

EXECUTIVE SUMMARY

In today's economy, many business entities taxed as partnerships³ for Federal tax purposes hold real properties that have fair market values below the adjusted tax bases of those properties (referred to in this paper as "loss property"). Many partnerships need to dispose of loss property to pay creditors or to move the loss property into the hands of others to remarket and redevelop the loss property.

Generally, if a partnership sells a loss property, the partnership can recognize and claim a loss on the sale, which may be an ordinary or capital loss. The partnership then generally can pass the loss through to its partners. Many loss limitation provisions at the partner level may suspend or limit the use of those losses by the partners.

Related party sale rules in Sections 267 and 707(b)(1) of the Internal Revenue Code of 1986, as amended,⁴ can apply to prevent a partnership from recognizing a loss that it realizes from a sale or exchange. Under those rules, the related taxpayer generally can use the disallowed loss to offset any gain recognized from the later sale or exchange of the loss property.

Section 267 originated with provisions that predate the Internal Revenue Code of 1939. Congress enacted Section 707(b)(1) when it enacted the partnership tax provisions of Subchapter K as part of the Internal Revenue Code of 1954. Neither of those provisions expressly dealt with sales of loss property by partnerships to persons related to partners, such as spouses or controlled corporations. In 1958, Treasury and the Service issued Treasury Regulation Section 1.267(b)-1(b) (the "Non-Partner Regulations") to govern those transactions. The Non-Partner Regulations apply an "aggregate" approach to partnerships by disallowing losses and deferring deductions as if the partners directly conducted the partnership transactions.

In 1982, 1984 and 1986, and as more fully discussed below, Congress significantly amended Sections 267 and 707(b)(1) for partnership

³ A reference to partnerships in this paper refers to limited liability companies, limited partnerships, limited liability limited partnerships, limited liability partnerships, general partnerships and other arrangements that are classified as partnerships under the classification provisions of Treas. Reg. § 301.7701-3.

⁴ All Section references are either to the Internal Revenue Code of 1986, as amended, or for Section references before October 22, 1986, to the Internal Revenue Code of 1954, as amended, unless otherwise specified.

transactions. In response to the 1984 statutory changes, Treasury and the Service issued Temporary Treasury Regulations § 1.267(a)-2T(c), Questions 2 and 3 (the “Partnership-to-Partnership Regulations”). The Partnership-to-Partnership Regulations disallow losses in whole or in part for sales of loss property between two partnerships generally without regard to the extent of overlapping common ownership of the partnerships. In contrast, Section 707(b)(1), as amended in 1986, expressly disallows the entire loss for sales between two partnerships, but only if the same persons, including related non-partners, own (actually or constructively through attribution) more than 50% of the capital or profits of both partnerships.

The legislative history to the 1986 amendments to Section 707(b)(1) indicates that those changes “are intended to replace” the Partnership-to-Partnership Regulations.⁵ Therefore, the 1986 statutory changes expressly nullify the Partnership-to-Partnership Regulations. This paper discusses why the 1986 and other statutory changes also nullify or give reason to withdraw the Non-Partner Regulations. Treasury and the Service have not yet formally withdrawn any part of the Partnership-to-Partnership Regulations or the Non-Partner Regulations. Section 7805 has at least since 1954 provided the authority to Treasury, delegated to the Service with approval, the power to change and withdraw those Regulations.⁶

This paper proposes that Treasury and the Service formally withdraw the Partnership-to-Partnership Regulations and the Non-Partner Regulations. Alternatively, this paper proposes that the Service issues a revenue ruling or other guidance which holds that those Regulations are no longer to be given effect. Those actions will eliminate the potential chilling effect on transactions caused by the Partnership-to-Partnership Regulations and the Non-Partner Regulations, their administrative burden on taxpayers and the government and their potential adverse affect on the recovery of the US economy.

⁵ S. Rep. No. 313, 99th Cong., 2d Sess. 980, reprinted in 1986-3 C.B. Vol. 3 960; Joint Committee on Taxation, *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation*, (JCS-11-87), 76 (May, 13, 1987).

