delegation Statute,²⁰⁹ and the limited liability company at issue chose all five of its members to be its managers. Although the managers obviously had a meaningful proprietary interest in the limited liability company, the Service held that the limited liability company had centralized management because the members did not have any authority under the statute to manage in their capacities as members and, therefore, they were managing in their capacities as managers, which the Service presumably viewed as a representative capacity akin to a board of directors. Thus, the Service's position seems to be that limited liability companies organized under Mandatory Delegation Statutes like the Colorado statute have statutory centralized management and, presumably, that limited liability companies organized under Discretionary Delegation Statutes will be deemed to have centralized management if the

2 C.B. 360 (management of a limited liability company by three of twenty-five members resulted in centralized management).

205. See, e.g., Colo. Rev. Stat. § 7-80-401(1) (1992), which was the statute at issue in Revenue Ruling 93-6, 1993-3 I.R.B. 8 (Jan. 19), as discussed in the following paragraphs in the text.

206. See discussion *supra* Part VI.

207. Curiously, the Service's private letter rulings regarding limited liability companies generally do not analyze the centralized management issue. The one exception is Private Letter Ruling 9010027 (Dec. 7, 1989), in which a limited liability company organized under a Discretionary Delegation Statute that was managed by all its members in their capacity as such was held to lack centralized management, although the distinctions described in the text below were not discussed.

208. 1993-3 I.R.B. 8 (Jan. 19).

209. See *supra* note 205 and accompanying text.

delegation option is chosen, even if all the members are designated as managers.²¹⁰

A second centralized management distinction for limited liability companies that seems to have been drawn by the Service is that limited liability companies must be managed by *all* their members to be deemed to lack centralized management. That point seems to have been made in Revenue Rulings 93-5 and 88-76,²¹¹ both of which involved a limited liability company organized under a Discretionary Delegation Statute that had twenty-five members, three of whom were elected as managers. The Service summarily concluded in each case that the limited liability company at issue had centralized management without providing any real explanation for its conclusion. While the result in these rulings can be explained based upon the above-described rationale set forth in Revenue Ruling 93-6, that theory was not referred to in Revenue Rulings 93-5 and 88-76. It also is possible that the result in those rulings could be explained based upon the relatively small percentage interest of the managers, assuming that they had a relatively small percentage interest, but the rulings do not specify their percentage interests.²¹² The only express basis for the result in those rulings was the Service's reference in each to Regulations section 301.7701-2(c)(1), which states the general rule that centralized management is present "if any person (or any group of persons which does not include all the members) has continuing exclusive authority to make the management decisions." Hence, the Service apparently does not intend to approach the centralized management issue in the limited liability context by analogy to the treatment of limited partnerships, which analogy would suggest that if members holding a meaningful proprietary interest managed in their capacities as members the limited liability company would lack centralized management.²¹³ Given the

210. See the letter to the editor from Susan Pace Hammill, Attorney Advisor in the Office of Assistant Chief Counsel (Passthroughs and Special Industries), 58 Tax Notes 1266, 1385 (Mar. 8, 1993). This position could be the death knell for Mandatory Delegation Statutes, since they do not afford limited liability companies organized under them the option of defeating centralized management, thereby forcing such limited liability companies to achieve partnership status by defeating free transferability of interests and continuity of life.

211. Rev. Rul. 93-5, 1993-3 I.R.B. 6 (Jan. 19); Rev. Rul. 88-76, 1988-2 C.B. 360.

212. Assuming that all members held a pro rata interest, the members that were managers would have held 12% of the interests in the limited liability company, which obviously would not satisfy the 20% safe harbor.

213. One possible rationale for that position would be that a limited liability company does not have any member that is analogous to a general partner with personal liability for entity liabilities and whose bankruptcy, death, etc. alone may cause a dissolution of the entity. In Revenue Ruling 88-79, 1988-2 C.B. 361, a Missouri business trust managed by beneficiaries who held ten percent of the interests and who had personal liability for trust liabilities was determined to have centralized management. The Service referred to both the general rule on centralized management and the limited partnership rule, perhaps because the trust was

first distinction described above, this second distinction is academic, of course, unless the limited liability company is organized under a Discretionary Delegation Statute.²¹⁴

