

2003

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Lawrence Lokken

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Recommended Citation

Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365 (2003)
<https://scholar.smu.edu/smulr/vol56/iss1/14>

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AS THE WORLD OF PARTNERSHIP TAXATION TURNS

*Lawrence Lokken**

I. REVOLUTION AND COUNTER-REVOLUTION

PROFESSOR Gergen's very interesting article reminds me of a story I heard years ago about a renowned orchestral conductor and one of his musicians. I change the names because I don't quite trust my memory about who the characters were. The conductor, Maestro *G*, one of the giants of the music world early in the twentieth century, was a micro-manager and insisted that his players pencil in markings on their parts indicating all of the twists and turns in his interpretations. After Maestro *G* had been music director of a leading American orchestra for several years, the orchestra's principal oboist, Mr. *L*, a long-standing member of the orchestra and a prominent figure in his own right, came to Maestro *G*, asking, "Is it all right if I ask the orchestra librarian to get me a new copy of my part for this piece we are doing next month? Over the years, you've had me make so many pencil markings on my part that I can hardly read it any more." Maestro *G* studied Mr. *L*'s part carefully for three or four minutes and said, "No, Mr. *L*, you don't need a new part. If you will just mark in 'crescendo' in bar 59 and 'ritardando' in bar 143, your old part will be just fine."

A few years ago, I wrote an article exploring the possibility of substituting something radically different for the present income tax rules for partners and partnerships.¹ As "an answer to" my suggestions,² Professor Gergen essentially says, "No, Professor Lokken, you don't need a new system. Over the years, we have penciled in many useful things on the old system, and I have a few additional things we need to pencil in. Then, everything will be just fine, at least until the next rehearsal." Well, perhaps.

Many scholars of partnership taxation have a nagging suspicion that much, perhaps most, of subchapter K is honored principally in the

* Professor of Law and Hugh F. Culverhouse Eminent Scholar in Taxation, University of Florida Levin College of Law; Distinguished Visiting Professor, Southern Methodist University Dedman School of Law.

1. Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249 (1999).

2. Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 344 n.2 (2003).

breach.³ The revolutionary changes so ably described by Professor Gergen consist of a dense web of detailed rules that are very difficult to learn, understand, remember, and apply. For 1999, the most recent year for which the IRS has published the relevant statistics, federal income tax returns were filed by 1,936,919 partnerships.⁴ My guess is that relatively few of these nearly 2 million partnerships had tax advisors whose understanding of subchapter K is sufficient to allow them to apply any of the rules described and proposed by Professor Gergen and that very few of the IRS personnel charged with auditing those returns could work comfortably with the rules. Even highly competent tax generalists may stumble badly on partnership issues not resolved by the basic pass-through idea of subchapter K. The construct of rules discussed by Professor Gergen may not even be part of the universe in which the income tax laws are applied and enforced with respect to a large majority of partnerships and partners.

Subchapter K is not the only disturbingly complex piece of the Internal Revenue Code. However, many complex structures in the Code have more specialized applications. A corporation need not have sophisticated advice on the reorganization provisions unless it engages in a reorganization transaction, on the qualified retirement plan provisions unless it wants to have a qualified plan, or on the controlled foreign corporation rules unless it has a foreign subsidiary. In each of these instances, the specialness of the transactions serves as a signal of the need for specialized advice. Subchapter K, in contrast, deals with such matters as partner contributions, allocations of partnership income among the partners, and distributions to partners—issues and transactions common to all partnerships, regardless of the nature of their activities, assets, and businesses. Although some aspects of subchapter K only apply in specialized circumstances, there is no clear boundary between the everyday and the specialized, no obvious signals to tax practitioners who are not partnership specialists of where they may tread without falling into a morass of legal complexity with which they are not prepared to deal.

On the other hand, all of the complexity of subchapter K, including the added complexity proposed by Professor Gergen, responds to genuine needs. Simple tax rules often yield distorted results when applied to complex financial and business arrangements. Although the distortions can adversely affect taxpayers, the principal problem with simplistic tax rules is that sophisticated tax practitioners exploit them ruthlessly to the government's detriment. Over the last three decades—the period of the revolution Professor Gergen describes—the aggressiveness of tax practitioners, and the willingness of their clients to follow aggressive tax advice, has steadily grown, with perhaps a brief pause following the enactment of

3. See, e.g., George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999).

4. Alan Zempel & Tim Wheeler, *Partnership Returns, 1999*, 21 STAT. INCOME BULL. 48 (2001).

the Tax Reform Act of 1986. The revolutionary accretion of detail in subchapter K is largely a response to aggressive uses of partnerships for tax avoidance, resembling a steady build-up in the arsenal of an army caught in an unwinnable guerilla war.