⁶ Treas. Reg. § 301.7805-1(a); Treas. Reg. § 601.601(a)(1).

DISCUSSION

As stated in the Executive Summary, Treasury Regulations Section 1.267(b)-1(b) (the “Non-Partner Regulations”) and Temporary Regulations Section 1.267(a)-2T(c), Questions 2 and 3 (the “Partnership-to-Partnership Regulations”), apply the aggregate approach of partnerships to disallow losses or to defer deductions in transactions between partnerships and related non-partners, including other partnerships. The balance of this paper explains why Treasury and the Service should formally withdraw the Non-Partner Regulations and the Partnership-to-Partnership Regulations.

I. BACKGROUND AND UNDERLYING LAW

A. Before 1954

Section 267 has a long history that predates Section 24(b) of the Internal Revenue Code of 1939. It contains two distinct components: (i) disallowing losses from the sale or exchange of property and (ii) deferring accrued deductions until included in income by the payee when paid. This paper focuses on disallowance of losses because of the number of loss properties currently outstanding in the US economy, but the Non-Partner Regulations, Partnership-to-Partnership Regulations, and legislative and case history deal with both components.

The history of Section 267 is set forth in great detail in materials prepared for the 2010 New York University Annual Institute of Federal Taxation.⁷ This paper will not restate the full history, but instead will focus on the history most relevant to the Non-Partner Regulations and Partnership-to-Partnership Regulations.

Suffice it to say that until the enactment of Section 707 in Subchapter K in the Internal Revenue Code of 1954, no statutory provision expressly addressed loss disallowance from sales of loss property by partnerships either to partners or to non-partners. Instead, the courts applied the precursor of Section 267 to those transactions by treating a partnership as

⁷ Jennifer H. Alexander & Colleen McHugh, *Sections 267 and 707: Are Related Party Transactions Leaving You at A Loss*, 68-11 New York University Annual Institute on Federal Taxation, § 11.02 (2010). This same work acknowledges the continued uncertainty surrounding the Non-Partner Regulations and discusses two instances in which the IRS has applied the Non-Partner Regulations.

the aggregate of its partners and then applying the related party rules to the persons as non-partners.

The lead case is *Comm'r v. Whitney*.⁸ In *Whitney*, a partnership, J.P. Morgan & Co., sold in 1940 the assets of the partnership conducting a general banking business in New York City to a newly formed trust company. The 13 individual partners of the partnership signed the bill of sale along with the partnership. Those and other factors indicate that the partnership was a general partnership. The partners directly owned 72.9% of the corporate stock of the trust company. The assets included assets sold with gains and with losses. The partners netted the gains and losses. The Service disallowed the losses. The Tax Court in a fully reviewed decision without dissent held in favor of the partners because the losses were partnership losses not covered by the statute. The Second Circuit reversed. The court first characterized the predecessor statute to Section 267 as “passed as a part of the dramatic investigations of and legislative attack upon ‘tax evasion’ which developed as a concomitant of the great loss in security values from 1929 on to the date of the legislation.” The court then concluded that to preclude the statute from applying to the sale of assets by the partnership would create a loophole “almost as large as the one it was trying to close – from its prohibition against deductible losses upon transfers between closely related persons or groups.”

The other primary case is *Comm'r. v. Busche*.⁹ In *Busche*, a partnership owned approximately 71% and 29% by two men sold all of its assets to a corporation in 1947. Each of the men owned 50% of the stock of the corporation after considering the ownership of individual family members and each owned 100% of the shares after attributing stock owned by the other as partners. Mr. Busche conceded the disallowance of minor losses suffered by the partnership on the sale, but not the loss suffered on the liquidation of his partnership interest. The Tax Court, with dissent, disallowed that loss as well. The court relied upon *Whitney* in concluding that the transactions should be treated as a direct asset sale by the partners.

⁸ 169 F.2d 562 (2nd Cir. 1948).

⁹ 23 T.C. 709 (1955).

