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## Federal Income Tax Classification of Natural Resource Ventures: Co-Ownership, Partnership, or Association

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# FEDERAL INCOME TAX CLASSIFICATION OF NATURAL RESOURCE VENTURES: CO-OWNERSHIP, PARTNERSHIP, OR ASSOCIATION?

*by*

*Frank M. Burke, Jr.\* and Steven F. Meyer\*\**

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Without the initial drafting assistance of Colbert C. Shapleigh of Peat, Marwick, Mitchell & Co., the preparation of this Article, which is intended to provide the framework for revision of certain chapters of a future edition of F. BURKE & R. BOWHAY, *INCOME TAXATION OF NATURAL RESOURCES* (1983), would not have been possible.

\*\* Until his untimely death after completion of this Article, Steven F. Meyer was a partner in the Dallas office of Peat, Marwick, Mitchell & Co. This Article is dedicated to his memory. He will be sorely missed by his family, partners, associates, and many friends.

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WHEN entering into any venture, a taxpayer faces a number of issues that he must resolve so that risks can be properly controlled and minimized and potential profits can be maximized. In particular, natural resource ventures entail high risks and heavy investments that often make it necessary for several taxpayers to join in a single venture.<sup>1</sup> Each member contributes skills or capital in return for an agreed-upon share of the risk and profit. Some type of business arrangement is necessary to define the rights and obligations of the members. The agreement creating the arrangement must set forth the participants' understanding of (1) the allocation of risks and profits, (2) the authority for conducting operations, and (3) each participant's ability to withdraw or transfer its interest. The terms of the agreement will generally also determine the nature of the organization for federal income tax purposes.<sup>2</sup>

The partnership is generally the preferred form of business entity for natural resource ventures because of the ability to pass through taxable losses incurred by the partnership to the individual partners.<sup>3</sup> Because the common law and federal income tax definitions of partnership are not

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Editor's Note: Unless otherwise indicated all statutory references are to the Internal Revenue Code of 1954, as amended, which is codified in title 26 of the United States Code. Internal Revenue Code sections are cited to the 1976 permanent edition and/or current supplement of the United States Code, if therein. Otherwise, code sections are cited to the main edition and/or current supplement of the United States Code Annotated published by West Publishing Company. All Treasury Regulations are cited by section number and may be found in 26 C.F.R. (1983) unless otherwise indicated.

1. Natural resource investments are an expanding universe of activities involving the exploration, acquisition, development, and conservation of mineral, oil and gas, water, and land resources. See Getches, *Preface: On Natural Resources as an Area of the Law*, 53 U. COLO. L. REV. 195 (1982). The term "natural resources" as used here includes oil, gas, coal, and other resources obtained by drilling or mining processes.

2. See, e.g., *United States v. Kintner*, 216 F.2d 418, 424 (9th Cir. 1954) (general partnership under state law treated as association taxable as a corporation); *Taxpayer's Actions Determine Existence of Partnerships*, 11 TAX'N FOR LAW. 246, 246 (1983) (conduct of parties and amendments to agreement determine characterization of organization). But see *Morrissey v. Commissioner*, 296 U.S. 344, 360 (1935) (organization formed as trust classified as association taxable as a corporation); 1 W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 2.02, at 2-7 (1977) (venturers are limited in their ability to have enterprise taxed as they desire).

3. See I.R.C. §§ 611-617 (West 1967 & Supp. 1983) (deductions for depletion, exploration, and development of natural resources).

identical, the partnership agreement should be carefully drafted to achieve the legal and tax consequences originally anticipated. On occasion, purported partnerships have been found to be associations taxable as corporations,<sup>4</sup> thereby precluding the members from using the profits or losses generated by the venture against other income or loss. In contrast to corporations, partnerships provide a degree of flexibility by allowing members to allocate income and deductions among themselves. If special allocations of income and deductions are not needed, co-ownership and joint operation may be less burdensome forms of doing business, even though the parties may be treated as members of a partnership for tax purposes. If special allocations are needed, the agreement between the parties must create a partnership and the provisions of the agreement will be important in determining whether a particular allocation will be respected for tax purposes.<sup>5</sup> This Article discusses selected tax problems of natural resource ventures relating to (1) the treatment of ventures as co-ownerships, and (2) the classification of ventures as partnerships or associations.

## I. TAX SIGNIFICANCE OF FORM OF ORGANIZATION

Joint operation of a mineral property may be conducted under any of the following forms of business organization: co-ownership, joint venture, partnership, trust, or corporation. A business operated in any of the noncorporate forms may become an association taxable as a corporation by engaging in conduct characteristic of a corporation. Each form of business organization may carry different tax consequences such as the selection of the taxable year, elections available to owners or operators of mineral properties, allocations of income and deductions between the owners, and certain elections available to owners or operators of mineral properties. The resolution of these issues is dependent upon whether the parties have created a separate entity that acts as principal in the development and operation of the property. In the absence of a separate entity the operator of the property is acting merely as agent for the owners.

### A. Taxable Year

If the parties create a venture in the form of a corporation or a trust, such entity is entitled to adopt a taxable year that may or may not correspond to the taxable year of the owners of the venture.<sup>6</sup> A partnership, on the other hand, may not adopt a taxable year other than that of all its principal partners, or other than a calendar year if the partners' years dif-

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4. See, e.g., *Pelton v. Commissioner*, 82 F.2d 473, 476 (7th Cir. 1936) (trust); *Foreman v. United States*, 232 F. Supp. 134, 137 (S.D. Fla. 1964) (partnership); *Treas. Reg. § 301.7701-1(c)*.

5. See I.R.C. § 704(a) (1976) (partnership agreement determines partner's distributive share of income, gain, loss, deduction, or credit); *Prop. Treas. Reg. § 1.704-1(b)*, 48 Fed. Reg. 9871 (Mar. 9, 1983) (allocations must have substantial economic effect).

6. See I.R.C. § 441 (1976 & Supp. V 1981).

fer, unless it establishes a business purpose therefor.<sup>7</sup> In 1972, however, the Internal Revenue Service issued a Revenue Procedure that allows a partnership to adopt a fiscal year other than that allowed under the preceding general rule where the change or adoption results in a deferral of income to the partners of three months or less.<sup>8</sup>

For tax purposes, a venture that is considered to be a separate entity reports its income and deductions on the basis of the fiscal year adopted.<sup>9</sup> In the case of a partnership, each partner includes in his return for a given taxable year his share of partnership income or loss for the partnership's year that ends with or within such partner's taxable year.<sup>10</sup> Where a venture is not, on the other hand, treated as a separate entity, each co-owner reports his share of the income or loss from the venture for the period ending with the owner's taxable year.

### B. Elections

In natural resources activities, certain elections are available to a taxpayer.<sup>11</sup> The term "taxpayer" does not necessarily refer to one who pays taxes, but may also refer to a reporting entity that is separate and distinct from its owners. Such entities may elect to expense intangible drilling and development costs (IDC) incurred on oil and gas wells, or to capitalize and defer exploration costs for other minerals.<sup>12</sup> When properly made by the entity, the elections are binding thereon, and its owners are not, therefore, entitled to separate elections.<sup>13</sup> By the same token, the entity is not bound by the elections made by its owners.<sup>14</sup>

### C. Allocation of Income and Deductions Among Owners

In general, most forms of natural resource joint operating arrangements contemplate or require that each participant share income or expense in direct proportion to the participant's interest in the underlying property. If the venture is a partnership, on the other hand, the partners may share certain items of income or expense, as well as net income or loss, in a manner that is not necessarily related to their capital contributions,<sup>15</sup> so long as the allocation of tax benefits among the partners has substantial economic effect. The partnership form of doing business thus affords its owners a great degree of flexibility in tax planning.

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7. *Id.* § 706(b)(1) (1976).

8. Rev. Proc. 72-51, 1972-2 C.B. 832.

9. I.R.C. § 441(b) (1976).

10. *See id.* § 702 (West 1982 & Supp. 1983).

11. *See, e.g., id.* § 263(c) (West Supp. 1983) (election to expense intangible drilling and development costs).

12. IDC may be expensed currently under § 263(c), *id.*, and Treas. Reg. § 1.612-4(a). Mining development expenditures may be deducted under I.R.C. § 616 (1976).

13. *See* Treas. Reg. § 1.612-4(d)-(e).

14. *See id.*

15. Concerning special allocations of partnership income, gain, deduction, or loss, see I.R.C. § 704(b) (1976) and the proposed Treasury Regulations thereunder.

## II. CO-OWNERSHIP

## A. Distinctions Under the 1939 Code

Prior to enactment of the Internal Revenue Code of 1954, both the courts and the Service indicated that co-ownerships would not be treated as partnerships for federal tax purposes under certain circumstances.<sup>16</sup> The principal test developed by the courts in differentiating co-ownerships from partnerships relied on the location of legal title to the venture's property.<sup>17</sup> The Service, on the other hand, took the position that the principal test as to the existence of a partnership was the presence of a joint profit objective.<sup>18</sup> Each of these approaches deserves further discussion.

## 1. Location of Title to Property

One characteristic of co-ownership that distinguishes it from a partnership is that under co-ownership title to property is ordinarily retained in the names of the individual participants. In a partnership title is normally held in the partnership name or that of a nominee on behalf of the partnership. Although the Service has not attached great significance to the question of title, the courts, at least for the years in which the 1939 Code was applicable, considered location of title an important test.<sup>19</sup>

In *Estate of Appleby v. Commissioner*<sup>20</sup> the Board of Tax Appeals considered whether a tenancy in common, the form of co-ownership normally used in natural resource activities, should be treated as a partnership. Although the case did not involve a natural resource property, the Board

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16. See, e.g., *Poe v. Seaborn*, 282 U.S. 101, 116-17 (1930); *Champlin v. Commissioner*, 71 F.2d 23, 28 (10th Cir. 1934).

17. See *Marcus v. Commissioner*, 22 T.C. 824, 832 (1954) (jointly owned property operated by joint owner does not give rise to partnership); *Cohan v. Commissioner*, 11 B.T.A. 743, 756-57 (1928), *aff'd*, 39 F.2d 540 (2d Cir. 1930) (jointly owned property does not establish partnership).

18. See *Finch v. Commissioner*, 14 T.C.M. (CCH) 692, 697 (1955) (Commissioner urged existence of partnership solely on basis of joint profit objective).

