Steve Leimberg's Business Entities Email Newsletter - Archive Message #129
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From: Steve Leimberg's Business Entities Newsletter
Subject: **Galant & Mark: Partnership Characteristics - Confusion Reigns**

"Recent litigation has put into question the tests for determining the validity of a partnership and one's status as a partner. The seemingly simple questions of whether, for tax purposes, a partnership exists and whether one is a partner require thoughtful, and sometimes complex, analysis to answer. There are two recognized tests for determining whether a partnership exists or whether one is a partner, but what remains uncertain is how these tests relate to each other.

Whether applying the subjective test under Culbertson, or the objective test under Section 704(e), the Castle Harbour cases have thus far made clear that where a purported partner's upside and downside are de minimus, such "partner" will not be respected as such for tax purposes."

Now, **Dana Mark** and **Jeffrey Galant** provide **LISI** members with their analysis of the so-called "Castle Harbour" cases recently decided by the Second Circuit. These cases arose in a tax shelter context, and have raised many tax issues in addition to whether a valid partnership was created and whether certain investors were partners.

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Here is their commentary:

EXECUTIVE SUMMARY:

Recent litigation has put into question the tests for determining the validity of a partnership and one's status as a partner. The seemingly simple questions of whether, for tax purposes, a partnership exists and whether one is a partner require thoughtful, and sometimes complex, analysis to answer. There are two recognized tests for determining whether a partnership exists or whether one is a partner, but what remains uncertain is how these tests relate to each other.

Culbertson[1] versus Section 704(e)[2]

Section 704(e) applies to all capital intensive partnerships, not just "family partnerships".[3] The purpose of Section 704(e) is to determine whether a purported partner in a capital intensive partnership, i.e., a partnership where capital is a material income producing factor, is a partner for tax purposes.[4] In order for a purported partner to be recognized as a partner in such a partnership, such person must "own" a capital interest in the partnership. That is, the purported partner must exercise sufficient dominion and control over such interest that rises to the level of ownership.

So what are the tests? *Culbertson*, the 1949 U.S. Supreme Court decision, established a subjective test. *Culbertson* involved the issue of whether a partnership was established between a father and one or more of his sons in connection with a cattle business. The Supreme Court said that an examination of the "totality of the circumstances" was required in order to determine whether the parties, acting in good faith and with business purpose, intended to join together in a common enterprise. Thus, motivation was a key factor in determining whether a partnership existed.

On the other hand, Section 704(e),[5] the predecessor of which was enacted in 1951, takes an objective approach. Section 704(e) concerns a partnership where capital is a material income-producing factor. It says that a person will be recognized as a partner of a capital intensive partnership if such person owns a capital interest.[6]

To draw the distinction between the two tests, in the case of capital intensive partnerships, complying with the capital ownership requirement of Section 704(e) may not require motivation or intent to form a partnership or to be a partner. In fact some commentators believe that business purpose is not required as long as there is some business activity at the entity level.[7] Note that this concept is derived from *Moline Properties*[8], which held that minimal business activity was sufficient to find a corporation as the taxpayer.

FACTS:

The Castle Harbour cases

The Second Circuit recently decided what is popularly known as *Castle Harbour III*, [9] again reversing the District Court and holding that the purported partners (foreign banks) of a capital intensive partnership did not qualify as partners. The *Castle Harbour* cases bring front and center the issue of the relationship between *Culbertson* and Section 704(e). These cases arose in a tax shelter context and have raised many tax issues in addition to whether a valid partnership was created and whether certain investors were partners.[10]

Just dealing with the partnership characterization aspects, a short synopsis is in order. The ultimate taxpayer, GE Capital, through various subsidiaries, established Castle Harbor LLC as a partnership for tax purposes in 1993. GE Capital, again through various subsidiaries, contributed fully depreciated leased airplanes, lease-related receivables and cash to the partnership. A short time later, two Dutch banks (the "Banks") purchased interests in the partnership from one or more of the GE Capital subsidiaries and also contributed cash to the partnership. Roughly speaking, GE Capital held an 82% interest in the partnership and the Banks held an 18% interest based on the invested capital.

The non-tax business reasons for the establishing the partnership with the Banks concerned GE Capital's business as a lessor of airplanes to various airlines. The company's executives were concerned about a downturn in the airline industry and wanted to alleviate some of the risk involved in leasing airplanes. In addition, the company's debt equity ratio (8:1) had reached the maximum level acceptable to the credit rating agencies, and negative pledges under various loan agreements prevented it from obtaining further financing except with respect to acquisition debt. Raising equity capital as opposed to debt was basically its only alternative in terms of financing. It was only through an equity infusion that GE Capital would be able to pay down some debt and to reallocate to the new investors some of the risks of the leasing business.