B. Before October 1982

In 1954, Congress enacted Section 707(b)(1).¹⁰ The committee reports for both the House and Senate expressed their intention to apply the entity approach in dealing with transactions between a partner and a partnership, but did not expressly describe the treatment of transactions with persons related to partnerships.¹¹

The tax provisions of Subchapter K also added Section 731(a)(2), which allows a partner to claim a loss in connection with the liquidation of the partner's partnership interest if the partner generally receives only a liquidating distribution of money. To coordinate with Section 731, Section 707(b)(1) expressly does not apply to losses incurred with respect to an interest in the partnership. Those changes would have forced the court in *Busche* to reach a different result had Section 731(a)(2) and Section 707(b)(1) been the law in 1947.

¹⁰ As initially enacted in the Internal Revenue Code of 1954, Section 707 read:

No deduction shall be allowed in respect of losses from sales or exchanges of property (*other than an interest in the partnership*), directly or indirectly between (A) a partnership and *partner* owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or (B) two partnerships in which the same *persons* own, directly or indirectly, more than 50 percent of the capital interests or profits interests. In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267(d) shall be applicable as if the loss were disallowed under section 267(a)(1). (Emphasis added).

¹¹ The Senate Report states:

When a partner sells property to, or performs services for the partnership, the problem arises whether the transaction is to be treated in the same manner as though the partner were an outsider dealing with the partnership (the "entity" approach). An alternative ("aggregate" approach) is to view the partner as dealing with himself to the extent of his own interest and as dealing with the partnership with respect to the balance of the transaction. The present code fails to cover the problem and judicial decisions on the subject go in both directions. Because of its simplicity of operation, the "entity" rule has been adopted by the House and your committee.

However, certain safeguards are included to prevent the sale of property between the partnership and a "controlling" partner for the purpose of recognizing losses or raising the basis of property. Under the rule provided by the House bill, a sale between the partnership and a partner will not be recognized if it involves a "controlling" partner, that is, a partner who owns 50 percent or more of a capital or income interest in the partnership. S. Rept. No. 1622, 83d Cong., 2d Sess. 92 (1954).

In 1958, Treasury and the Service issued the Non-Partner Regulations.¹² The Non-Partner Regulations apply the aggregate approach to partnerships so that a partner's share of losses or deductions are disallowed or deferred for transactions between the partnership and a person related to that partner regardless of the extent of the partner's percentage interest in capital or profits. For example, if A is a 15% partner of a partnership selling loss property to A's wholly owned corporation or to A's spouse, A would have his or her 15% share of the partnership's loss disallowed.

In September 1982, the US Tax Court in *Casel v. Comm'r*,¹³ analyzed whether the enactment of Section 707 changed the application of Section 267 to transactions between partnerships and persons related to partners and whether the Non-Partner Regulations were valid. *Casel* dealt with accrued, but unpaid management fees owed by a partnership to a corporation in 1974 and 1975, which pre-dated statutory changes described in the next paragraph. Mr. Casel owned a 50% interest in the partnership and he and his children wholly-owned the corporation. In denying a deduction for Mr. Casel's 50% share of the accrued, but unpaid fee, the *Casel* court first reviewed the conference committee report to Section 707. It stated that despite the entity approach, "No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions."¹⁴ The court then upheld the validity of the Non-Partner

¹² Treas. Reg. 1.267(b)-1(b). The full text reads:

Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and §1.707-1. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed — (i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and (ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction. [Examples omitted.]

¹³ 79 T.C. 424, 434 (1982).

¹⁴ H. Rept. No. 2543, 83d Cong., 2d Sess. 59 (1954).

Regulations as not an inconsistent or unreasonable interpretation of Section 267.

C. Statutory and Regulatory Changes in 1982, 1984 and 1986

In October 1982, for the first time, Congress included partnerships as related parties in Section 267. Congress added Section 267(b)(10) as part of the Subchapter S Revision Act of 1982 to provide for loss disallowance and deferral between a commonly controlled S corporation and partnership. The legislation added other relationships for S corporations as well.¹⁵

In 1984, Congress revised Section 267 again. It changed Section 267(b)(10) to include transactions between commonly controlled partnerships and all corporations, not merely S corporations.¹⁶ This legislative change would have expressly covered the circumstances in *Whitney*, where a partnership sold assets to a corporation more than 70% owned by the partners.