Notwithstanding the current hoopla regarding limited liability companies, the above-described steps that a limited liability company must take to achieve partnership status will, as a practical matter, tend to confine the use of limited liability companies to the closely held and personal service business contexts. A limited liability company must arrange to lack at least two out of the three corporate characteristics that they can avoid, i.e., free transferability of interests, continuity of life and centralized management. Lacking free transferability of interests obviously requires tying up the transferability of the members' interests, which often is not practical, particularly for a widely held entity. Lacking continuity of life requires living with the possibility of a dissolution, which is particularly troubling given that there can be no assurance of reconstitution because of the unanimous consent requirement under current law. Finally, lacking centralized management requires that the members manage in their capacities as such, which generally would not be practical for a widely-held entity, except possibly in the personal service business context (e.g., a law firm). Thus, even over the longer term as the personal liability and state and local tax concerns regarding limited liability companies are sorted out, it seems doubtful that limited liability companies will cause the disincorporation of America.

B. *One-Partner Partnerships*

Another type of entity that poses unique partnership classification issues is the one-partner partnership. That situation is rather unusual in the plain vanilla partnership context, since under state partnership law a partnership normally must have at least two partners.²¹⁵ However, two different situations can arise where a partnership has two partners in the eyes of state partnership law but only one partner in the eyes of federal income tax

more analogous to a limited partnership in light of the personal liability of the managers. *Id.*

214. The Delaware Limited Liability Company Act (Delaware LLCA) apparently would permit a Delaware limited liability company to be managed by some but not all of its members in their capacities as such, since section 18-402 of the Delaware LLCA states that "unless otherwise provided in a limited liability company agreement," the limited liability company will be managed by all the members in their capacities as such or by designated managers. Del. Code Ann. tit. 6, § 18-402 (Supp. 1992). However, there may be a negative implication in section 18-404 of the Delaware LLCA, which sets forth various options for how management may be carried out by designated managers but does not mention management by members.

215. See, e.g., Del. Code Ann. tit. 6, § 17-101(7) (Supp. 1992) (defining limited partnership); *id.* at § 1506(4) (defining general partnership).

law. The first is where one of the partners has such a de minimis interest that it might not be regarded as being a partner for federal income tax purposes. The second is where the partners are a REIT and its "qualified REIT subsidiary" within the meaning of section 856(i), which is not treated as a separate entity for federal income tax purposes. Moreover, one-member entity classification issues obviously can arise where the entity is a trust, limited liability company or other type of organization that does not need to have more than one member under applicable state law.

As a threshold matter, one could question whether any such entity could be a partnership for federal income tax purposes. The essence of a partnership is two or more persons joining together to carry on some business activity, and there is language in a number of cases supporting that conclusion.²¹⁶ The Service endorsed that position in two Technical Advice Memoranda issued in 1985 dealing with the issue of whether one-member entities may be partnerships for federal income tax purposes.²¹⁷ In Technical Advice Memorandum 8533003, for example, the Service ruled that a single beneficiary trust that was formed to make various investments was the agent of its beneficiary for federal income tax purposes, rather than a trust, partnership or association. The Service first concluded that the trust was not a trust for federal income tax purposes, because the trust was engaged in a business for profit and the trust had associates, relying on the authorities holding that an entity with one owner can be deemed to have associates if the owner participates in the entity's creation and management.²¹⁸ The Service next concluded that the entity was not a partnership, using the following rationale: "Despite the fact that under *Hynes* a single member organization can be treated as having associates for purposes of determining if it is an association, no single member organization possesses associates in the partnership sense and an organization with only a single member cannot be a partnership."²¹⁹ The Service then stated that the trust should be classified as either an association or as an agency arrangement, depending upon whether it had more than two out of four of the corporate characteristics that are relevant in distinguishing associations from partnerships under Regulations section 301.7701-2. On the facts, the Service concluded that the trust represented an agency arrangement on the theory that it lacked limited

216. See, e.g., *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840, 848-49 (1957), acq. 1957-2 C.B. 3.

217. I.R.S. T.A.M. 8552010 (Sept. 25, 1985); I.R.S. T.A.M. 8533003 (May 7, 1985); see G.C.M. 39395 (Aug. 5, 1985) (discussing I.R.S. T.A.M. 8533003); Priv. Let. Rul. 8139048 (June 30, 1981).