19. In *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565 (1953), the Tax Court disregarded the situs of title to property. Three co-owners of a lease, pursuant to a Service ruling, filed a partnership-information return of income, designating the operation as a joint venture. On the return a deduction was claimed for intangible drilling costs. The taxpayer, which was one of the co-owners, elected to capitalize intangible drilling costs in its individual return. In examining the taxpayer's returns the Service at first disallowed the loss of the co-ownership to the extent that it was attributable to intangible drilling costs that were treated as a deduction. The disallowance was based on the grounds that the co-owners were not partners. After protest by the taxpayer, the entire loss was allowed on the basis that the operation of the lease constituted a partnership. Before the Tax Court, the taxpayer argued that its previous position was incorrect, that the co-ownership did not constitute a partnership, and that the intangible costs incurred should have been capitalized. The court, without stating a reason for its conclusion, found that the operation of the lease constituted a joint venture or partnership. *Id.* at 571. Unless the Tax Court decided the issue on some grounds of equitable estoppel, or on the grounds that the filing of the partnership-information return designating the operation as a joint venture was a conclusive indication of the intention of the parties to form a joint venture, the decision appears questionable. The petition for review by the Court of Appeals for the Fifth Circuit was dismissed as the result of a compromise settlement on all issues for approximately one-fifth of the proposed deficiency.

20. 41 B.T.A. 18 (1940), *aff'd*, 123 F.2d 700 (2d Cir. 1941).

held that tenancy in common was an estate so old and well known that it was almost inconceivable that it could be classified as a partnership for federal tax purposes.<sup>21</sup> The Board observed that tenancies in common were not normally treated as a unit, and stated that the extension of the definition of partnership to such a form of ownership would raise serious questions as to the classification of other forms of ownership having similar attributes, such as marital communities and tenancies by the entirety.<sup>22</sup>

Co-owners of improved realty who appoint a common agent to maintain and manage the property are also not partners for federal tax purposes. In *Gilford v. Commissioner*<sup>23</sup> the court held that co-owners doing business through an agent were not partners in the absence of any intention to become partners.<sup>24</sup> The appointment of a common agent did not manifest an intent to create such a partnership.

The importance of the title test is also indicated by court decisions regarding the right to income and deductions between principal and agent. In *Oliver Iron Mining Co. v. Commissioner*<sup>25</sup> the Tax Court held that when an agent operates a property for the owner, the owner is taxable on all income and entitled to claim all deductions relating to the property.<sup>26</sup> The court stated that the same result would be reached where the operator was also owner of an interest in the property.<sup>27</sup> Each owner is required to report his proportionate share of the gross income and deductions from the property.

## 2. Joint Profit Objective

The joint profit objective test originated in Income Tax Ruling 3930.<sup>28</sup> In that ruling the Service took the position under the 1939 Code that in determining whether an organization was a co-ownership or a partnership the most important factor was the presence of a joint profit objective.<sup>29</sup> If a joint profit objective was present, the Service held that the organization was either a partnership or an association taxable as a corporation, depending upon which of the two forms the organization more nearly resembled.<sup>30</sup> The Service further held in Income Tax Ruling 3930 that when the parties to an oil and gas operating agreement associate themselves only in the operation of the property and not in the sale of the product derived from the property, they did not have a joint profit objective.<sup>31</sup> In other words, if the parties to the agreement reserved the right to take production

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21. 41 B.T.A. at 20; *see also* 6 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 35.03 (rev. ed. 1983) (outlining various tests for determining existence of partnership).

22. 41 B.T.A. at 20-21.

23. 11 T.C.M. (CCH) 175 (1952), *aff'd*, 201 F.2d 735 (2d Cir. 1953).

24. 11 T.C.M. (CCH) at 177.

25. 10 T.C. 908 (1948).

26. *Id.* at 914.

27. *Id.*

28. I.T. 3930, 1948-2 C.B. 126, *as modified by* I.T. 3933, 1948-2 C.B. 130.

29. I.T. 3930, 1948-2 C.B. 126.

30. *Id.*

31. *Id.*

from the property in kind and dispose of it themselves, or if they delegated the right of disposal for a limited period of time and the right was terminable at will, they had reserved to themselves individually the income producing features of the operation and therefore lacked a joint profit objective.

The Service had not always followed the position espoused in Income Tax Ruling 3930. In Income Tax Ruling 2749 co-owners of a jointly operated oil and gas lease were held to be partners.<sup>32</sup> The ruling disregarded both the question of title to property and the joint profit objective in finding the existence of a partnership. The Service stated that the relationship fell within the broad scope of the term "joint venture," without reference to any test to be applied in individual circumstances.<sup>33</sup> Since such an association of individuals constituted a partnership, the organization was required to file a partnership return and was entitled to make elections as to taxable year and expensing of IDC.<sup>34</sup> Shortly thereafter, the Service ruled that the filing requirement of Income Tax Ruling 2749 would be fulfilled where the operator of the co-owned property prepared and filed a modified partnership return showing only the owners' respective shares of revenues and expenditures.<sup>35</sup> The views expressed in these rulings remained in effect until the Service issued Income Tax Ruling 3930 in 1948.

More recently, the Tax Court refused to follow the conclusion drawn in Income Tax Ruling 3930 that a take-in-kind provision forecloses partnership status. In *Madison Gas & Electric Co. v. Commissioner*<sup>36</sup> the court found that a valid partnership may exist for federal income tax purposes even though a joint venture agreement contains a take-in-kind provision, which eliminates the joint profit objective.<sup>37</sup> The holding of Income Tax Ruling 3930 may therefore be moot since it appears that this judicial interpretation of the term "partnership" provides an adequate basis for classifying ventures as partnerships. The holding may, however, still have validity in determining whether a venture is a co-ownership or an association taxable as a corporation.

### B. Rules Under the 1954 Code

The 1954 Code recognizes the joint profit objective test<sup>38</sup> and the regulations give recognition to the title test,<sup>39</sup> although such provisions are not expressly incorporated to distinguish between co-ownerships and partnerships. Section 761(a) does not expressly state, but may imply, that all joint

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32. I.T. 2749, 13-1 C.B. 99 (1934). This ruling was later modified by I.T. 3930, 1948-2 C.B. 126.

33. I.T. 2749, 13-1 C.B. 99 (1934).

34. *Id.*

35. I.T. 2785, 13-1 C.B. 96 (1934). This ruling was also modified by I.T. 3930, 1948-2 C.B. 126.

36. 72 T.C. 521 (1979), *aff'd*, 633 F.2d 512 (7th Cir. 1980).

37. 72 T.C. at 557-63.

38. I.R.C. § 761(a) (Supp. V 1981).

39. Treas. Reg. § 1.761-1(a).



operations of natural resource properties that do not constitute corporations, associations taxable as corporations, trusts, or estates are partnerships for federal income tax purposes.<sup>40</sup> The statute also grants, however, under certain circumstances, an option to members of unincorporated organizations to exclude such organization from the application of all or part of the partnership rules contained in subchapter K of the Code.<sup>41</sup> The election must be made by all of the members of the organization and is available only if the organization is availed of:

(1) for investment purposes only and not for the active conduct of a business, [or]

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted

...

[In such cases, the election is available only] if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.<sup>42</sup>

In addition to the requirements of the statute, the regulations require that the participants "[o]wn the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights" in order to qualify for the election.<sup>43</sup> The regulations apparently take the position that co-ownerships that actively carry on a trade, business, financial operation, or venture and divide the profits thereof are considered for federal income tax purposes to be partnerships, and that an election to be excluded from application of the partnership rules must be made to obtain treatment as a co-ownership.<sup>44</sup>

A co-ownership that does not make the necessary election, a joint venture, a limited partnership, and a general partnership come within the Code provisions relating to partnerships, and each form of organization is considered a separate entity acting as principal for its own account.<sup>45</sup> In such cases the entity is entitled to adopt a taxable year and make appropri-

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40. The statutory definition of partnership contained in I.R.C. § 761(a) (Supp. V 1981) is identical with the definition in § 3797 of the 1939 Code. Under the prior Code, co-ownerships were not considered partnerships by reason of the general terms of the Code. Congress, by granting an election to certain types of organizations to be excluded from application of the partnership provisions, probably did not intend organizations that were not partnerships under prior law to now be treated as partnerships in the absence of an election.

41. I.R.C. § 761(a) (Supp. V 1981).

42. *Id.* § 761(a). *Id.* § 761(a)(3) provides that an unincorporated organization availed of "by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities" is also eligible to elect out of the provisions of subchapter K of the Code.

43. Treas. Reg. § 1.761-2(a)(3)(i).

44. Mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a partnership in the absence of such an intent by the co-owners, nor does the filing of a partnership return substantially establish partnership existence. *Id.* § 1.761-1(a); *Powell v. Commissioner*, 26 T.C.M. (CCH) 161, 164-65 (1967).

45. Theoretically, a true partnership might meet the qualifying requirements of I.R.C. § 761 (1976 & Supp. V 1981) and the regulations thereunder, and be entitled to the election, but such circumstances would probably be rare.

ate elections.<sup>46</sup> In the case of a co-ownership that makes an appropriate election not to become subject to the partnership provisions, a separate entity is not created, and the operator acts on behalf of the other co-owners.<sup>47</sup> In this instance, each co-owner reports as taxable income his share of all items of taxable income received or accrued by the operator and reports as allowable deductions his share of all deductions paid or incurred by the operator. The income and deductions are reported at the time received, accrued, paid, or incurred by the operator without regard to the operator's fiscal period, and each co-owner makes separate elections regarding IDC and similar items.<sup>48</sup>

In Revenue Ruling 65-118 the Service ruled that a joint venture that elects not to be treated as a partnership for purposes of subchapter K is nevertheless a partnership for purposes of determining the limitation on the amount of used section 38 property that qualified for the investment tax credit.<sup>49</sup> The Service therefore takes the position that a co-ownership arrangement is still considered a partnership for purposes of those sections of the Code outside subchapter K.<sup>50</sup> The Tax Court sustained the position of the Service in *Bryant v. Commissioner*.<sup>51</sup> On the basis of the above reasoning, IDC incurred by ventures electing out of subchapter K should be considered as incurred at the entity level, rather than by the co-owners, since the option to deduct such costs is granted under section 263(c), which is not a part of subchapter K.<sup>52</sup> The Service, however, apparently uses the foregoing reasoning only to impose limitations that would apply at the partnership level on credits and deductions if no election to be excluded from subchapter K had been made.