Moreover, in 1984, Congress changed Section 267(e) to defer deductions between partnerships and their partners or persons related to the partners under Section 267(b) or Section 707(b)(1). This change would have expressly disallowed 100% of the accrued, but unpaid management fees involved in *Casel*, which the partnership owed to Mr. Casel's wholly owned corporation.

In response to the 1984 changes, Treasury and the Service issued the Partnership-to-Partnership Regulations. Those regulations expressly contain provisions that apply to transactions between two partnerships that are not more than 50% owned by the same persons.¹⁷ The

¹⁵ Subchapter S Revision Act of 1982, P.L. 97-354, § 3(h).

¹⁶ Deficit Reduction Act of 1984, P.L. 98-369, § 174(b)(3).

¹⁷ Temp. Treas. Reg. 1.267(a)-2T(c). The language of the Partnership-to-Partnership Regulations and Question 1 is as follows:

Question 1: Does section 267(a) disallow losses and defer otherwise deductible amounts at the partnership (entity) level?

Answer 1: Yes. If a loss realized by a partnership from a sale or exchange of property is disallowed under section 267(a)(1), that loss shall not enter into the computation of the partnership's taxable income. If an amount that otherwise would be deductible by a partnership is deferred by section 267(a)(2), that amount shall not enter into the computation of the partnership's taxable income until the taxable year of the partnership in which falls the day on which the amount is includible in the gross income of the person to whom payment of the amount is made.

(Footnote continued on next page)

essence of the Partnership-to-Partnership Regulations is to apply the aggregate theory of partnerships first to the selling partnership and then to the buying partnership to determine which characterization leads to the greatest disallowed loss. The rules create loss disallowance that would not occur if the sale had happened directly between a partnership and a no-more-than-50% partner. Moreover, under those rules, the potential disallowed loss can far exceed the percentage of capital and profits in the selling partnership owned by the partner related to the buyer.¹⁸ For example, if A owns a 15 percent interest in a partnership AB and a 45 percent interest in a partnership AC and partnership AB sells a loss property to partnership AC for a loss of \$100, the Partnership-to-Partnership Regulations would disallow recognition of \$45 ($\$100 \times 45\%$) of the loss, not merely \$15 or \$0. In contrast, if

Question 2: Does section 267(a)(1) ever apply to disallow a loss if the sale or exchange giving rise to the loss is between two partnerships even though the two partnerships are not persons specified in any of the paragraphs of section 267(b)?

Answer 2: Yes. If the other requirements of section 267(a)(1) are met, section 267(a)(1) applies to such losses arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) as follows, and § 1.267(b)-1(b) does not apply. If the two partnerships have one or more common partners (i.e., if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the selling partnership's loss will be disallowed under section 267(a)(1). The amount disallowed under this rule is the greater of: (1) The amount that would be disallowed if the transaction giving rise to the loss had occurred between the selling partnership and the separate partners of the purchasing partnership (in proportion to their respective interests in the purchasing partnership); or (2) the amount that would be disallowed if such transaction had occurred between the separate partners of the selling partnership (in proportion to their respective interests in the selling partnership) and the purchasing partnership. Notwithstanding the general rule of this paragraph (c) Answer 2, no disallowance shall occur if the amount that would be disallowed pursuant to the immediately preceding sentence is less than 5 percent of the loss arising from the sale or exchange.

Question 3: Does section 267(a)(2) ever apply to defer an otherwise deductible amount if the taxpayer payor is a partnership and the person to whom payment of such amount is to be made is a partnership even though the two partnerships are not persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e))?