The dilemma of subchapter K is that rules considered essential to the effective application of the tax laws to some partnerships and their partners apply to all partnerships, including those utterly lacking in capability to apply the rules, which likely comprise a large majority of all partnerships. As Professor Gergen notes, Professor George Yin has proposed a solution to this dilemma: a simplified subchapter K ("K lite") that could apply to ordinary partnerships, leaving the full panoply of subchapter K to apply only to more complex partnerships for which it is more appropriate.⁵ Although Professor Gergen does not say directly whether he favors this proposal, he implies that he does, so that "we may demand more of entities that opt for the freedom of K-heavy."⁶

Of course, we already have a K lite, consisting of the present subchapter K stripped of all of the rules and nuances that tax practitioners serving ordinary partnerships do not understand and simply ignore. The value of a more formal K lite, as Professor Yin proposes, is that it erects signposts, informing practitioners of just what the simplified rules are and just what must be done (and avoided) in order to maintain a partnership's eligibility to use the simplified rules.

But we already have a K lite in this form too: subchapter S, which provides a relatively simple scheme for allocating income among shareholders of electing corporations observing a relatively simple set of qualification criteria. Subchapter S is very popular. For 1999, the most recent year reported, approximately 2.7 million corporations filed returns as S corporations.⁷ For that year, the number of S corporation returns was more than 135 percent of the number of partnership returns. These statistics may surprise some observers, who see subchapter S as a relic of an earlier era. Limited liability company laws protect members against personal liability for entity debt much like corporation laws and are much more flexible than corporation laws; moreover, an LLC and its members can enjoy the permissiveness of subchapter K and not be burdened by the rigidities of subchapter S. However, the 1999 statistics lend little support to the common assumption that LLCs are well on the way to supplanting S corporations. The number of S corporation returns in 1999 was 5.3 percent larger than the number of 1998 returns, while the number of partnership returns increased by 4.4 percent.⁸ Approximately 302,000 corporations first elected S status for 1999, of which approximately

5. Gergen, *supra* note 2, at 345.

6. *Id.*

7. Kelly Bennett, *S Corporation Returns, 1999*, 21 STAT. INCOME BULL. 59 (2002).

8. Zempel & Wheeler, *supra* note 4, at 48 fig.A. The number of LLCs, however, grew by 25.2 percent—from 470,657 in 1998 to 589,403 in 1999—while the number of general partnerships declined and the number of limited partnerships grew only 3.4 percent. *Id.* at 53 fig.F.

217,000 were newly organized corporations.⁹ Newly organized S corporations thus exceeded ten percent of the number of all partnerships, new and old. Vanishing relic, indeed! Anecdotal evidence indicates that organizing a new venture as an LLC, checking the box corporate, and electing subchapter S is a not uncommon (if treacherous) practice.

Do we need K lite in addition to subchapter S? K lite, like subchapter S, would be elective, and it is not clear that the life of a typical small business would be materially improved by the addition of another election to be evaluated by its, perhaps already overstressed, tax advisor. Ideally, K lite might be substituted for subchapter S. However, that would raise the problem of what to do with the millions of existing S corporations. Would they be forced to undergo taxable liquidations if their owners want to retain pass-through taxation? Or, would they be given a tax-free pass into subchapter K? Presently, a C corporation can elect to become an S corporation without immediate tax consequences. Would that privilege disappear with subchapter S? If S corporations were generally allowed to pass tax-free into subchapter K, would this privilege extend to former C corporations, including corporations that became S corporations shortly before repeal of subchapter S? Surely, a proposal to eliminate the runaway favorite form of small business organization could succeed politically only if leavened with significant benefits for taxpayers.