218. I.R.S. T.A.M. 8533003 (Aug. 5, 1985) (citing *Hynes v. Commissioner*, 74 T.C. 1266 (1980)).

219. *Id.*

liability and continuity of life.²²⁰

The Service's reasoning in these rulings is more tortured than is necessary. The cases holding that an association may have only one member do not really conclude that the term "associates" may refer to the singular, but, rather, they conclude that the presence of associates is not necessary for a single-member association based upon the parenthetical language in Regulations section 301.7701-2(a)(2).²²¹ That language does not indicate that it is not necessary to have associates in the partnership context. Thus, the Service could simply have relied on the literal language of the regulations regarding associates, rather than the bald assertion that a one-member entity has associates for association and trust classification purposes but not for partnership classification purposes.

In any event, the result seems sound. It should be noted that the "single economic interest" theory would apply in this context, presumably making it impossible for a one-member entity to lack free transferability of interests, except, possibly, if the governing instrument prohibited transfers of interests or provided that the entity would dissolve upon the occurrence of an attempted transfer.²²² Thus, the issue of whether the entity constitutes an association versus an agency would turn on whether the entity lacks at least two of the remaining three corporate characteristics, i.e., limited liability, continuity of life and centralized management. However, because one normally thinks of an agency situation as involving personal liability, it would seem prudent always to arrange for the absence of limited liability.²²³ It should be noted that the Service has under active consideration the issue of whether one-member limited liability companies may qualify as partnerships for federal income tax purposes.²²⁴

220. *Id.*; see also I.R.S. T.A.M. 8552010 (Sept. 25, 1985) (concluding that a trust was an association, relying on the presence of centralized management, continuity of life and limited liability); cf. Rev. Rul. 92-105, 1992-49 I.R.B. 4 (Dec. 7) (Illinois land trust owned by one individual, who apparently was personally liable for trust liabilities, treated as an agency); Priv. Let. Rul. 8139048 (June 30, 1981) (apparently treating what the Service regarded as a one-member entity as an agency without any discussion of Regulations section 301.7701-2).

221. Regulations section 301.7701-2(a)(2) states that "associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (*other than the so-called one-man corporation and the sole proprietorship*)" (emphasis added).

222. See *supra* Part IV(B)(6) (discussing free transferability issues raised by the "single economic interest" theory).

223. It presumably is not a coincidence that all four rulings referred to *supra* note 220 involved personal liability.

224. See Treatment of Single-Member LLCs under Debate at IRS, Hamill Says, reprinted in Tax Notes Today (Feb. 2, 1993) (LEXIS, FEDTAX Library, TNT file, elec. cit. 93 TNT 25-22). Apparently this currently is an issue only for Texas limited liability companies, since all other state limited liability company statutes require at least two members.

C. Business Trusts and Common Law Trusts

In recent years, there has been a growing interest in the use of business trusts and common law trusts as vehicles for business transactions. That interest is due in large part to the potential that trusts, like limited liability companies, offer to provide limited liability and flow-through tax treatment, which interest was piqued by the issuance of Revenue Ruling 88-79.²²⁵ In addition, trusts often are preferred for "securitization" transactions where the primary tax position may be that the entity is a grantor trust, but the parties want to be able to argue that the entity is a partnership as a "fallback" position if grantor trust status is challenged.²²⁶

As with limited liability companies, the status of a business trust or common law trust as a partnership for federal income tax purposes depends upon an application of Regulations section 301.7701-2, without the benefit of the favorable presumptions in Regulations section 301.7701-2 for Uniform Act partnerships or the ruling guidelines for limited partnerships. However, unlike the case with limited liability companies, which are formed under statutes designed to insure partnership classification, a trust normally is formed under a statute or body of common law that affirmatively provides for the four relevant corporate characteristics.²²⁷ Thus, the only way to achieve partnership status is to override at least two of those characteristics by contract.

Specifically, the characteristic of limited liability may be overridden through a contractual assumption of liabilities by a beneficiary, although that would be unusual outside the securitization area (where the expected liabilities of the entity are all nonrecourse), since one of the principal reasons to use a trust is to limit the liability of all the beneficiaries.²²⁸ However, it

225. 1988-2 C.B. 361 (classifying a Missouri common law royalty trust as a partnership for federal income tax purposes).

226. In securitization transactions using grantor trusts, there may be a risk that the trust would be viewed as failing the "Sears" regulations regarding multiple classes of interests or that it would be viewed as engaging in an impermissible reinvestment or other business activity. See Regs. § 301.7701-4(b), -4(c). In either case, the trust would be classified either as an association or as a partnership based on Regulations section 301.7701-2. See generally James M. Peaslee & David Z. Nirenberg, *Federal Income Taxation of Mortgage Backed Securities*, 31-58 (1989).