Answer 3: Yes. If the other requirements of section 267(a)(2) are met, section 267(a)(2) applies to such amounts arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) (as modified by section 267(e)) as follows, and § 1.267(b)-1(b) does not apply. If the two partnerships have one or more common partners (i.e., if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the payor partnership's otherwise allowable deduction will be deferred under section 267(a)(2).

¹⁸ A thorough discussion of the Partnership-to-Partnership Regulations is in an article written by Schaaf & Wisialowski, *Disallowance of Losses and Deferral of Deductions in Partnership Transactions*, 9 J. of Partnership Tax'n 191 [subsequently renamed, Business Entities] (WG&L Fall 1992).

partnership AB sold the property to A, no portion of the loss would be disallowed.

In 1986, Congress amended Section 707(b)(1)(A) by changing the word “partner” to “person.” Accordingly, for sales or exchanges after September 27, 1985, a sale of loss property between a partnership and a person who owns more than 50% of the capital or profits interest in the partnership, actually or in whole or in part through broad constructive ownership rules, will cause the entire loss on the transaction to be disallowed.¹⁹ This change results in 100% loss disallowance even if the person actually or constructively owns only 51% of the capital or profits interest in the partnership. Congress also expressly made the deferral of accrued, but unpaid deductions apply to transactions between two commonly controlled partnerships. The Senate Report to the 1986 changes states:

[T]he bill provides that the provisions of section 707(b)(1)(A) and 707(b)(2)(A) will apply whether or not the person constructively holding a 50-percent partnership interest was himself a partner. In addition, the bill provides that the deferral provisions of section 267(a)(2) will apply to two partnerships in which the same persons hold a more than 50-percent of the capital interests or profits interests. This rule is intended to replace the rule in the Treasury regulations,⁷ [Temp. Reg. Sec. 1.267(a)-2T(c), Questions 2 and 3] [footnote 7 inserted in text] which was suggested by the 1984 Committee Reports, relating to transactions between related partnerships with common partners.

S. Rep. No. 313, 99th Cong., 2d Sess. 980, reprinted in 1986-3 C.B. Vol. 3 960.²⁰

¹⁹ Very generally, the constructive ownership rules treat an individual as owning stock and partnership interests (i) owned by ancestors (*e.g.*, parents and grandparents), spouse, lineal descendants (*e.g.* children and grandchildren), brothers and sisters, (ii) owned by corporations, partnerships, trusts and estates in which the individual is a shareholder, partner or beneficiary, proportionately, and (iii) for stock, stock actually owned by co-partners in any partnership (whether or not related to the corporation). Sections 267(c) and 707(b)(3).

²⁰ Because of the specific 1986 statutory changes to Section 707(b)(1), this paper does not explore the impact of the recodification of the Internal Revenue Code of 1954 into the Internal Revenue Code of 1986 on the continued validity of the Non-Partner Regulations or Partnership-to-Partnership Regulations.

Congress has also enacted many other loss limitation provisions since *Whitney* first adopted the aggregate approach to partnerships. For instance, among other changes, Congress has enacted (i) the partnership basis rules of Section 704(d), which prevent a taxpayer from using losses of a partnership unless the partner has sufficient tax basis in the partner's partnership interest; (ii) the "at risk" rules of Section 465 that similarly require a sufficient investment in specific activities of a partnership before claiming losses; (iii) the passive activity loss rules in Section 469, which generally require material participation or the disposition of an activity in a fully taxable transaction to an unrelated person before a taxpayer can use losses to offset income from non-passive activities; (iv) the economic performance rules of Section 461(h) that generally require payment before an accrual based taxpayer can deduct items of expense; (v) Section 280A that limits losses related to certain dwelling units; (vi) Section 195 which limits the deduction of various start-up expenses; and (vii) Section 7701(o) which codifies the economic substance doctrine.²¹

Similarly, Treasury and the Service have issued other Regulations. Perhaps most notably, they issued broad sweeping partnership anti-abuse rules under Section 701.²² Those rules generally enable the Service to apply the aggregate theory of partnerships for transactions that it determines lack a substantial business purpose.