### 1. Election to be Treated as Co-Ownership

Joint ventures and genuine partnerships, whether general or limited,

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46. *Id.* § 706 (Supp. V 1981) (governing adoption of taxable year for organization that qualifies as partnership); see *Kritzik v. Gallman*, 344 N.Y.S.2d 107, 109, 41 A.D.2d 994, 996 (1973). Other elections made by the entity include whether to treat cutting of timber as a sale or exchange, *Beilke v. Commissioner*, 22 T.C.M. (CCH) 13, 13 (1963), and whether to expense land-clearing costs, *Rev. Rul. 66-141*, 1966-1 C.B. 56.

47. *Treas. Reg. § 1.761-2(b)* indicates that an organization electing out of the provisions of subchapter K is no longer a separate entity, but is an organization composed of members who must report their respective shares of income, deduction, and credit items, making such elections as to individual items as may be appropriate.

48. *Id.* The election to expense IDC is particularly important both in and out of the partnership context, since once made the election is permanent. See *Boone v. United States*, 374 F. Supp. 115, 121 (D.N.D. 1974). Note, however, that partnership elections do not bind the partners with respect to matters they are entitled to elect as individuals and vice versa. I.R.C. § 703(b) (Supp. V 1981). Thus, one important consideration in determining whether to form a partnership is the treatment to be given IDC. If the individual "elected" to capitalize IDC, formation of a partnership that will elect to expense IDC may be advantageous.

49. *Rev. Rul. 65-118*, 1965-1 C.B. 30, 31; see also *Sexton & Charyk, The Partnership Corner*, 7 J. REAL EST. TAX'N 382 (1980) (rules regarding allocation of partnership investment credit).

50. *Rev. Rul. 65-118*, 1965-1 C.B. 30, 31.

51. 46 T.C. 848 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968).

52. I.R.C. § 263(c) (West Supp. 1983), which allows either capitalization or current deduction of IDC, is in subchapter B of the Code.

rarely have a right to elect out of subchapter K under section 761.<sup>53</sup> Where the election is available, as in the case of joint operating agreements between co-owners, the issue is whether the venturers desire to be treated as a partnership or to elect not to be subject to all or part of the partnership provisions. As a general rule, treatment as either a co-ownership or a partnership will not carry adverse tax consequences if the participants in the joint operation are aware of the classification of the enterprise and plan their operations accordingly. Most joint operations will elect not to become subject to the partnership provisions because less coordinated tax planning is required in a co-ownership than in a partnership, but the choice in each instance will be influenced by many factors.

An election of partial exclusion is hazardous due to the uncertainty that is introduced into the tax planning of the participants. Under the regulations, an election to be excluded from the application of all of the partnership provisions of the Code is automatically effective, whereas the Commissioner reserves the power to deny, limit, or expand an election of partial exclusion.<sup>54</sup> The request for partial exclusion must be filed within ninety days after the beginning of the first taxable year for which partial exclusion is desired.<sup>55</sup> If the participants consummate a transaction during the period required for filing and approval of the request, an adverse ruling on the request may upset their tax planning.

## 2. *Qualifying Requirements—Natural Resources*

The election to be excluded from application of subchapter K is available to most unincorporated joint operations of natural resource properties, regardless of when the venture was formed, provided that (1) the participants retain ownership of the property as co-owners, in fee or under a lease or contract granting exclusive operating rights;<sup>56</sup> and (2) each participant reserves the right to take his share of production in kind, although an individual participant may delegate to another the authority to sell his share of production for a period of time not to exceed the minimum needs of the industry, and in no event for more than one year;<sup>57</sup> and (3) the organization does not have as one of its principal purposes "cycling, manufacturing, or processing" operations for others.<sup>58</sup>

Most ventures operating under standard joint operating agreements fulfill the first two of these requirements. Those joint operations that do not, therefore, involve cycling, natural gasoline plant operation, or processing

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53. *Id.* § 761(a) (Supp. V 1981); see Campbell & Crump, *Drilling Venture Does Not Meet Criteria to Qualify for Exclusion from Subchapter K*, 31 OIL & GAS TAX Q. 472 (1982).

54. See Treas. Reg. § 1.761-2(c).

55. *Id.*

56. *Id.* § 1.761-2(a)(3)(i).

57. *Id.* §§ 1.761-2(a)(3)(ii)-(iii). In T.A.M. 8226014 (Mar. 10, 1982) the Service ruled that the right to purchase oil and gas products under an exclusive right of first refusal constituted a contract to purchase when the right was, in essence, of unlimited duration. The right was held, therefore, to invalidate the election to be excluded from the partnership provisions.

58. Treas. Reg. § 1.761-2(a)(3).

for nonmembers other than owners of related royalty interests, should clearly be eligible for the election. In such cases the venture is not required to file a partnership return in order to protect its ability to expense IDC or costs of mine exploration.

If the operation of a cycling plant or other manufacturing or processing facility for others is an integral part of the joint operations, then the question arises whether the performance of such activities constitutes one of the principal purposes of the organization, thus depriving such organization of the right to elect exclusion.<sup>59</sup> This question is one of fact that must be decided on the basis of the circumstances in each case. Where the joint owners of producing oil and gas properties also own a cycling or gasoline plant that services nonmembers and wish to avoid partnership status, prudence dictates that a partnership return be filed and the election exercised. In this manner the election out of subchapter K will be protected if the joint operation is later classified as not having processing for others as one of its principal purposes. The return should also contain language concerning the election to expense IDC or the election to capitalize mine exploration expenditures in case the election out of subchapter K is held to be ineffective.

### 3. *Manner of Making Election*

Under current regulations, the election by a qualified joint operation not to be subject to subchapter K generally must be made in a statement attached to, or incorporated in, a properly executed partnership return.<sup>60</sup> An election to secure exclusion from subchapter K will be recognized, however, even though no formal election is filed if the facts and circumstances indicate that the members of the organization intended at the time of its formation to secure exclusion from subchapter K.<sup>61</sup> Such an intention may be indicated if, at the time of formation, an agreement exists among the members that the organization be excluded from subchapter K, or if the members of the organization report their respective shares of items of income, deduction, and credit from the joint operation on their returns in a manner consistent with an exclusion from subchapter K.<sup>62</sup> Under the regulations the election need not be incorporated in the operating agreement.<sup>63</sup> Nevertheless, operating agreements should contain (1) an express election not to be subject to subchapter K, and (2) an express direction to the operator to take all necessary steps under the statute and regulations to elect to avoid the application of the partnership rules to the joint operation.

A co-ownership is not required to elect exclusion under section 761 for the first year of its existence, but instead is permitted to make the election

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59. *Id.*

60. *Id.* § 1.761-2(b)(2)(i).

61. *Id.* § 1.761-2(b)(2)(ii).

62. *Id.*

63. *Id.*; see also 6 J. MERTENS, *supra* note 21, § 35.03 (describing election to be excluded from provisions of subchapter K).

in any taxable year for which exclusion from subchapter K is desired.<sup>64</sup> If the co-owners desire to be excluded under section 761 from inception of the joint venture, they must file the election or meet the requirements for a deemed election under the "all facts and circumstances" test for the first year in which a partnership return is required.<sup>65</sup> The regulations provide that an unincorporated organization that engages in any business, financial operation, or venture is a partnership and must, therefore, file a partnership return.<sup>66</sup> For purposes of filing a partnership return, however, an unincorporated organization will not be considered to carry on a business, financial operation, or venture as a partnership before the first taxable year in which the organization receives income or incurs any deductible expenditures.<sup>67</sup> In this regard, the Service held in a published ruling that expenditures by co-owners relating to exploratory work or payment of rentals prior to any joint activity for production, extraction, or use of the property are classified as made for the acquisition or retention of property and are not considered expenditures requiring the filing of a return.<sup>68</sup> In contrast, expenditures made for purposes of exploration and use, such as expenditures made for the location of individual wells, are expenditures requiring the filing of a return. If the election to be excluded from the provisions of subchapter K is not made for the first taxable year, a complete partnership return is required.<sup>69</sup> The return should contain the appropriate partnership elections, such as the IDC election, for partnership activities during the period covered by the return.<sup>70</sup>

In order to elect not to be covered by the provisions of subchapter K, a newly formed organization should file a first year partnership return that contains, in lieu of the usual information required thereon, (1) the name and address of the organization, (2) the names and addresses of the participants, (3) a statement that the organization qualifies for the election and that all members elect to have it excluded from all of the partnership provisions of the Code, and (4) a statement as to where a copy of the operating agreement, if written, is located. If the agreement is oral the return should indicate the person or persons who can supply the provisions of the agreement.<sup>71</sup> Since joint operations of oil and gas properties are not normally given a separate name, the most useful nomenclature would be the name or description of the property, if any, used by state regulatory authorities. In the absence of such designation, the customary lease description should suffice. The address shown on the return should be the address of the principal office of the operator and the return should be filed in the office of the Service Center in the district in which the principal office of the operator is

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64. Treas. Reg. § 1.761-2(b)(1).

65. *Id.* § 1.761-2(b)(2)(ii).

66. *Id.* §§ 1.6031-1(a), 1.701-1.

67. *Id.* § 1.6031-1(a).

68. Rev. Rul. 56-500, 1956-2 C.B. 464, 466.

69. Treas. Reg. § 1.6031-1(a).

70. *See id.* § 1.703-1(b).

71. *Id.* § 1.761-2(b)(2)(i).

located. If the return is filed by a co-owner other than the operator, the return should be filed with the Service Center in the district where the person filing the return has his principal office or place of business. In this case the address of the person filing the return should be indicated instead of the address of the operator.<sup>72</sup>

If the election is made in a year after the organization has filed partnership returns, problems arise as to potential recapture of IDC, depreciation, investment tax credit, and similar items.<sup>73</sup> Whether the organization is required to recapture such items depends on the manner in which the organization makes the transition from partnership to another form of business entity. The focus is on whether the partnership liquidates followed by a reconstitution of the partnership subject to the election or the partnership remains intact with the subchapter K provisions removed. In either event, IDC and depreciation are not recaptured since the deemed liquidating distribution is pro rata. In *Bryant v. Commissioner*<sup>74</sup> the Tax Court stated that although the election prevented the application of subchapter K, the partnership remains intact so that other provisions of the Code apply as if no election existed. Therefore, investment credit recapture<sup>75</sup> should not be required because for the purpose of section 47, which lies outside of subchapter K, the partnership and each participant's interest therein are still intact.