Whether or not subchapter S persists, I am not sure that it is realistic to expect that, with the addition of K lite, "we may demand more of entities that opt for the freedom of K-heavy."¹⁰ By demanding more, Professor Gergen apparently means requiring compliance with highly refined rules that are conceived with a focus on achieving economically realistic results, not ease of application. I agree with his assumption that a business or financial venture organized in a complex way disqualifying it from K lite could usually afford to obtain the sophisticated tax advice necessary to comply with complex rules tailored to match the complexity in the venture's organization. For such a venture, sophisticated accounting is necessary to effectuate the partners' agreement, and the tax laws do not usually impose an undue burden by requiring tax accounting at the same level of sophistication as the venture's financial accounting. Tax rules might, in fact, show the way to financial accounting more faithful to partners' agreements.

However, partnerships will generally comply with difficult tax rules only if the IRS insists, and in my only partially informed opinion, the IRS could insist only by investing far more resources in the audit of partnership returns than it presently does. This investment must be judged not only in terms of the number of returns audited, but also in terms of the education, training, and talent of the personnel assigned to the task. I

9. The number of LLC returns increased by 118,746 from 1998 to 1999. *See id.* at 53 fig.F. Although the number of new LLCs was larger than this number (some 1998 filers having disappeared from the 1999 rolls) it seems unlikely that the number of new LLCs was a great as the number of newly organized S corporations.

10. Gergen, *supra* note 2, at 345.

point, of course, to only an aspect of a much larger problem of tax non-compliance and governmental willingness to do something about it. Our elected representatives seem to be growing beyond the belief that great gain lies in demonizing those charged with enforcing the tax laws. This growth seems to be leading only very gradually to a commitment to give the IRS the resources it requires to obtain a minimal level of tax compliance.¹¹ Until that commitment is more firmly in place, the intellectual revolution that is the subject of Professor Gergen's article will not become a revolution in the practical reality of partnership taxation.

II. CONCEPTUAL ELEGANCE IN PARTNERSHIP TAXATION

As a teacher and observer, one of the things I like best about partnership taxation is that so much of it is spun out of a few fundamental ideas. Professor Gergen's article nicely illustrates at least two of these ideas.

First, there is the often noted dichotomy between the entity theory of partnership taxation, which views a partnership as a thing independent of its partners, at least for some purposes, and the aggregate theory, which views a partnership as merely an aggregate of the separate interests of the partners. The revolution Professor Gergen discusses can be seen as triumph of the aggregate theory over the entity theory. Increasingly, the rules determine tax consequences to partners by looking through the partnership veil to ascertain the partners' separate interests in partnership income, deductions, losses, and assets. Noting this does not, of course, demonstrate that the revolution is either good or bad. Arguments over whether the aggregate theory or the entity theory suggests the appropriate answers to particular questions of partnership taxation have persisted throughout subchapter K's history.¹²

A second fundamental concept illustrated by Professor Gergen is the substantial economic effect idea. The famous Haig-Simons definition of income, modified for application to a business entity, is that income for any period is the change in the entity's net worth over the period, adjusted for contributions and distributions.¹³ Translated into the tax law's terminology of gross income and deductions, gross income is an item that, standing alone, enhances net worth and a deduction is a cost that impairs net worth.¹⁴ The substantial economic effect idea is that partnership gross

11. The IRS has given Congress some reason to question whether the IRS could, even with more funds, do an effective job of auditing partnerships. See George Guttman, *Why Did The K-1 Matching Program Go Awry?*, 97 TAX NOTES 736 (2002) (discussing the IRS's difficulties in matching information returns filed by partnerships with individual returns of partners).

12. For a recent example, see *Brown Group, Inc. v. Comm'r*, 104 T.C. 105 (1995) (relying extensively on aggregate theory in applying controlled foreign corporation rules to partnership income), *rev'd*, 77 F.3d 217 (8th Cir. 1996) *nonacq.*, (criticizing Tax Court's broad acceptance of aggregate theory).

13. See 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 3.1 (3d ed. 1999).

14. This statement is, of course, a broad generalization that holds only approximately with respect to many items of income and deduction.

income, gains, losses, and deductions should be allocated among partners in the proportions that they enjoy or suffer the corresponding increases or decreases in partnership net worth. Substantial economic effect is the statutory touchstone for partnership allocations generally.¹⁵ Professor Gergen identifies as the starting point in the intellectual revolution in partnership taxation the Treasury's adoption of a capital account analysis to effectuate the substantial economic effect rule.¹⁶