Section 7805(a) provides broad authority to Treasury to issue Regulations, "including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."²³ Treasury expressly issued the Non-Partner Regulations pursuant to this authority and must have issued the Partnership-to-Partnership Regulations under Section 7805, as well, since no specific provision of Section 267 provides for the issuance of them. Thus, to the extent relevant, those Regulations appear to be interpretive regulations.

²¹ Those provisions are in addition to rules that limit the use of losses in Sections 165, 166, 172, 269, 362(e), 382, 704(c), 743(b), 1091, 1211, SRLY, loss disallowance and other consolidated return regulations and elsewhere for which determining whether the law originated before *Whitney* is beyond the needs of this paper.

²² Treas. Reg. § 1.701-2.

²³ Treasury has delegated this responsibility to the Service, with the approval of Treasury. Treas. Reg. § 301.7805-1(a).

II. ANALYSIS OF ISSUES

A. Statutory Changes in 1982, 1984 and 1986 Supersede the Regulations

The Senate Report to the 1986 amendments to Section 707(b)(1)(A) unequivocally states with “[t]his rule is intended to replace the rule in the Treasury regulations, [Temp. Reg. Section 1.267(a)-2T(c), Questions 2 and 3] which was suggested by the 1984 Committee Reports” that the 1986 amendments replace the Partnership-to-Partnership Regulations. This conclusion is echoed by a leading partnership tax treatise which states that “sales between partnerships are now exclusively governed by § 707(b).”²⁴ Therefore, by Congressional mandate, Treasury and the Service should withdraw the Partnership-to-Partnership Regulations.

Perhaps someone reading the quoted sentence in the previous paragraph might conclude that the Senate Report made a mistake by referencing both Questions 2 and 3, since the sentence preceding the quoted sentence addresses Section 267(a)(2) only, which relates to Question 3.²⁵ However, the “1984 Committee Reports” referred to in the quoted sentence refer to the need for a rule (singular) for Section 267 in general, not merely Section 267(a)(2).²⁶ Moreover, the preamble to the Partnership-to-Partnership Regulations refers to “this rule” when referring to both Section 267(a)(1) and 267(a)(2).²⁷ Therefore, Questions 2 and 3 were viewed as one integrated rule, and the Senate Report’s citation to Question 2 in addition to

²⁴ W. Nelson, W. McKee & R. Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 14.04[3], fn. 312 (Thomson Reuters/WG&L 4th ed. 2007 & Supp. Feb. 2011).

²⁵ See *supra* p. 10 for the entire passage.

²⁶ Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, (JCS 41-84), 543 n.21 (Dec. 31, 1984), stating:

The Committee Reports stated that it was expected that the Treasury Regulations under this provision would provide a *rule* for cases not specifically covered by the new rules where the same persons are partnership in both the payor partnership and payee partnership in order to ensure that the rules of section 267 cannot be avoided by the use of a partnership as an intermediary. (Emphasis added).

²⁷ The preamble to the Partnership-to-Partnership Regulations states:

In such cases, the regulations require disallowance under section 267(a)(1) and deferral under section 267(a)(2) to the extent that they would have been required had the transaction occurred between the payor partner and the partners of the payee partnership or, if the amount disallowed or deferred would be greater, between the payee partnership and the partners of the payor partnership. *This rule* ensures that section 267 will not be avoided by use of a partnership as an intermediary in related party transactions, and is thus consistent with the general approach suggested in the legislative history, [cite omitted] as well as the rules of the regulations under section 267 prior to amendment. Preamble to T.D. 7991 (Nov. 30, 1984) (Emphasis added).

Question 3 can only be viewed as an intentional mandate to remove both halves of that rule.

It should be noted that after the addition of Section 7805(e) in 1988, any temporary regulation issued after November 20, 1988 expires within three years of the date of issuance. Accordingly, Treasury likely would have had to have withdrawn or finalized the Partnership-to-Partnership Regulations long ago if issued after that date. Withdrawing those regulations at this time comports with the purpose of Section 7805(e).