#### 4. Right of Co-Owners to Invalidate or Change Election

The election to be excluded from the provisions of subchapter K will be automatically effective unless one of the co-owners, within ninety days after formation of the organization, notifies the Commissioner that he desires subchapter K to apply "and also advises the Commissioner that he has so notified all other members of the organization by registered or certified mail."<sup>76</sup> Timely notification prevents the other co-owners from making the election because the statute requires that the election be made by all co-owners.<sup>77</sup> Hence, failure to take timely affirmative action to dissent to an election out of subchapter K prevents a co-owner from later objecting to such an election.<sup>78</sup> Once made, the election to be excluded from the provisions of subchapter K is irrevocable so long as the joint operation remains qualified, unless approval of revocation is secured from the Commissioner.<sup>79</sup> Application for permission to revoke the election must be submitted to the Commissioner not later than thirty days after the begin-

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72. *Id.* (address of person filing return should be used; no mention is made of operator).

73. See, e.g., Patton, *The Investment Credit and its Recapture in Partnership Transactions*, 5 REV. TAX'N INDIVIDUALS 53 (1981).

74. 46 T.C. 848 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968).

75. I.R.C. § 47 (West 1967 & Pam. Supp. 1983).

76. Treas. Reg. § 1.761-2(b)(3).

77. I.R.C. § 761(a) (Supp. V 1981).

78. Treas. Reg. § 1.761-2(b)(3)(i).

79. *Id.* The members of the organization are always free to enter into a separate agreement whereby the business or venture is conducted as a partnership for tax purposes. This would effectively remove the new organization from "qualifying" for the exclusion, since it

ning of the taxable year for which the revocation is to apply.<sup>80</sup>

### 5. Unwanted Partnership

When a natural resource co-ownership fails to make the election prescribed by section 761, a partnership is deemed to be created by contribution of undivided interests in property, and may be termed an "unwanted partnership." Under such circumstances, section 704(c)(3) provides that depreciation, depletion, and gain or loss with respect to such properties "shall be determined as though such undivided interests had not been contributed to the partnership."<sup>81</sup> Under the regulations, the word "determined" is assumed to mean "allocated."<sup>82</sup> Items of depreciation, depletion, and gain or loss attributable to undivided interests are, therefore, computed at the partnership level and allocated to the partners.<sup>83</sup> The word "determined" might more logically be interpreted as "computed," with the result that depreciation, depletion, and gain or loss relating to each undivided interest would be determined using the individual owner's accounting methods. This approach recognizes that property may be used by a partnership as part of its business operations, but not be treated as partnership property.<sup>84</sup> This approach has not, however, been adopted by the Service.

## III. ASSOCIATIONS, TRUSTS, AND PARTNERSHIPS

The classification of an organization as an association taxable as a corporation is frequently an unwanted result. If an organization is classified as an association, the participants in the venture will not be able to use any of the entity-level tax deductions otherwise available if the organization were classified as a partnership.<sup>85</sup> An association is a separate taxable entity, independent of its members, whereas a partnership or trust generally acts as a conduit whereby items of income and loss flow through to the partners or beneficiaries.<sup>86</sup>

The Code defines the term "corporation" to include associations, joint stock companies, and insurance companies, in addition to those entities commonly known as corporations.<sup>87</sup> The regulations state that an organization is an association taxable as a corporation if it more closely resem-

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would simply forego the making of an election to be excluded from the provisions of subchapter K. See 6 J. MERTENS, *supra* note 21, § 35.03.

80. Treas. Reg. § 1.761-2(b)(3)(i).

81. I.R.C. § 704(c)(3) (1976).

82. Treas. Reg. § 1.704-1(c).

83. *Id.* § 1.704-1(c)(3)(i).

84. The theory of recognizing the separateness of partner and partnership is given statutory recognition by I.R.C. § 707 (1976), wherein certain transactions between a partner, not acting in his capacity as a partner, and the partnership are treated as if the partner was not a member of the organization.

85. *Id.* § 703 (Supp. V 1981) and the regulations thereunder permit organizations qualifying as a partnership to make elections not accorded other entities.

86. See *supra* notes 3-15 and accompanying text.

87. I.R.C. § 7701(a)(3) (1976).

bles a corporation than a partnership or trust.<sup>88</sup> Corporate semblance is indicated by six characteristics that are enumerated in the regulations.<sup>89</sup> The first two characteristics, associates and an objective to carry on a business and divide the gain therefrom, are common between partnerships and corporations and are therefore not important in distinguishing between the two forms of business entities.<sup>90</sup> The last four characteristics, continuity of life, centralization of management, limited liability, and free transferability of interest, are not common between the two types of organizations and, accordingly, are the distinguishing factors. Generally, an organization is deemed to be an association if it possesses both of the common characteristics and more than two of the distinguishing characteristics.<sup>91</sup> Although the regulations state that other factors may be considered,<sup>92</sup> most classification cases have considered only the above factors.

*A. Judicial and Administrative Background—Morrissey and the Ensuing Treasury Regulations*

To determine the classification of a tax entity, principles established in prior case law must be reviewed, particularly the landmark decision in *Morrissey v. Commissioner*.<sup>93</sup> The *Morrissey* decision is significant for two reasons. First, the basic concepts developed in that case by the Supreme Court for classifying entities are very much in use today.<sup>94</sup> Further, the decision synthesized what, up to the time of the decision, were a number of confusing and apparently irreconcilable court decisions.<sup>95</sup>

In *Morrissey* a trust was established by a group of real estate promoters who conveyed land to the trustees, accompanied by exclusive power to purchase additional properties and develop the trust holdings. The trustees subdivided a portion of the land and sold lots on an installment basis. On the remaining acreage they constructed a golf course and club house. Beneficial interests were established in the trust, consisting of 2000 transferable preferred shares and 2000 transferable common shares. Sole management of the trust resided in the trustees, the shareholders being permitted to vote on certain matters in an advisory capacity. Holders of

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88. Treas. Reg. § 301.7701-2(a)(1).

89. *Id.*

90. *Id.* § 301.7701-2(a)(3).

91. *Id.* § 301.7701-2(a)(2).

92. *Id.* § 301.7701-2(a)(1).

93. 296 U.S. 344 (1935). For an in-depth discussion of *Morrissey* and other case law involving classification of entities for federal income tax purposes, see Klein, *Split Personality Problems: Partnership or Association?*, 24 OIL & GAS TAX Q. 453, 457-66 (1976); McGee, *Problems of the Unintentional Corporation: The Association Taxable as a Corporation*, 29 INST. ON FED. TAX'N 853, 856-67 (1971); Sexton & Osteen, *Classification as a Partnership or as an Association Taxable as a Corporation*, 24 TULANE TAX INST. 95, 101-22 (1975).

94. See, e.g., *Zuckman v. United States*, 75-2 U.S.T.C. (CCH) ¶ 9778 (Cl. Ct. 1975); *Elm St. Realty Trust v. Commissioner*, 76 T.C. 803 (1981).

95. One pre-*Morrissey* court described the distinction between an association and a pure trust as "seemingly in a hopeless state of confusion." *Coleman-Gilbert Assocs. v. Commissioner*, 76 F.2d 191, 193 (1st Cir.), *rev'd*, 296 U.S. 369 (1935) (reversal based on criteria established in *Morrissey* on same day).



shares were not liable for acts of the trustees, and the life of the trust was to continue unaffected by the death of any trustee or beneficiary.

The Supreme Court reviewed prior case law and determined that the standards used in determining the classification issue had not been definitively stated.<sup>96</sup> In the early trust versus association cases, for example, one court employed a single standard for determining proper classification.<sup>97</sup> The Court accepted the opportunity to deliver a comprehensive explanation of all the relevant factors. First, the Court clearly stated that the overall principle is one of resemblance to the corporate form, that "[t]he inclusion of associations with corporations implies resemblance; but it is resemblance and not identity."<sup>98</sup> After setting forth that overriding concept, the Court enumerated the specific attributes that are the benchmarks of corporate form. These attributes were divided into two "primary" attributes and five "salient" attributes. The absence of either of the primary attributes precludes an organization from being an association, whereas the presence of these attributes requires additional review of the salient attributes to determine whether there is a preponderance of corporate characteristics.<sup>99</sup>

The primary attributes consist of associates and a common business objective. The Court determined that the word "association" implies associates and the entering into a joint enterprise for the transaction of business.<sup>100</sup> A trust is distinguishable from such an enterprise since beneficiaries of a trust do not ordinarily "plan a common effort or enter into a combination for the conduct of a business enterprise."<sup>101</sup> After identifying the primary attributes the Court focused on the other salient features that the corporate form possesses. In addition to holding title to property as an entity a corporate organization furnishes centralized management through representatives of the members of the corporation. A corporate enterprise is secure from termination or interruption by the death of the owner of beneficial interests and thus the transfer of beneficial interests does not affect the continuity of the enterprise. Finally, a corporation permits limited personal liability for participants in the organization in the amount of the participants' investment.<sup>102</sup> The *Morrissey* Court compared the corporate attributes to the characteristics of a trust and noted the striking simi-

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96. 296 U.S. at 356.

97. The standard used by the court was the degree of control exercised by the beneficiaries over the management of the trust. See *Crocker v. Malley*, 249 U.S. 223, 232-34 (1919). This view was followed in early regulations, Treas. Reg. 45, 62, art. 1504 (1921), but was overturned by the Supreme Court in *Hecht v. Malley*, 265 U.S. 144, 155 (1924). The Court in that case decided that beneficiary control was not of special significance for association status, but did not elucidate which factors were relevant. Treas. Reg. 65, art. 1504 (1924), T.D. 3748, IV-2 C.B. 7 (1925), followed the reasoning of *Hecht* that the extent or lack of control exercised by the beneficiaries was not in itself determinative of the tax status of a trust.

98. 296 U.S. at 357.

99. *Id.* at 359.

100. *Id.* at 360.

101. *Id.* at 357.