However, the idea is reflected in many rules not containing the phrase "substantial economic effect." An example is § 704(c), which requires, among other things, that a partnership's gain or loss on selling property contributed to it by a partner must generally be allocated to the contributing partner to the extent of the unrealized appreciation or depreciation in the property when contributed. Assume *A* and *B* organize an equal partnership by *A* contributing Blackacre, worth \$1,000 and having a basis to *A* of \$600, and *B* contributing \$1,000 in cash. The partnership must record Blackacre on its books at fair market value (\$1,000),¹⁷ even though it succeeds to *A*'s adjusted basis for the property of \$600.¹⁸ If the partnership later sells Blackacre for, say, \$1,100, realizing gain of \$100 for book purposes and gain of \$500 for tax purposes, *A*'s share of the tax gain is \$450, consisting of the \$400 of appreciation that accrued to *A* before the contribution and one half of the amount by which Blackacre appreciated while held by the partnership. By crediting *A*'s capital account with Blackacre's fair market value on contribution, the partnership assigns to *A* the portion of the partnership's initial net worth represented by the pre-contribution appreciation. Allocation to *A* of the first \$400 of the partnership's gain on selling Blackacre thus effectuates the substantial economic effect idea, even though it is accomplished by a rule in which the words "substantial economic effect" do not appear.

The regulations depart from the substantial economic effect idea with respect to some situations involving contributed property. Assume the *AB* partnership sells Blackacre in an arm's length transaction for \$900. The sale results in book loss of \$100 (selling price of \$900, less book value of \$1,000) and tax gain of \$300 (amount realized of \$900, less adjusted basis of \$600). The substantial economic effect idea suggests that *A* should be allocated gain on the sale of \$350, consisting of \$400 of pre-contribution appreciation and one half of the post-contribution loss of \$100, and *B* should be allocated \$50 of loss. Only in this way can the tax allocations accurately reflect the partners' agreement on sharing economic gains and losses. However, the regulations have long imposed a ceiling rule, which in this situation precludes an allocation to any partner exceeding the partnership's total gain on a sale.¹⁹ Thus, all of the tax gain (\$300) is allocated to *A*, but no tax gain or loss is allocated to *B*. The apparent

15. See I.R.C. § 704(b) (2002).

16. See Gergen, *supra* note 2, at 343.

17. See Treas. Reg. § 1.704-1(b)(2)(iv)(b) (2002).

18. See I.R.C. § 723 (2002).

19. This rule is presently stated in Treas. Reg. § 1.704-3(b)(1) (2002).

basis for the ceiling rule is that a partnership allocation can only consist of a division among the partners of a partnership item computed under the tax rules generally defining income, gain, deduction, and loss.

The regulations provide two alternatives to the traditional method, one of which, a remedial allocation method,²⁰ can be seen as an expression of the substantial economic effect idea. Under the remedial method, as applied to the example, *AB*'s tax gain of \$300 is allocated to *A*, as under the traditional method, but additional allocations are made to *A* of a notional \$50 of gain and to *B* of a notional \$50 of loss. The notional items have the same character as the actual gain. The results accurately reflect the partners' agreement for sharing economic gains and losses: that *A* have the benefit of the \$400 of unrealized appreciation in Blackacre as of the time of its contribution and that *A* and *B* share equally any appreciation or depreciation occurring after the partnership's formation.

Partnerships are generally free to choose among the three alternative rules for handling items associated with contributed property. However, given the pervasive influence of the substantial economic effect idea in recent legislative and administrative changes, the Treasury could logically proceed one step further in this direction by making the remedial allocation method the exclusive and mandatory rule for all items related to contributed property. As Professor Gergen notes, both Congress and the Treasury have accepted in other contexts that a single adjustment, whether positive or negative, can be fragmented into a group of positive and negative adjustments.²¹ The notion that partnership allocations can only consist of divisions of items determined under tax rules generally defining income, gain, deduction, and loss now seems quite old fashioned. If the notion had validity, the remedial allocation method, even as an elective alternative, would be illegitimate. Every application of the ceiling rule produces distortion.²² By abandoning the rule, the Treasury would eliminate such distortions and simplify the law by eliminating both any need for taxpayers to evaluate competing options and any need for an anti-abuse rule to disallow overly aggressive uses of the alternative rules.