Although perhaps not as clearly stated, the same Congressional mandate to withdraw the Partnership-to-Partnership Regulations should apply to the Non-Partner Regulations. The 1982, 1984 and 1986 changes to Section 707(b)(1) outright rejected the aggregate approach to partnerships. Those changes make most transactions subject to Section 707(b)(1) and added partnerships as separately identified persons in Section 267. They also disallow or defer 100% of the partnership loss or deduction involved once a controlling, more than 50% threshold ownership of capital or profits interests is involved. Congress saw how unwieldy an aggregate approach could become in the rules drawn up for the Partnership-to-Partnership Regulations and outright rejected it in favor of 100% disallowance or deferral. The Senate Report specifically lists only Questions 2 and 3 of Temp. Treas. Reg. 1.267(a)-2T(c) as being replaced, NOT Question 1, which states that Section 267 applies to partnerships at the entity level.

B. The Non-Partner Regulations Have No Legitimate Remaining Base

Other reasons support withdrawing the Non-Partner Regulations. First, after the 1982, 1984 and 1986 statutory changes, the Non-Partner Regulations apply only to a very small portion of the transactions to which they first applied. The addition of Section 267(b)(10) deals with transactions between partnerships and corporations. Section 707(b)(1) deals with transactions between partnerships and persons owning more than 50% of the capital or profits interests in the partnership. Section 267(e) causes 100% deferral of deductions under Section 267(a)(2) between a partnership and a person related to a partner generally without regard to the percentage ownership of the capital or profits interest of the partner in the partnership. The only transactions left for which the Non-Partner Regulations could conceivably apply are to sales of loss property between a partnership and individual family members or entities related to a partner

who owns no more than 50% of the capital or profits interest of the partnership. In other words, the transactions left for which the Non-Partner Regulations could apply are sales to which Section 267 would apply more harshly than if made directly with the non-controlling partners themselves.

Second, none of the fact patterns in *Whitney*, *Busche* or *Casel*, which caused courts to apply the aggregate principals to partnerships when interpreting Section 267 need to rely upon such a theory under existing law. *Whitney* would be covered by the commonly controlled partnership and corporation provision of Section 267(b)(10). *Busche* would be covered by Sections 731 and 707(b)(1), which excepts losses on partnership interests. *Casel* would be covered by Section 267(e), except that the whole management fee would be deferred, rather than only 50%. The *Casel* court would never have needed to entertain an argument regarding the validity of the Non-Partner Regulation. Moreover, if Section 707(b)(1)(A) had used the word “person,” rather than “partner,” it is doubtful that the *Casel* court would have looked outside of Section 707 to Section 267 in the first place to applying aggregate principals outside of Subchapter K. Accordingly, the 1982, 1984 and 1986 statutory changes have effectively mooted the case law that supports the Non-Partner Regulations.

C. The Policy Behind the Non-Partner Regulations Is No Longer Served

Furthermore, the underlying policy for applying the aggregate approach of the Non-Partner Regulations is not served well by the continued existence of those Regulations. *Whitney* adopted the aggregate approach to prevent taxpayers from economically selling property to themselves. In that case, the J.P. Morgan partners controlled more than 70% of the stock of the buying corporation after the transaction. When 50%-or-less-owned entities sell or buy a loss property, the economic group will not continue to control the property or the sale proceeds after the transaction as measured by ownership. The partners not owning more than 50% of the profits and capital of a selling partnership will have to convince other non-related partners of the merits of the transaction and to return some or all of the consideration paid in the sale to make those partners and related persons stand more closely in the same position as before the sale. Cash will only go from one pocket to the other if persons outside the related party economic group agree to it. Even then, the non-related partners will have exchanged their economic interests in loss property for sale proceeds. The sale will not be economically equivalent to selling to oneself, so engaging in such a

transaction merely to trigger a tax loss seems much less likely to be a principal purpose for such a sale.