102. *Id.* at 362.

larities.<sup>103</sup> Subsequent judicial and administrative decisions rely almost exclusively on *Morrissey's* comparison technique and on the concepts developed in the case to settle questions of classification. The most notable example is the definition in the current Treasury Regulations of "associations," which almost mirrors the *Morrissey* decision.<sup>104</sup> A general review of all corporate characteristics follows since a thorough understanding of each is important in analyzing a classification issue, whether the intended form of operation is a partnership, trust, co-ownership, or some other form of organization.

## B. Corporate Characteristics

### I. Associates

In order to create an association, two or more persons must take part in a joint undertaking.<sup>105</sup> "Person" is used in a sense that includes individuals, corporations, partnerships, trusts, and other entities.<sup>106</sup> If only one person is involved, or if several are involved but there is no joint action, no association will be found. The Tax Court confirmed the requirement that more than one person be engaged in the undertaking when it held that a sole proprietorship, not an association, existed where the sole owner of a corporation carried on the business after revocation of the corporate charter.<sup>107</sup> Although the operation of a business after expiration of a corporate charter ordinarily creates an association taxable as a corporation,<sup>108</sup> the Tax Court held that the general rule was not applicable where there were no associates.<sup>109</sup>

The same principle was illustrated in *A.A. Lewis & Co. v. Commissioner*,<sup>110</sup> in which the grantor of a trust assigned a tract of land to a trustee who was empowered to collect and distribute to the grantor the funds received from disposition of portions of the land handled by an exclusive agent. The trustee paid the prearranged commission to the agent and the remainder of the proceeds to the grantor. The Court in *Lewis* held that (1) there were no associates, (2) the relationship between the parties was one of agency, and (3) there was therefore no association taxable as a corporation.<sup>111</sup> Even though two or more persons were involved, the combination must be voluntary and with the intent of conducting a joint effort

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103. *Id.* at 363.

104. Treas. Reg. § 301.7701-2.

105. *Id.* § 301.7701-2(a)(2); see *A.A. Lewis & Co. v. Commissioner*, 301 U.S. 385, 388 (1937).

106. I.R.C. § 7701(a)(1) (1976).

107. *Knoxville Truck Sales & Serv., Inc. v. Commissioner*, 10 T.C. 616, 622 (1948); see also *Coast Carton Co. v. Commissioner*, 10 T.C. 894, 905 (1948) (corporation held to be an individually owned and operated business and not an association taxable as a corporation).

108. See *Crocker v. Commissioner*, 84 F.2d 64, 66-67 (7th Cir. 1936); *Burleson v. Commissioner*, 12 T.C.M. (CCH) 932, 936-37 (1953). This view was codified in prior regulations. Treas. Reg. 103, § 19.3797-2 (1940).

109. *Knoxville Truck Sales & Serv., Inc. v. Commissioner*, 10 T.C. 616, 622 (1948).

110. 301 U.S. 335 (1937).

111. *Id.* at 389.

in order to constitute an association taxable as a corporation. This principle has been applied in a number of situations involving trusts. In one case, the court held that in an ordinary trust the beneficiaries are in no real sense associated in the conduct of the trust affairs. The trust does not become an association simply because there are two or more beneficiaries.<sup>112</sup> In that case the court observed that the associates test is not ordinarily met merely because of the existence of a trust, but that the characteristics of the trust may fulfill the test of resemblance to a corporation.<sup>113</sup> The Supreme Court advanced a similar test in *Morrissey*,<sup>114</sup> stating that the beneficiaries of a trust "do not ordinarily . . . plan a common effort or enter into a combination for the conduct of a business enterprise."<sup>115</sup> In both of these cases, however, the courts held that the organizations were associations taxable as corporations, in part because such a voluntary common effort did exist.<sup>116</sup>

In another case where a trust was not formed or continued by voluntary action of the beneficiaries, the court stated that no conclusive evidence indicated that the organization was a business venture or that the trustee had engaged in business.<sup>117</sup> Accordingly, the court held that the trust was not taxable as a corporation.<sup>118</sup> The court stated that the presence of salient corporate attributes is some evidence, but not a conclusive test, of an association taxable as a corporation, since an association implies associates and doing business.<sup>119</sup> The trust in question was substantial in amount, with property consisting of corporate stocks, bonds, notes, bank deposits, and loans to several companies. The trust property was held by the trustee for the benefit of four children who held transferable shares or trust certificates that were in fact never transferred. The purpose of the trust was to convert the trust property and make distributions to the beneficiaries. The court held that association status implies entering into a joint enterprise and that no joint enterprise existed in this case since the trust was not formed by voluntary act of the beneficiaries.<sup>120</sup> Conversely, where the grantors of the trust are also the beneficiaries, and the trust is simply a means of pooling common interests to conduct a joint business enterprise for profit, the trust is merely a mechanism used by the associate-benefi-

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112. *Kilgallon v. Commissioner*, 96 F.2d 337, 340 (7th Cir.), *cert. denied*, 305 U.S. 622 (1938); see *Estate of Becker v. Commissioner*, 2 T.C.M. (CCH) 341, 346 (1943).

113. *Kilgallon v. Commissioner*, 96 F.2d 337, 340 (7th Cir.), *cert. denied*, 305 U.S. 622 (1938).

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

115. *Id.* at 357.

116. *Id.* at 360; *Kilgallon v. Commissioner*, 96 F.2d 337, 340 (7th Cir.) *cert. denied*, 305 U.S. 622 (1938).

117. *United States v. Davidson*, 115 F.2d 799, 801 (6th Cir. 1940). Voluntary action could not have occurred since two of the beneficiaries did not know of the trust for six months. *Id.*

118. *Id.* at 802.

119. *Id.* at 801. In *Morrissey v. Commissioner*, 296 U.S. 344 (1935), the Court stated the reverse side of this rule: "While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms . . . cannot be regarded as decisive." *Id.* at 358.

120. *United States v. Davidson*, 115 F.2d 799, 801 (6th Cir. 1940).

ciaries to operate a business venture. Under such circumstances, the trust is an association taxable as a corporation.<sup>121</sup>

## 2. Business Conducted for Profit

Even if two or more persons have associated themselves in a joint effort and in a form that bears a substantial resemblance to a corporation, the organization is not an association taxable as a corporation unless the joint effort amounts to the conduct of a business for profit.<sup>122</sup> The phrase "conduct of a business for profit" contains two distinct concepts: initially there must be an active conduct of a business and, further, a profit motive must exist with respect to the business conducted.

Profits may be derived from investments, such as royalty interest, that require no particular management decisions. This is the case where the trustee's primary responsibility is to collect income and distribute the proceeds net of expenses. A distinction should be drawn between those trusts formed for investment purposes based upon the powers conferred upon the trustee by the trust agreement and other trusts. If the trustee has power under the trust agreement to vary the investment of the beneficiaries, the trust will be considered an association. Conversely, if the trust is a fixed investment trust wherein no such powers exist, it will be treated as a pure trust.<sup>123</sup> Competent tax planning requires notice of the fact that the mere presence of such powers has been held sufficient to cause the trust to be treated as an association.<sup>124</sup>

In the oil and gas industry there is revived interest in the use of royalty trusts. Typically, the trusts are created as a means of financing or for the purpose of effecting distributions to shareholders.<sup>125</sup> Recent examples of such trusts include those created by Houston Oil and Minerals, Mesa Petroleum Co., and Southland Royalty Co.<sup>126</sup> The classification issue for these trusts tends to turn on whether conduct of business for a profit is present.<sup>127</sup> Due to a myriad of related tax consequences involving the cre-

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121. *Kilgallon v. Commissioner*, 96 F.2d 337, 339 (7th Cir. 1938); *Leszczynski v. Commissioner*, 29 B.T.A. 551, 557 (1933).

122. *Treas. Reg. § 301.7701-2(a)(2)*; see *Morrissey v. Commissioner*, 296 U.S. 344, 356 (1935).

123. *Treas. Reg. § 301.7701-4(c)*; see *Commissioner v. North Am. Bond Trust*, 122 F.2d 545 (2d Cir. 1941), *cert. denied*, 314 U.S. 701 (1942).

124. *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369, 373-74 (1935); *Hoersting Family Trust v. Commissioner*, 4 T.C.M. (CCH) 810, 812 (1945).

125. Liquidating trusts, which are not subject to treatment as associations taxable as corporations, are defined as trusts "formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business." *Treas. Reg. § 301.7701-4(d)*. A liquidating trust may become a taxable association, however, by unduly prolonging the liquidation or by obscuring the liquidating purpose with business activities. *Id.* Liquidating trusts are frequently formed to receive assets that are difficult to sell within the 12-month liquidating period specified in I.R.C. § 337 (West 1978 & Supp. 1983).

126. See Pearl, *Too Clever by Half?*, *FORBES*, July 6, 1981, at 43.

127. In *Porter Property Trustees, Ltd. v. Commissioner*, 42 B.T.A. 681 (1940), the Board stated that even a strict trust may be an association taxable as a corporation "if it is at the same time conducted for profit." *Id.* at 690; see *Hoersting Family Trust v. Commissioner*, 4

ation of these trusts, the Service initially stated that it would not issue advance rulings on "[w]hether a trust which is beneficially owned by the shareholders of the settlor corporation is a trust for federal income tax purposes if the corporation . . . retains working interests in oil, gas, or mineral properties, the royalty interests of which properties are transferred to the trust."<sup>128</sup> Recently, however, the Service announced that it will issue rulings in this area.<sup>129</sup>

A private letter ruling issued before the initial ban on advance rulings considered the tax consequences of such organizations.<sup>130</sup> The ruling involved a corporation and one of its subsidiaries that formed a partnership to which certain overriding royalty interests were transferred. A separate trust was created for the purpose of selling beneficial interest certificates to the public and using the proceeds of the offering to acquire a ninety-nine percent interest in the partnership. The service held that the entity constituted a fixed investment trust taxable as a trust since the trustee possessed no power to alter the investment of the certificate holders. The ruling noted that the trust could make temporary investments of the income prior to the time distributions were made to certificate holders. These temporary investments prior to distribution, however, did not constitute the carrying on of a trade or business.<sup>131</sup>

Although the conduct of business without a profit objective is relatively rare, examples may be found in organizations that are formed to furnish services or supply products to members of the organization. In one such case under the 1939 Code three corporations bought and operated a power plant exclusively for their mutual benefit through a committee composed of one representative from each corporation. The joint operation was held not to be an association taxable as a corporation because the court emphasized that profit was not the objective of the cooperative arrangement.<sup>132</sup> Subsequently the Tax Court rejected this conclusion in *Madison Gas & Electric Co. v. Commissioner*.<sup>133</sup> In a similar factual situation the partnership agreement contained a take-in-kind provision. The court determined that the joint profit motive was present with the in-kind distribution of electricity from the power plant, and that the organization should, therefore, be classified as a partnership.<sup>134</sup>

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T.C.M. (CCH) 810 (1945); *National Bank of Commerce v. Commissioner*, 34 B.T.A. 119 (1936).