Professor Gergen devotes considerable attention to so-called reverse § 704(c) allocations, using the following example: the equal partnership of

20. Treas. Reg. § 1.704-3(d) (2002).

21. See Gergen, *supra* note 2, at 350, 360. Two examples of this cited by Professor Gergen are regulations under § 755, adopted in 1999, and a 1997 statutory change to § 732(b), also effectuated by regulations adopted in 1999. Treas. Reg. §§ 1.732-1(c), 1.755-1 (2002). In both of these contexts, the regulations require a difference between partner basis and partnership basis to be allocated among assets by a series of adjustments that can include both increases and decreases.

22. A partnership's use of an allocation method, including the traditional method, is disallowed if the contribution of the property and allocation "are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability." Treas. Reg. § 1.704-3(a)(10) (2002). However, the mere fact of a distortion, even one benefiting taxpayers, does not preclude use of the traditional method.

K and *L* is organized by contributions of \$10,000 each from the partners, which the partnership uses to buy securities for \$20,000. When the securities have increased in value to \$50,000, *M* contributes \$25,000 for a one third interest in the partnership. If, on admitting *M*, the partnership restates the book value of the securities to \$50,000 and the capital accounts of *K* and *L* to \$25,000 each, tax gain on a subsequent sale of the securities will first be allocated to *K* and *L* in the amount of \$15,000 each, their shares of the \$30,000 by which the securities appreciated before *M* became a partner. This is the reverse § 704(c) allocation. For example, on later selling the securities for \$74,000, the partnership would have book gain of \$24,000 (\$74,000, less book value of \$50,000), allocable \$8,000 to each partner, and tax gain of \$54,000 (\$74,000, less adjusted basis of \$20,000), allocable to *K* and *L* in the amount of \$23,000 each (sum of \$15,000 and \$8,000) and to *M* in the amount \$8,000.

Reverse § 704(c) allocations reflect the substantial economic effect idea. By restating the book value of the securities at \$50,000 when *M* becomes a partner, the partners reserve to *K* and *L* the economic enjoyment of \$30,000 of appreciation in the securities' value. The reverse § 704(c) allocations allocate to *K* and *L* the tax items corresponding to this appreciation. Only by the reverse § 704(c) allocations can the tax results accurately reflect the partners' sharing arrangement.

Restatements on the admission of new partners, and the resulting reverse § 704(c) allocations, are, at least nominally, optional.²³ Professor Gergen suggests that the Treasury make them mandatory, and I agree with this suggestion.²⁴ If these procedures are not followed, the *KLM* partnership's tax gain of \$54,000 on selling the securities (amount realized of \$74,000, less adjusted basis of \$20,000), is allocated one third to each partner (\$18,000 each), with the following results:

	After admission of <i>M</i>	Gain on sale	After sale
<hr/>			
Book value of assets			
Money	\$25,000		\$99,000
Securities	<u>20,000</u>	\$54,000	
	\$45,000		
Capital accounts			
<i>K</i>	\$10,000	\$18,000	\$28,000
<i>L</i>	10,000	18,000	28,000
<i>M</i>	<u>25,000</u>	18,000	<u>43,000</u>
	\$45,000		\$99,000
<hr/>			

23. Treas. Reg. § 1.704-1(b)(2)(iv)(f) (2002).

24. See Gergen, *supra* note 2, at 349. A carefully crafted set of special allocations could serve the same function as a restatement and reverse § 704(c) allocations. Partners may prefer to handle the issue in this way in some situations, particularly if they do not agree on the value of partnership assets. If the Treasury makes reverse § 704(c) allocations mandatory, it should consider whether and, if so, under what circumstances, special allocations could be substituted for reverse § 704(c) allocations.

If the partnership liquidates immediately after selling the securities by distributing its asset (money) in accordance with the capital accounts, the liquidating distributions to the partners, \$28,000 each to *K* and *L* and \$43,000 to *M*, are starkly inconsistent with the agreement to be equal partners. Without a restatement, the partners must choose between (1) making distributions to the partners in accordance with the capital accounts, thereby violating their agreement, or (2) making distributions in accordance with their agreement, thereby vitiating all tax allocations as violative of the substantial economic effect rule. For a partnership admitting a new partner when partnership assets are materially appreciated or depreciated, a restatement is mandated by the practical need to do tax allocations in a way that does not upset the partners' agreement. Revising the restatement rule in the regulations to require, rather than merely permit, restatements would thus simplify the rules in practical application.