Moreover, the premise for applying the aggregate theory of partnerships has changed with the advent of limited liability companies and limited partnerships. Each of the partnerships in *Whitney*, *Busche* and *Casel* appears to be a general partnership. Courts have found that general partnership interests are more closely akin to ownership of undivided interests in partnership assets.²⁸ Tax partnerships today are generally limited liability companies and limited partnerships in which one or more members have no active role in the entities business affairs and for which their ownership interests have attributes similar to stock of a corporation.

In short, tax partnerships in 2011 largely no longer function as aggregates under governing state law. The Non-Partner Regulations harken back to the state of business in the 1950's and business arrangements from the Great Depression.

D. The Non-Partner Regulations Involve Excessive Regulatory Burdens

Additionally, the administrative complexity of applying both the rules of Section 707(b)(1) and the Non-Partner Regulations can be mind numbing. Those related party rules require that a partnership obtain family trees and organizational charts for its partners. If the Non-Partner Regulations still apply then a partnership needs to know not only the organizational chart for its largest partners to apply Section 707(b)(1), but must also obtain that information for even the smallest of its owners to satisfy the Non-Partner Regulations. Many modern day tax partnerships have 35 or more owners. If one needs a “poster child” for over-regulation to hoist in front of today's politicians, one needs to look no farther than the Non-Partner Regulations.

E. The Government Does Not Need the Non-Partner Regulations

Further still, the Service now has many more statutory and regulatory tools for dealing with losses incurred by partnerships than present when *Whitney* first applied the aggregate approach to partnerships. As

²⁸ See generally *Magneson v. Comm'r*, 753 F.2d 1490 (9th Cir. 1985).

referenced above,²⁹ those tools include, among a litany of others, the partnership interest basis limitation rules of Section 704(d), the at-risk rules of Section 465, the passive activity loss rules of Section 469, the partnership anti-abuse rules, and a codified economic substance doctrine. Can the government really need the Non-Partner Regulations to administer effectively the revenue laws of this country?

F. The Non-Partner Regulations Hamper the Recovery of the US Economy

Lastly, but not less importantly, the Non-Partner Regulations hamper the recovery of the US economy. On the whole, Sections 267 and 707(b)(1) involve real economic losses. People really lost money in the stock market crash of 1929, which precipitated the enactment of Section 267, and people really have lost money on the US real estate market in the last decade. The problem addressed by the Section 267 and 707(b)(1) is not losses caused by tax shelters or sham transactions. The problem stems from a lack of a bona fide realization event – namely either that an acceptable buyer cannot be found that is willing to pay the desired price or that the selling partnership believes in the economics of a loss property and does not want to dispose of it.

If the Non-Partner Regulations apply, partnerships generally will prefer sales of loss properties to complete strangers to the property to avoid loss disallowance. The pool of those potential buyers, such as lenders, investment funds and similar investors will more likely have a short-term perspective for holding the loss property and are looking for “fire” sale prices to compensate them for the risks they undertake and corresponding returns they require. Managers and one or more existing partners are more likely to be in a better position to evaluate leasing rates, market demand, development possibilities, the local political and economic climate, prior uses, and environmental practices, among other considerations, that can materially enhance their views about the risks they take and the potential long-term returns of loss property.

A sale of loss property by a partnership to a complete stranger will at least make it possible for the partners to recognize tax losses so as to recover a portion of the real economic loss through a reduction of income taxes. General partners and managers may be hard pressed to sell loss

²⁹ See *supra* p. 10 & 11.

property to another entity owned by any of the existing partners for fear of losing tax deductions for persons who have already lost much of the economic value of their investments.

III. CONCLUSION

The foregoing discussion sets forth many reasons why Treasury and the Service should withdraw formally the Partnership-to-Partnership Regulations and the Non-Partner Regulations. In addition to Congressional mandate and other legal reasoning, those reasons include the strong policy reasons of eliminating excessive and burdensome Regulations and facilitating the recovery of the US economy. Treasury and the Service have the authority and position to withdraw those Regulations and they should exercise that authority now as tax partnerships contemplate ways to restructure distressed investments. As an alternative, perhaps the Service could issue a revenue ruling or similar guidance to show that they will no longer enforce those Regulations.