128. Rev. Proc. 82-22, 1982-1 C.B. 469.

129. Rev. Proc. 83-11, 1983-8 I.R.B. 14.

130. Ltr. Rul. 8113068 (Dec. 31, 1980); *see also* Ltr. Rul. 8223015 (trust created to effect distribution to shareholders treated as trust).

131. *See Commissioner v. North Am. Bond Trust*, 122 F.2d 545, 546 (2d Cir. 1941); Rev. Rul. 75-192, 1975-1 C.B. 384.

132. *Cooperative Power Plant v. Commissioner*, 41 B.T.A. 1143, 1149 (1940); *see also Cooperative Ins. v. Commissioner*, 41 B.T.A. 1151 (1940) (cooperative service joint agency formed by three corporations to administer workmen's compensation claims held not association taxable as corporation).

133. 72 T.C. 521 (1979).

134. *Id.* at 561-62. Similarly, a joint profit motive exists where partners in an oil and gas

### 3. Centralized Management

The Treasury Regulations state that centralized management exists if any person or group of persons not constituting all the members of the organization has continuing exclusive authority to make management decisions in order to conduct the affairs of the organization.<sup>135</sup> This quality is, however, characteristic of most business enterprises. In limited partnerships, for example, the general partners are the parties vested with management of the enterprise. In such cases centralized management exists if substantially all the partnership interests are held by limited partners.<sup>136</sup> If the general partners own substantial interests in the partnership, however, centralized management is lacking. Based on the holding of substantial ownership interests, the general partners presumably make decisions largely for their own benefit rather than for the other members. Hence, the general partners are not deemed to be acting in a representative capacity.<sup>137</sup> The Service will rule that centralized management is not present if the general partners own twenty percent or more of the capital or profits of the partnership.<sup>138</sup> In addition to the ownership requirements, the right of the limited partners to remove the general partner may cause the organization to possess centralized management.<sup>139</sup> The determination is primarily one of fact. If the limited partner's right to removal is substantially restricted, as in the event of theft or embezzlement, then the partnership will not necessarily possess centralized management.<sup>140</sup> Apparently the right of removal must be exercised by most of the limited partners and must not be restricted in order for centralized management to exist. In a general partnership all of the partners have the right to incur obligations on behalf of the partnership insofar as the relation of the partnership to outsiders may be concerned,<sup>141</sup> even though the partners between themselves may have agreed that such authority is vested only in a managing partner or group of partners. As a consequence, a general partnership is not deemed to have centralization of management.<sup>142</sup>

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partnership have the right to take oil and gas in kind. *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565, 571 (1953).

135. Treas. Reg. § 301.7701-2(c)(1).

136. *Id.* § 301.7701-2(c)(4).

137. *Zuckman v. United States*, 524 F.2d 729, 738-39 (Ct. Cl. 1975); *Larson v. Commissioner*, 66 T.C. 159, 177 (1976).

138. *See* 1 W. McKEE, W. NELSON & R. WHITMIRE, *supra* note 2, § 3.06[4][b], at 3-50 (1977).

139. The Service recently amended the regulations to deal with such situations. *See* Treas. Reg. § 301.7701-2(c)(4).

140. In *Larson v. Commissioner*, 66 T.C. 159 (1976), the general partner's interest in the partnership terminated on dismissal of the general partner by the limited partners, such that the general partner was held not to have the independent proprietary interest of a typical general partner. *Id.* at 177-79. Additionally, the finding of centralized management was supported by the fact that the limited partners held substantially all the interests in the partnership. *Id.* at 177, 179.

141. UNIF. PARTNERSHIP ACT § 9(1), 6 U.L.A. 132 (1969).

142. Treas. Reg. § 301.7701-2(c)(4); *see* Rev. Rul. 75-19, 1975-1 C.B. 382.

#### 4. *Continuity of Life*

The common corporate characteristic of continuity of life exists if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.<sup>143</sup> Dissolution means the alteration of the relationships among the members of an organization by application of local law.<sup>144</sup> A corporation is not affected by the death or incapacitation of its members. A corporate shareholder may withdraw his investment in a corporation only by finding a buyer for his shares or upon liquidation, whereas, barring an agreement to the contrary, a partner has the ability to withdraw from continued participation in the venture, thus causing the partnership to terminate.<sup>145</sup> Hence, continuity of life means that (1) a member, once in the organization, is limited in the means by which he may withdraw, and (2) the organization itself continues in spite of changes in the identity or character of its members.

Frequently, members of a partnership suffer a substantial detriment if the venture does not continue to the specified transaction date or at least until all of the partners have fulfilled their obligations under the agreement. To so provide in the partnership agreement runs afoul of the continuity test whether, theoretically, the specified term was one day, a year, or several years.<sup>146</sup> The agreement may, however, provide that the partnership continue for a specified term, abrogate the usual termination because of withdrawal, and provide a substantial economic penalty upon any partner, general or limited, who decides to withdraw at an earlier date. So long as each partner has a right to withdraw, even though such right is subject to penalty, the entity apparently lacks continuity, but this conclusion may be subject to question by the Service.

As previously noted, the term "dissolution" means a change in the relationship among the members of an organization by operation of local law. Members of a partnership frequently provide in the agreement that the remaining partners may continue the business despite the death, bankruptcy, or withdrawal of any partner. For example, assume the remaining partners may reform the partnership within thirty days after dissolution. In this situation the partnership does not necessarily possess continuity of life.<sup>147</sup> If the death, bankruptcy, or withdrawal of a partner causes a dissolution by operation of local law in spite of the terms of the agreement, then

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143. Treas. Reg. § 301.7701-2(b)(1).

144. *Id.* § 301.7701-2(b)(2).

145. Because of this right to terminate the partnership, "a general partnership subject to a statute corresponding to the Uniform Partnership Act and a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act both lack continuity of life." *Id.* § 301.7701-2(b)(3).

146. *Id.* § 301.7701-2(b)(2).

147. In *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176 (1942), the general partners reserved the right to continue the business on the death, incapacity, or retirement of a general partner. The Board held that this form of "contingent continuity," whereby the remaining general partners must agree to continue the business of the partnership, did not fulfill the corporate characteristic of continuity of life. *Id.* at 185-86.

continuity of life is lacking.<sup>148</sup> The practical effect of the agreement in these circumstances is to cause a dissolution of the partnership followed by formation of a new partnership by the remaining partners.<sup>149</sup>

### 5. *Transferability of Interest*

Provided a buyer can be found, corporate shareholders are usually free to dispose of their interests or shares in the corporation. Partners, however, must usually obtain the consent of the other partners before transferring their interests since partners reserve the right to select their business associates.<sup>150</sup> Thus, transferability of interests, a corporate characteristic, exists if the members owning substantially all the interests may transfer such interests to a third party without the consent of the other members.<sup>151</sup> Both general and limited partners must, unless the agreement provides otherwise, obtain consent of all the partners before transferring their interests in the organization.<sup>152</sup> The Service generally holds that the transferability of interest attribute is not present if a limited partner must obtain the consent of the general partner or partners to transfer his partnership interest and have the transferee considered a substituted partner under local law. The attribute is also lacking if a transfer of a partnership interest effects a dissolution, under local law, of the old organization and a formation of a new organization.<sup>153</sup>

Of interest in this area are the myriad of new publicly traded partnerships such as Apache Petroleum Co., May Energy Partners, and others. In these arrangements the limited partnership interests are freely tradable on exchanges or over the counter markets.<sup>154</sup> At one time free transferability of partnership interests alone was presumed to cause the Service to attack the entity as an association. Currently, however, the Service may rule favorably as to the partnership status of these tradable entities.<sup>155</sup>

### 6. *Limited Liability*

Limited liability exists if, under local law, no member is personally liable for the debts of the organization.<sup>156</sup> General partnerships subject to the Uniform Partnership Act do not possess this attribute since personal liability exists with respect to each general partner.<sup>157</sup> Limited partnerships do not have limited liability because the general partner is responsi-

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148. Treas. Reg. § 301.7701-2(b)(2).

149. See Rev. Proc. 83-50, 1983-27 I.R.B. 142. The Service will not rule whether continuity of life exists if, upon removal of a general partner, less than a majority vote in interest of the limited partners may elect a new one. *Id.*

150. See UNIF. PARTNERSHIP ACT § 18(g), 6 U.L.A. 213 (1969).

151. Treas. Reg. § 301.7701-2(e)(1).

152. See UNIF. PARTNERSHIP ACT § 18(g), 6 U.L.A. 213 (1969); UNIF. LIMITED PARTNERSHIP ACT § 19(4), 6 U.L.A. 603 (1969).

153. Treas. Reg. § 301.7701-2(e)(1).

154. See Mack, *Disincorporating America*, FORBES, Aug. 1, 1983, at 76.

155. Ltr. Rul. 8241100 (July 19, 1982).

156. Treas. Reg. § 301.7701-2(d)(1).

157. UNIF. PARTNERSHIP ACT § 15, 6 U.L.A. 174 (1969).



ble for partnership debts.<sup>158</sup> If, however, the general partner does not have substantial assets other than its partnership interest and is, in effect, a dummy, limited liability exists. A general partner is a dummy if it acts as the agent of the limited partners.<sup>159</sup> In one Tax Court case the general partner was not considered a dummy, even though subject to removal by the limited partners, because the court found that the general partner was very active in the business and did not merely carry out the limited partner's wishes.<sup>160</sup> Further, the right of removal gave the limited partners control only over their investment, not control of operations.<sup>161</sup> What constitutes substantial assets for an individual general partner is not clear. Substantial assets apparently exist if the general partner's assets are large in comparison to the assets of individuals, even though insufficient to cover the partnership's liabilities. If the general partner or partners' assets are insignificant, however, the limited partners have effectively insulated themselves from liability and the corporate attribute of limited liability is present. The Service has provided, at least for ruling purposes, a more objective test for determining whether a *corporate* general partner of a limited partnership has substantial assets.<sup>162</sup>

*C. Special Problems Relating to Limited Partnerships and Limited Liability Companies*

*1. Corporate Characteristics and Limited Partnerships—The Larson Case*

Limited partnerships rather than general partnerships have been a frequent object of scrutiny in determining classification for taxation purposes. *Larson v. Commissioner*<sup>163</sup> provides an excellent example of the scrutiny a limited partnership may undergo in the resolution of the classification issue. The initial opinion by the Tax Court in that case was favorable to the government in classifying the limited partnership as an association.<sup>164</sup> The decision caused considerable concern in the tax community due to fears that most limited partnerships would thereafter be considered associations. The full Tax Court subsequently reconsidered the case and held in favor of the taxpayer.<sup>165</sup> In *Larson* two limited partnerships were formed. One acquired an apartment complex and the other acquired an orchard with future development potential. Because the two partnerships were similar in structure, the court considered them together.<sup>166</sup> Upon review of prior case law, the full Tax Court noted the continuing significance of the basic

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158. Generally speaking, a general partner in a limited partnership is subject to the same restrictions and liabilities as a general partner in a general partnership. UNIF. LIMITED PARTNERSHIP ACT § 9(1), 6 U.L.A. 586 (1969).