III. DISCOUNTS AND OPTIONS

Professor Gergen ends his article with a discussion of two issues whose resolution, he speculates, might stretch the intellectual revolution in partnership taxation beyond the breaking point: the treatment of discounts (issuance of a partnership interest in exchange for a capital contribution less than a ratable portion of the net fair market value of partnership assets), premiums, and options to acquire partnership interests from the partnership.²⁵

Discounts may be more troublesome in theory than they are in practice. Assume the equal partnership of *K* and *L*, which owns securities worth \$50,000 for which it has an adjusted basis of \$20,000, admits *M* as a one third partner in exchange for a contribution of \$16,000, which is \$6,000 less than one third of the net value of the partnership's assets immediately thereafter; *K*, *L*, and *M* deal at arm's length and agree on the discounted price because they collectively conclude that the market would allow a discount of this size to reflect *M*'s status as holder of a minority interest. Conceptually, this situation is troublesome because it seems to undermine the aggregate theory of partnership taxation, which, I suggest, is the foundation of the intellectual revolution in partnership taxation. That the value of the whole (partnership) does not equal the sum of the values of its parts (the partnership interests) suggests that the whole differs in kind from its parts. Moreover, the idea that a partnership is merely an aggregate of the separate interests of the partners can readily be translated into operational tax rules only by assuming that partnership assets and interests in a partnership are merely two expressions of the same thing and that the aggregate value of one equals the aggregate value of the other.

25. See Gergen, *supra* note 2, at 355-56.

However, the rules derived from this assumption seem to work well enough when applied in situations where the assumption is contrary to fact. In the *KLM* example, at least two results are possible if the partners elect to restate book values on the admission of *M*. One possibility is to restate partnership assets at their actual fair market values, with the partnership's tax and book balance sheets, immediately after *M*'s admission to the partnership and after the partnership's subsequent sale of the securities for \$74,000, being as follows:

	<i>After admission of M</i>		<i>Gain on sale</i>		<i>After sale</i>	
	<i>Tax</i>	<i>Book</i>	<i>Tax</i>	<i>Book</i>	<i>Tax</i>	<i>Book</i>
Assets						
Money	\$16,000	\$16,000			\$90,000	\$90,000
Securities	<u>20,000</u>	<u>50,000</u>	\$54,000	\$24,000		
	\$36,000	\$66,000				
Capital accounts						
<i>K</i>	\$10,000	\$25,000	\$23,000*	\$ 8,000	\$33,000	\$33,000
<i>L</i>	10,000	25,000	23,000*	8,000	33,000	33,000
<i>M</i>	<u>16,000</u>	<u>16,000</u>	8,000	8,000	<u>24,000</u>	<u>24,000</u>
	\$36,000	\$66,000			\$90,000	\$90,000

* The tax allocations to *K* and *L* consist of their shares of the amount by which the securities appreciated before *M*'s admission to the partnership (\$15,000 each) and of the book gain (\$8,000 each).

Alternatively, the securities could be valued in the restatement at \$32,000, the figure that equates the values of the partnership assets with the values of the partnership interests, with the following results:

	<i>After admission of M</i>		<i>Gain on sale</i>		<i>After sale</i>	
	<i>Tax</i>	<i>Book</i>	<i>Tax</i>	<i>Book</i>	<i>Tax</i>	<i>Book</i>
Assets						
Money	\$16,000	\$16,000			\$90,000	\$90,000
Securities	<u>20,000</u>	<u>32,000</u>	\$54,000	\$42,000		
	\$36,000	\$48,000				
Capital accounts						
<i>K</i>	\$10,000	\$16,000	\$20,000*	\$14,000	\$30,000	\$30,000
<i>L</i>	10,000	16,000	20,000*	14,000	30,000	30,000
<i>M</i>	<u>16,000</u>	<u>16,000</u>	14,000	14,000	<u>30,000</u>	<u>30,000</u>
	\$36,000	\$48,000			\$90,000	\$90,000

* The tax allocations to *K* and *L* consist of their shares of the amount by which the securities' restated value exceeded their cost (\$6,000 each) and of the book gain (\$14,000 each).