227. Under many state trust laws, particularly non-statutory trust laws, there may be questions as to whether the trust really provides limited liability for any of the beneficiaries or, alternatively, it may be clear that any beneficiaries that actively participate in management do have personal liability. See, e.g., Rev. Rul. 88-79, 1988-2 C.B. 361 (noting that "manager" beneficiaries had personal liability for trust liabilities under agreement interpreted under Missouri law); Rev. Rul. 64-220, 1964-2 C.B. 335 (noting that beneficiaries who manage and control trust property incur personal liability under Illinois law).

228. For an example of a trust determined to lack limited liability due to a

should be noted that under a number of trust laws, beneficiaries that participate in management (by directing the actions of the trustee, managing as a designated "manager" or otherwise) may have personal liability for trust liabilities. In those cases, the trust may lack limited liability without a contractual assumption of liability.²²⁹

The continuity of life of a trust may be broken by providing in the declaration of trust or other governing instrument that the trust shall dissolve on the bankruptcy, death, etc. of one or more designated beneficiaries.²³⁰ However, the point made earlier,²³¹ that it generally would not seem prudent to rely on the absence of continuity of life of an entity where its members are closely affiliated and the dissolution provision is purely a contractual matter, would apply in the trust case. Nevertheless, a trust is somewhat different from other types of entities where the dissolution provision is a contractual matter, inasmuch as the dissolution provision normally would be enforceable not only by the beneficiaries but also by the trustee, who may feel compelled to effect a dissolution upon the occurrence of a dissolution event. Consequently, it may be possible for a trust with closely affiliated beneficiaries to avoid continuity of life, provided that the trustee is not a beneficiary (or a close affiliate of a beneficiary).²³²

Likewise, free transferability of interests may be defeated by requiring the consent of one or more designated beneficiaries to any transfer of an interest by a beneficiary.²³³ However, it does not appear sufficient for transfers of interests to be subject to the consent of the trustee (at least where the trustee is not also a beneficiary), since the free transferability issue turns on whether the consent of a member is required.

The only difficult corporate characteristic is centralized management, since a certain amount of centralized management usually is unavoidable by virtue of the fact that a trust usually is managed by trustees for the benefit of the beneficiaries. In view of the Service's recent published rulings analyzing

contractual assumption of trust liabilities, see Private Letter Ruling 9247009 (Aug. 20, 1992).

229. See Revenue Ruling 64-220, 1964-2 C.B. 335 and Revenue Ruling 88-79, 1988-2 C.B. 361, for examples of trusts held to lack limited liability because of the personal liability of beneficiaries that participated in management.

230. See Rev. Rul. 88-79 (relying in part on such a provision to support the partnership status of a Missouri royalty trust).

231. See *supra* text accompanying notes 154-58.

232. If the trustee could easily be removed by the beneficiaries (and replaced with a friendly trustee) after the occurrence of a dissolution event to preempt a dissolution by the trustee, the result would be less certain. Since a dissolution presumably would occur unless the beneficiaries took that action, there would still be some substance to the dissolution provision.

233. See Rev. Rul. 88-79, 1988-2 C.B. 361 (relying in part on such a provision to support the partnership status of a Missouri royalty trust).

the centralized management factor in the context of limited liability companies,²³⁴ it seems that a trust generally would be determined to have centralized management, since the trustee of a trust acts in a representative capacity. That would be true even if the trust were organized under a state statute or common law that permitted the beneficiaries to act as trustees and the beneficiaries did so. However, it might be possible to defeat centralized management if the trust were organized under a statute or common law that permitted the beneficiaries to manage the business as “managers” with personal liability for trust liabilities.²³⁵ In that event, it could be argued that the centralized management rules for limited partnerships²³⁶ should apply by analogy and, therefore, that the trust would lack centralized management if the managers held at least twenty percent of the interests.²³⁷ In addition, it should be possible to defeat centralized management by providing in the declaration of trust or other governing instrument that the trustee may take only ministerial actions without the consent of the beneficiaries, that the trustee will take whatever actions are directed by the beneficiaries, and that the trustee may be removed at any time by the beneficiaries. In that event, the trustee would effectively be functioning as the agent of the beneficiaries and would not have “exclusive authority” to manage the business of the trust, which should result in a lack of centralized management under Regulations section 301.7701-2(c)(3). That conclusion is supported by a number of published rulings involving trusts.²³⁸