159. Treas. Reg. § 301.7701-2(d)(2).

160. *Larson v. Commissioner*, 66 T.C. 159, 181 (1976).

161. *Id.*

162. See *infra* notes 179-85 and accompanying text.

163. 66 T.C. 159 (1976).

164. 65 T.C. No. 10 (1975) (opinion withdrawn on Nov. 7, 1975). This opinion was favorable since an association is taxable as a corporation.

165. 66 T.C. 159 (1976).

166. The same corporation served as the general partner in both limited partnerships.

concept enunciated in *Morrissey*<sup>167</sup> that “[a]n organization will be taxed as a corporation if, taking all relevant characteristics into account, it more nearly resembles a corporation than some other entity.”<sup>168</sup> The court further observed that the apparent intent of the applicable regulations was to give each major corporate characteristic equal weight in the final classification of the entity.<sup>169</sup>

The court reviewed each corporate attribute in detail before determining that the limited partnerships were taxable as such. Continuity of life was lacking because the bankruptcy of the general partner would cause dissolution. The fact that a 100% vote of the limited partners could result in the appointment of a new general partner did not change the conclusion. Relying on *Glensder Textile Co. v. Commissioner*,<sup>170</sup> the court determined that contingent continuity of life is not a corporate characteristic.<sup>171</sup> Centralized management was present in each partnership since the general partner did not have a substantial proprietary interest<sup>172</sup> and could be removed by vote of the limited partners, similar to the director of a corporation.<sup>173</sup> The court also found the attribute of free transferability of interests. Although the partnership agreement placed some restrictions on transfer, they did not apply to transfers for fair market value.<sup>174</sup> Finally, the organizations lacked limited liability since the general partner was not a dummy of the limited partners but rather took an active part in management of the venture.<sup>175</sup> Since the limited partnerships did not exhibit a preponderance of corporate characteristics and since each characteristic is to be given equal weight, the partnerships were treated as such.<sup>176</sup> The court stated that its decision was based on the framework provided by the regulations.<sup>177</sup> The court also indicated that the Service should attack the limited partnership form by legislative or additional administrative action, not by attempting to diminish the importance or alter the construction of the existing regulations.<sup>178</sup>

## 2. Ruling Policies—Limited Partnerships

Since limited partnerships are a popular form of investment, the rele-

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167. *Morrissey v. Commissioner*, 296 U.S. 344, 354-55 (1935).

168. 66 T.C. at 172; *see* *Bush #1 v. Commissioner*, 48 T.C. 218, 227-28 (1967).

169. 66 T.C. at 172.

170. 46 B.T.A. 176 (1942).

171. 66 T.C. at 174-75.

172. *Id.* at 177-79.

173. *Id.* at 178.

174. *Id.* at 183. The general partner's approval was required before a limited partner could transfer his or her interest, but such approval could not unreasonably be withheld. The limited partners' interests were nonetheless held to be freely transferable.

175. *Id.* at 181. The Commissioner argued in *Larson* that limited liability existed if the general partner lacked substantial assets *or* was acting merely as a dummy for the limited partners, contrary to the conjunctive language of the regulations. *See* Treas. Reg. § 301.7701-2(d)(2). The court held that both conditions of the regulation must be satisfied. 66 T.C. at 180.

176. *Id.* at 185.

177. *Id.* at 185-86.

178. *See id.*

vant characteristics and ruling policies that will affect the classification of such an entity deserve examination. For many years, the general partner of a limited partnership was typically a corporation possessing few or no assets in order to avoid liability to the promoters of the partnership. The theory was that at least two of the other three corporate attributes (i.e., centralized management, continuity of enterprise, and transferability of interest) could be avoided, and therefore, the partnership status of the limited partnership would not be affected even if the corporate attribute of limited liability were present. To avoid this result, the Service as a matter of ruling policy requires that a sole corporate general partner of a limited partnership have, exclusive of its partnership interest, assets that are "substantial" in relation to the capital contributions of the limited partners.<sup>179</sup> This policy finds support in a Board of Tax Appeals decision that stated "[i]f, for instance, the general partners were not men with substantial assets risked in the business, but were mere dummies without real means acting as the agents of the limited partners, whose investments made possible the business, there would be something approaching the corporate form of stockholders and directors."<sup>180</sup>

In 1972 the Service formalized its ruling policy relating to limited partnerships having a sole corporate general partner and announced that it would issue rulings concerning the partnership status of such a limited partnership only if the sole corporate general partner had a net worth at all times during the life of the partnership as follows:

If the corporate general partner has an interest in only one limited partnership and total [capital] contributions to the partnership are less than \$2,500,000, the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions [to the partnership] or \$250,000, whichever is [smaller];

if [the corporate general partner has an interest in only one limited partnership and] the total [capital] contributions to the partnership are \$2,500,000 or more, the net worth of the corporate general partner at all times will be at least 10 percent of such total contributions.<sup>181</sup>

In computing net worth under both requirements, the fair market value of the corporate general partner's assets is used.<sup>182</sup> In making the net worth calculation, the value of the corporate general partner's interests in the limited partnership, presumably whether as a general partner or as a limited partner, and accounts and notes receivable from and payable to the limited partnership are excluded.<sup>183</sup> If the corporate general partner holds interests in more than one limited partnership, both net worth requirements are applied separately for each limited partnership and the corporate general partner must have a net worth at least as great as the sum of

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179. Rev. Proc. 72-13, 1972-1 C.B. 735. The regulation requires that the general partner have substantial assets, without providing a reference point from which to measure the adequacy of such assets. Treas. Reg. § 301.7701-2(d)(2).

180. *Glensder Textile Co. v. Commissioner*, 46 B.T.A. 176, 183 (1942).

181. Rev. Proc. 72-13, 1972-1 C.B. 735.

182. *Id.*

183. *Id.*

the amounts required under either requirement for each separate limited partnership.<sup>184</sup>

In addition, the 1972 pronouncement of ruling policy requires that (1) the limited partners cannot own, directly or indirectly (as determined under section 318), more than 20 percent of the stock of the corporate general partner or any of its affiliates, as determined under section 1504, (2) the purchase of a limited partnership interest cannot entail an option or a requirement to purchase any type of security in the corporate general partner, and (3) the limited partnership must be organized and operated in accordance with applicable local law.<sup>185</sup> The Service applies these guidelines rather strictly. Private rulings indicate that the partnership status of the particular limited partnership is dependent on continued compliance with the guidelines.<sup>186</sup> The implication is, therefore, that if the partnership fails to satisfy the above ruling requirements, regardless of the absence of two or more of the other corporate attributes such as centralized management, continuity of enterprises, and transferability of interest, the Service might deem the partnership to be an association. A more logical conclusion would be that if the requirements are not met, the advance ruling is invalid. The approach the Service will take in this area remains to be seen.

These requirements apply, however, only to the issuance of advance rulings as to partnership status in situations where a limited partnership has a corporation as its *sole* general partner. Apparently if a limited partnership has more than one corporate general partner, the net worths of the corporations can be aggregated to meet the requirements, although the Service's ruling policy is not clear in this area. If the limited partnership has one or more noncorporate general partners, the ruling requirements do not seem to apply and the only requirement is that a representation be made that the noncorporate general partner or partners are not judgment-proof and have substantial assets that can be reached by creditors.<sup>187</sup> Such a representation is generally satisfactory for advance ruling purposes.

One question that has arisen regarding the computation of net worth under the requirements is whether the value of a subscription receivable, account receivable, demand note receivable, or other note receivable from an affiliate can be included as an asset. If the receivable bears interest so that it can be readily valued and could be attached by creditors, it should qualify as an asset for purposes of the net worth test. Determining the proper measure of the total contributions to the partnership when partnership contributions are paid in installments presents another problem. If a limited partnership intends to have the limited partners contribute \$500,000 in each of three years, totalling \$1,500,000 over the three years, it

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184. *Id.* This computation is exclusive of interest in any limited partnership, presumably whether as general partner or as a limited partner, and accounts and notes receivable from and payable to any limited partnership in which the corporate general partner has any interest. *Id.*

185. *Id.*

186. *See, e.g.*, Ltr. Rul. 8202097 (Oct. 16, 1981).

187. Treas. Reg. § 301.7701-2(d)(2).

is generally understood that the Service will apply the fifteen percent requirement to the total of \$1,500,000, not to an amount that increases by \$500,000 each year. Additionally, if a corporate partner initially meets the net worth requirements but subsequently its net worth falls below the required amount, the result is uncertain. The logical result would be that the ruling is invalidated,<sup>188</sup> but the classification of the entity as a limited partnership should not be altered. Subsequent changes in fortune caused by events outside the control of the parties should not cause reclassification. Caution is required when confronting such a situation since the Service has given no indication of its view of such events.