The first alternative, which leaves *M* with a lower capital account than the other partners, may seem to contradict the partners' agreement that

each would have a one third interest in the partnership. However, *K* and *L* might argue for this alternative on the ground that the amount by which the securities appreciated before *M*'s admission as a partner should be reserved exclusively to them and that *M*'s one third interest should only include her capital contribution and one third of the income, gains, and losses accruing after she becomes a partner; *M*'s lesser capital account, by this view of the matter, simply reflects the discounted price for which her interest was issued. *M*, in contrast, might claim the benefits of the second alternative, arguing that because all partnership interests are minority interests, none is more valuable than any other and the excess of inside value over outside value does not truly exist for any partner until it is unlocked by sale of the securities and distribution of the proceeds to the partners.

The choice between the alternatives should be considered a matter for agreement among the partners, not one to be imposed by the tax law. As shown by the balance sheets, under both alternatives, each partner's tax and book capital accounts are equal after the securities are sold, demonstrating that both alternatives allocate the tax gain in the same proportions as the partners receive the corresponding economic gain. Both alternatives are therefore consistent with the substantial economic effect concept. Which alternative best reflects the partners' agreement is for the partners, not the tax law, to decide. However, the case illustrates the importance of restating the books on the admission of a new partner. Without a restatement, it would likely be impossible to ascertain the partners' agreement on how they would share economically the appreciation in partnership assets accruing before *M* became a partner.

In many instances, options on partnership interests probably raise no special tax issues, apart from the discount issue just discussed. The treatment of these options should be consistent with the tax rules for options generally, which are not particularly rational or consistent with tax rules applying to closely related transactions but are firmly established.²⁶ Assume *W* grants *H* an option to purchase Blackacre, which is presently worth \$800 and has an adjusted basis to *W* of \$600; the option price is \$950, the option is exercisable at any time within the next three years, and *H* pays *W* a premium of \$50 for the option. If *H* exercises the option, *W* recognizes gain on the ensuing sale of Blackacre of \$400 (amount realized of sum of \$50 and \$950, less adjusted basis of \$600), and *H* takes a cost basis for Blackacre of \$1,000. If the option expires unexercised, *W* has income of \$50 at the time of lapse and *H* is allowed a deduction in the same amount.

Professor Gergen's option example is as follows: *K* and *L* each contribute \$9,500 in cash on the organization of the *KL* partnership, which immediately grants *M* an option to acquire a one third interest in the partnership for \$16,000, receives an option premium of \$1,000 from *M*,

26. See 2 BITTKER & LOKKEN, *supra* note 13, ¶ 57.3.1.

and invests the \$20,000 received from *K*, *L*, and *M* in securities. *M* exercises the option when the securities are worth \$50,000.²⁷ Consistently with the treatment of options generally, *M* should not be treated as a partner until she exercises the option, and appreciation in the underlying property while the option is outstanding should be taxed to *K* and *L*. The procedures for restating partnership books after the admission of a new partner, applied as of the time *M* exercises the option, produce these results and are thus consistent with the option rules. Since *M*, on exercising the option, acquires her interest at a discount, the application of these procedures raises the issues discussed above.

In-the-money options, however, should be treated differently, in at least some circumstances. Assume *K* and *L* each contribute \$8,000 cash on the organization of the *KL* partnership, which immediately grants *M* an option to acquire a one third interest in the partnership for \$5,000, receives an option premium of \$4,000 from *M*, and invests the \$20,000 received from *K*, *L*, and *M* in securities. In this case, *M* should probably be considered a partner from the outset since she will likely exercise the option and failure to treat her as a partner from the outset would open the door to using such a device to shift tax gains to persons (*K* and *L*) who will never reap the corresponding economic gains. The option in this case is not wholly without substance; until she exercises the option, *M* cannot lose more than \$4,000. However, if *M* is treated as a partner from the beginning, the protection against loss provided by the option can be reflected in the allocation of partnership losses. For example, *M* could be given an initial capital account of \$4,000 and allocated one third of all partnership income, gains, and losses, except that losses would be allocated to *K* and *L* only once *M*'s capital account reaches zero.

In sum, I do not share Professor Gergen's fear that the issues raised by discounts, premiums, and options threaten to end the intellectual revolution in partnership taxation. Revolutionary dogma (the new thinking) can probably provide acceptable solutions for all of these problems. However, the solutions will bring us no closer to answering the more imponderable question: has the revolution ever begun, and should it ever begin, for the daily practice of partnership taxation for the ordinary partnership?

27. See Gergen, *supra* note 2, at 357.