The tax reasons were much more dramatic. There was a need to reduce the tax burden in GE Capital's leasing business. The airplanes had run out of depreciation, and, as a result, there was little ability to offset the rental income with deductions. To basically restart depreciation (or at least realize the same after tax effect), at the suggestion of investment bankers that GE Capital had solicited, the Banks became "partners." The key to the plan was that the Banks were tax indifferent, i.e., they were not US taxpayers, and, in any event, GE Capital indemnified the Banks from the threat of any US tax.

The arrangement was that 98% of the taxable rental income was allocated to the Banks. They, of course, did not pay any US tax. However, in allocating income to the Banks' capital accounts, the amount of the taxable income was reduced by depreciation as computed on the then fair market value of the airplanes. Since the depreciation was not deductible for tax purposes, this basically meant that although 98% of the taxable income was allocated to the Banks, they received capital account credit for only about 30% of such income. The bottom line was that GE Capital saved about $62 million in taxes.

After audit, the IRS concluded that the partnership was a sham, the Banks were lenders not partners, and the profit and loss allocations lacked substantial economic effect. Thus, GE Capital was assessed the amount of the purported tax savings (plus interest and penalties). GE Capital paid the tax and brought a refund suit in the US District Court in Connecticut. In a long, exhaustive opinion, Judge Underhill held that: (1) the partnership's formation was not a sham transaction; (2) the Banks were partners rather than lenders both in economic reality and for tax purposes; and (3) the allocation of the partnership's income did not violate the "overall tax effect" rule of Section 704(b). The government appealed the decision to the Second Circuit, which reversed the District Court (*Castle Harbour II*) on the partner issue and remanded the question of the impact of Section 704(e), if any.

In *Castle Harbour II*, the Second Circuit, applying the *Culbertson* ("totality of the circumstances") test held that the Banks were not partners; rather they were more like secured creditors. As a result the taxable income of the partnership should have been allocated to GE Capital. In reaching this conclusion, using a debt-equity analysis, the Second Circuit found that the Banks were effectively protected from loss and that they had no real upside.

There was no risk of loss in the Second Circuit's view, due to: a total performance guarantee by GE Capital; a liquidity requirement that compelled the partnership (through a subsidiary) to maintain in liquid asset form an amount equivalent to 110% of the capital invested by the Banks plus the agreed upon return (about 9%); and the maintenance of catastrophic casualty insurance in an amount about three times the amount of the capital invested by the Banks. The Banks had the power to liquidate the partnership and recover their capital plus the guaranteed yield in the event of a breach by GE Capital of any of its obligations.

The Banks had no upside, according to the Second Circuit, since GE Capital had the power to recharacterize income and thereby change how that income was allocated between them and GE Capital. In other words, except for the basically guaranteed return of the Banks' investments and the agreed upon yield, whether the Banks received anything additional from the partnership was totally under the control of GE Capital.[11]

The Second Circuit, considering all of the facts as required by *Culbertson*, held that the Banks were not partners; rather, "for all intents and purposes," they were secured creditors.[12] However, the case was not over. The Second Circuit remanded the case so that Judge Underhill could determine whether the Banks could be partners under Section 704(e) even though they were not partners under *Culbertson*.

On remand (*Castle Harbour III*), Judge Underhill dismissed the government's argument that the Second Circuit's holding that the Banks

were not partners under *Culbertson* foreclosed any inquiry into whether they were partners under Section 704(e). If that were true said Judge Underhill, there would have been no remand.
Judge Underhill holds that the Banks are partners under Section 704(e), notwithstanding that under *Culbertson* they were not partners. He indicates that it is not clear whether Section 704(e) overrules *Culbertson* with respect to capital intensive partnerships or whether it is an alternative test. He cites the Seventh Circuit case, *Pflugradt v. U.S.* (310 F.2d 412 (1962)) as one court that decided that *Culbertson* was overruled.[13] Judge Underhill does admit continuing vitality for *Culbertson,* at least in the case of non-capital intensive partnerships since Section 704(e) does not apply. See, *Carriage Square, Inc. v. Commissioner*, 69 T.C.119 (1977).

It is noteworthy that in order for a person who holds a mere profits interest (i.e., a so-called "carried interest") in a capital intensive partnership to be considered a partner for tax purposes, such person must qualify as a partner under *Culbertson*, since such person would not meet the capital ownership requirement of Section 704(e). (See discussion below.)