Another area of ruling policy regarding limited partnership has concerned the Service since early 1973. This question involves the necessity of the general partner or partners having an interest in the partnership profits and losses throughout the life of the partnership. Historically, in many limited partnerships and natural resources limited partnerships it has been customary and allowable under section 704 to allocate all losses to the limited partners at least to the extent they provide the cash that creates such losses. Further, in some cases limited partners receive all of the income until they recover their original investment. Thereafter the general partner or partners share profits with the limited partners. The Service apparently finds such allocations in limited partnerships objectionable regardless of section 704. As a result of its concern, the Service issued a Revenue Procedure in 1974 that states that rulings will not ordinarily be issued unless the aggregate partnership interests of all general partners in each material item of partnership income, gain, loss, deduction, or credit are equal to at least one percent of each of such items at all times during the life of the partnership.<sup>189</sup> Any interest owned by the general partners as limited partners is ignored in computing the one percent interest. This ruling policy, as indicated above, seems to preclude a special allocation under section 704 of all IDC to limited partners providing the cash for such costs. Under the Service's policy, either one percent of such costs must be allocated to the general partners, which would seem to violate the substantial economic effect requirement of section 704<sup>190</sup> if the general partners do not bear any economic burden for such costs, or the general partners must provide one percent of the cash for such costs. Whether such ruling policy can override seemingly permissible allocations under section 704 will presumably be decided by litigation.

The 1974 Revenue Procedure also requires certain additional representations for advance ruling purposes to the effect that aggregate deductions claimed by the partners during the first two years will not exceed the amount of equity capital invested in the limited partnership and any creditor making a nonrecourse loan to the partnership may not receive an inter-

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188. See Rev. Proc. 72-13, 1972-1 C.B. 735; Ltr. Rul. 8202097 (Oct. 16, 1981).

189. Rev. Proc. 74-17, 1074-1 C.B. 438.

190. See I.R.C. § 704(b)(2) (1976); Treas. Reg. § 1.704-1(b)(2); Prop. Treas. Reg. § 1.704-1(b)(2), 48 Fed. Reg. 9873 (Mar. 9, 1983).

est in the profits, capital, or property of the limited partnership in a capacity other than as a creditor.<sup>191</sup> Both of these representations cause difficulties for limited partnerships involved in natural resources exploration and development. If a natural resource limited partnership is successful early in its life and can arrange a nonrecourse loan for development purposes, it may be required to defer such development until after the end of its second year of existence if the nonrecourse loan will create deductions in excess of its equity capital, thereby causing possible interruption of normal business activities. If a nonrecourse lender requires an option on production as a condition to the loan, the Service may allege that such option constitutes an interest in partnership property that violates the representations mandated by the 1974 Revenue Procedure.<sup>192</sup>

### 3. *The Limited Liability Company*

More recently, a classification problem has arisen out of the creation of the limited liability company. The first such company was created in 1977 when the State of Wyoming enacted a statute creating the Wyoming limited liability company.<sup>193</sup> The organization is a hybrid between a corporation and a limited partnership, similar in form to the Spanish law *limitada*. The limited liability company provides, for federal income tax purposes, the conduit aspect of a partnership as well as limited liability to its members. The administrative problems of some of the more exotic entities, such as the Spanish law *limitada*, are avoided.<sup>194</sup>

The classification issue with respect to the limited liability company has caused the Service a great deal of consternation. Initially, in a private letter ruling the Service concluded that the organization should be treated as a partnership for federal income tax purposes.<sup>195</sup> Almost concurrently with the issuance of the ruling, however, the Service issued proposed amendments to the regulations that stated that an organization will be treated as an association if under local law no member is personally liable

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191. Rev. Proc. 74-17, 1974-1 C.B. 438, 439, provides:

[1.] The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.

[2.] A creditor who makes a nonrecourse loan to a limited partnership must not have or acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor.

192. In 1975 the Service issued Rev. Proc. 75-16, 1975-1 C.B. 676, relating to the issuance of private rulings for limited partnerships. This Revenue Procedure provides a checklist for advanced rulings for both general and limited partnerships, and focuses on many of the issues normally associated with the formation and operation of natural resources partnerships. *Id.*

193. Wyoming Limited Liability Company Act, 1977 Wyo. Sess. Laws 537 (codified at WYO. STAT. ANN. §§ 17-15-101 to -136 (1977 & Supp. 1983)).

194. For a more detailed comparison of the various entities, see Burke & Sessions, *The Wyoming Limited Liability Company: An Alternative to Sub S and Limited Partnerships?*, 54 J. TAX'N 232 (1981).

195. Ltr. Rul. 8106082 (Nov. 18, 1980).

for the debts of such organization.<sup>196</sup> The Service later announced that the amendments were to be withdrawn for further consideration.<sup>197</sup> Currently, the Service will not issue advance rulings on the classification of limited liability companies.<sup>198</sup>

In order to analyze the classification issue, one must review the applicable statute. Under the Wyoming statute, for example, the organization clearly possesses the attribute of limited liability.<sup>199</sup> Depending upon the structure of the agreement, however, the company may or may not possess centralized management. The Wyoming statute allows for a flexible management structure.<sup>200</sup> Should the members, via the agreement, confer continuing exclusive authority to a member to act on behalf of the organization, then centralized management will exist. If this feature is omitted from the agreement then each member has management authority and the attribute will be lacking.<sup>201</sup> A limited liability company also lacks continuity of life since the same factors that would cause dissolution of a partnership are present in the organization.<sup>202</sup> Further, transferability of interest should be held lacking. The ownership interests are transferable,

196. Prop. Treas. Reg. § 301.7701-2(a)(2)-(3), 45 Fed. Reg. 75,709 (Nov. 17, 1980).

197. I.R.-82-145 (Dec. 16, 1982), *reprinted in* 2 FED. TAXES (P-H) ¶ 54,704, at 54,591 (1983).

198. Rev. Proc. 83-15, 1983-11 I.R.B. 9.

199. WYO. STAT. ANN. § 17-15-113 (1977) provides:

Neither the members of a limited liability company nor the managers of a limited liability company managed by a manager or managers are liable under a judgment, decree or order of a court, or in any other manner, for a debt, obligation or liability of the limited liability company.

200. *Id.* § 17-15-116 provides:

Management of the limited liability company shall be vested in its members in proportion to their contribution to the capital of the limited liability company, as adjusted from time to time to properly reflect any additional contributions or withdrawals by the members; however, if provision is made for it in the articles of organization, management of the limited liability company may be vested in a manager or managers who shall be elected by the members in the manner prescribed by the operating agreement of the limited liability company. . . . The manager or managers shall also hold the offices and have the responsibilities accorded to them by the members and set out in the operating agreement of the limited liability company.

201. *Id.* § 17-15-117 provides:

[N]o debt shall be contracted or liability incurred by or on behalf of a limited liability company, except by one (1) or more of its managers if management of the limited liability company has been vested by the members in a manager or managers or, if management of the limited liability company is retained by the members, then by any member.

202. *Id.* § 17-15-123(a) provides:

A limited liability company . . . shall be dissolved upon the occurrence of any of the following events:

(i) When the period fixed for the duration of the limited liability company shall expire;

(ii) By the unanimous written agreement of all members; or

(iii) Upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event which terminates the continued membership of a member in the limited liability company, unless the business of the limited liability company is continued by the consent of all the remaining members under a right to do so stated in the articles of organization of the limited liability company.

but without the written consent of the other members the transferee is unable to step into the shoes of the transferor with respect to the membership and management rights of the transferor.<sup>203</sup> Accordingly, since the organization lacks a preponderance of corporate characteristics it should be treated as a partnership.

#### 4. *Limited Liability—The Only Relevant Factor?*

As illustrated by the controversy over the proper classification of the Wyoming limited liability company, the Service has taken a very dim view toward organizations having the characteristic of limited liability. The apparent thrust of the Service's actions in proposing to amend the regulations is to make clear that limited liability is the single most important corporate characteristic for taxation purposes. This position is not, however, supported by well-established case law. *Morrissey* established the fundamental principles for determining the federal income tax classification of organizations and provided the overriding principle that corporate resemblance governs classification. Resemblance is determined by comparing the corporate attributes identified in *Morrissey* to the features of the organization in question. As indicated earlier, no one attribute controls to the exclusion of the others and each attribute is weighed equally. The prominence of *Morrissey* is evidenced by the substantial body of case law that has followed its dictates for the past forty-eight years and the Service's historical adherence to *Morrissey*. A concrete example of *Morrissey's* importance is the current definition of "association" in the Treasury Regulations, which is squarely based on the *Morrissey* decision. These regulations were issued over twenty years ago. In addition, the administrative rulings have consistently followed the *Morrissey* decision and its progeny. The courts have consistently held that long-standing administrative rulings should not be lightly overturned and that when such interpretations and rulings continue unchanged under unamended statutes, they should be considered as having the force and effect of law.<sup>204</sup> Taxpayers and the Service alike depend on the reliability and enforceability of the administrative rulings, regulations, and case law in determining their course of action. If the Service is reluctant to concede the issue of classification because of potential tax avoidance possibilities, a means is already

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203. *Id.* § 17-15-122 provides:

The interest of all members in a limited liability company constitutes the personal estate of the member, and may be transferred or assigned as provided in the operating agreement. However, if all of the other members of the limited liability company other than the member proposing to dispose of his or its interest do not approve of the proposed transfer or assignment by unanimous written consent, the transferee of the member's interest shall have no right to participate in the management of the business and affairs of the limited liability company or to become a member. The transferee shall only be entitled to receive the share of profits or other compensation by way of income and the return of contributions, to which that member would otherwise be entitled.

204. *Helvering v. Winmill*, 305 U.S. 79, 83 (1938); *Dismuke v. United States*, 297 U.S. 167, 173-74 (1936); *Universal Battery Co. v. United States*, 281 U.S. 580, 583 (1930).



available to combat such problems. The at-risk provisions of section 465<sup>205</sup> may be used to disallow deductions by any members in excess of the amount invested in the organization.

#### IV. CONCLUSION

The area of entity classification for federal income tax purposes is one in which the Service continues to express considerable interest. Because of the well-established classification guidelines provided by the *Morrissey* case, however, the Service has been generally unsuccessful at trying to change the classification rules by regulative or administrative rulings. If the rules, which have served all parties relatively well for many years, are to be changed, and this author does not believe that they should, it should be done by legislation so that both the Service and interested taxpayers can have an opportunity to express their views.

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205. I.R.C. § 465 (West 1978 & Supp. 1983).