234. See *supra* text accompanying note 187.

235. Those were the facts in Revenue Ruling 88-79, 1988-2 C.B. 361.

236. See *supra* notes 170-71 and accompanying text.

237. In Revenue Ruling 88-79, the Service indicated that the centralized management rules for limited partnerships should apply by analogy, but it determined on the facts that the 10% interest held by the managers was not sufficient to defeat centralized management. At first blush, that position seems inconsistent with the Service’s position on analyzing the centralized management issue in the context of limited liability companies (as discussed *supra* text accompanying notes 207-14), but it may be justified on the ground that a trust manager has personal liability for trust liabilities, which makes the trust manager seem much more analogous to a general partner of a limited partnership than the person that manages a limited liability company.

238. See Rev. Rul. 64-220, 1964-2 C.B. 335 (trust lacked centralized management because the trustee was required to manage the trust as directed by beneficiaries); cf. Rev. Rul. 57-607, 1957-2 C.B. 887 (trust lacked centralized management because the trustee’s duties were “strictly ministerial”); Rev. Rul. 88-79, 1988-2 C.B. 361 (Missouri trust, which had a trustee that performed ministerial acts only and was substantively managed by “managers,” determined to have centralized management due to the small size of the managers’ interests, not due to the presence of the trustee).

VIII. CONCLUSION

As the foregoing discussion indicates, the recent history of the partnership classification law demonstrates a trend towards minimizing the substantive barriers to achieving partnership status. The most recent example is the promulgation of Revenue Ruling 93-4,²³⁹ which purported to eliminate the continuity of life concern that arises for partnerships that have closely affiliated partners. The law that has emerged is an essentially mechanical test as to whether the entity lacks two out of the four standard corporate characteristics set forth in Regulations section 301.7701-2, with those factors often being formalistic, with no real practical significance for the typical partnership. However, there still are a number of technical issues that can arise under the four factor test, creating uncertainty for the diligent and traps for the unwary.

One might be tempted to conclude that we are effectively moving towards an elective, "check the box" type of entity classification scheme. However, to a large extent the current state of the partnership classification law is simply a product of the literal language of the four factor test set forth in Regulations section 301.7701-2, which we have been living with since 1960. Thus, while the Service's announcement in 1988, that it would not insist on the absence of limited liability in all cases,²⁴⁰ might be regarded as a major milestone in breaking down the barriers to partnership classification, the Service really was just reaffirming the mechanical nature of the four factor test in Regulations section 301.7701-2 under which limited liability is coequal with the other three standard corporate characteristics. As illustrated by the *Larson* case, limited liability may be found lacking on the basis of absence of dumminess even where the general partner has no assets. All that has really happened to the substantive law since 1960 is that the meaning of the four factor test has been fleshed out in a little more detail.

When one steps back from the fray, it becomes apparent that the real liberalization that has occurred since 1960 has been the quiet failure of the Service and the courts to take into account the more subjective elements of Regulations section 301.7701-2, such as whether an entity should be regarded as being "incorporated," which would obviate the need to apply the four factor test, or whether the entity has attributes other than the four standard corporate characteristics that might be relevant to its classification. It is not clear whether that state of affairs reflects a conscious, studied decision on the Service's part, or merely the cumulative effect of numerous ad hoc decisions on partnership classification matters over the years. In any event, the de-emphasis of the subjective elements of Regulations section 301.7701-2

239. 1993-3 I.R.B. 5 (Jan. 19).

240. See *supra* text accompanying note 37.

does have the virtue of bringing a fair amount of certainty to the partnership classification law, which obviously is highly desirable given the tax consequences at stake.

The relative ease with which limited partnerships, limited liability companies and other unincorporated entities may achieve partnership classification for federal income tax purposes undoubtedly will come under scrutiny by the Service and Congress in the near future. Unincorporated entities that are treated as partnerships have already started to move into the spotlight as part of the simmering debate over corporate integration, since such entities provide a mechanism to achieve "do-it-yourself" integration. Moreover, the current hoopla over limited liability companies has focused renewed attention on the partnership classification rules. And if corporate tax rates increase as proposed by the Clinton administration, there may be increasing pressure to conduct business in unincorporated form and, therefore, additional revenue concerns raised by the partnership classification rules.