In any event, since the Second Circuit applied *Culbertson*, Judge Underhill had no choice but to accept its application. However, he views Section 704(e) as being an alternative test for partnership validity and partner status. The question that he had to answer was whether the Banks were partners under Section 704(e).[14] He analyzes the three basic requirements of Section 704(e). First, he finds that the Banks owned their respective interests in the partnership. Applying the regulations, he finds that the transaction by which the Banks became partners was not a sham due to the non-tax business purposes outlined above. He finds, in compliance with the regulations, that the Banks exercised dominion and control over their respective interests. Second, he finds that the Banks had capital interests. Basically, the Banks respective capital accounts were credited with their investments in the partnership, and for their share of income; and in the case of distributions and loses their capital accounts were to be debited. Finally, the partnership was capital intensive. As required by the regulations, a substantial portion of its gross income was derived from capital rather than services.

Before, reaching these conclusions, however, Judge Underhill spends some time in the opinion dealing with the Second Circuit's view of the facts and he expresses disagreement with some of its conclusions. His view was that the partnership provided some economic upside for the Banks as well as the risk of loss, although minimal.[15] Judge Underhill also disagreed with the Second Circuit's view that the Banks were secured creditors rather than partners. On this point he compares the interests with the characteristics of preferred stock and states that historically the courts, including the Second Circuit, have respected preferred stock as equity rather than debt, citing *Jewel Tea Co. v. U.S.* (90 F2d 451 (2d Cir. 1937)). He was not constrained by the Second Circuit's finding that the Banks' interests were "debt-like" for purposes of determining whether they were capital interests. Quite the opposite, Judge Underhill found that the Banks held capital interests that could constitute equity and as a result they were partners under Section 704(e).

This past January the Second Circuit again reversed Judge Underhill holding that the Banks did not qualify as partners. The Second Circuit stated that the interests of the Banks in the partnership were in the nature of debt, and did not give rise to any equity participation, and, therefore, were not capital interests under section 704(e) (1). The Court stated that Section 704(e) was never intended to treat partnership debt as a capital interest in a partnership. Rather, the focus of Section 704(e) is on who should be recognized as the owner of a capital interest.

COMMENT:

Culbertson and Case Law

Basically, *Castle Harbour III* has not directly answered the question. The Second Circuit determined that the Banks were not partners under either *Culbertson* or Section 704(e), and one could argue that it implicitly decided that each test has its place.

The context of the seminal cases in this area is assignment of income. We know that income derived from the performance of services is taxable to the person performing the services. *Lucas v. Earl*, 281 U.S. 111 (1930). Also we know that income derived from property is generally taxable to the owner of the property. *Helvering v. Horst*, 311 U.S. 112 (1940).

Historically, partnerships have been used to circumvent these assignment of income principles through manipulating the allocations of profits and losses.

Commissioner v. Tower[16] was such a circumstance. The manufacturing business was operated for many years by a corporation controlled by Tower who owned most of the outstanding stock. An unrelated employee owned about 10% of the outstanding shares, and Mrs. Tower owned 1%. Following the advice of his tax advisors, Tower gave his wife additional shares so that she owned 39% of the corporation, and then caused the corporation to liquidate and the business to be continued as a limited partnership, with his wife as the limited partner and he and the employee as general partners. The purpose of this restructuring was to allocate a significant portion of the income from the business to Mrs. Tower and thereby, under the law at the time, reduce overall income taxes.

The Tax Court held that Mrs. Tower was not a partner. Although reversed in the Third Circuit, the Supreme Court followed the Tax Court on the basis that "... the partnership [to the extent it was between Mr. and Mrs. Tower] was a mere paper reallocation of income among family members." "Before the partnership, the husband managed, controlled, and did a good deal of the work involved in running the business, and he had funds at his disposal which he either used in the business or expended for family purposes. The wife did not contribute her services to the business, and received money from her husband for her own and family expenses. After the partnership was formed, the husband continued to control and manage the business exactly as he had before. The wife again took no part in the management or operation of the business. If it be said that, as a limited partner, she could not share in the management without becoming a general partner, the result is the same. No capital not available for use in the business before was brought into the business as a result of the formation of the partnership."

After *Tower* (and a companion case, *Lusthaus v. Commissioner*, 327 U.S. 293 (1946)), the IRS and Tax Court were of the view that *Tower* required that the family member must either have contributed vital services to the partnership or capital that originated with such family member in order to recognize such family member as a partner.

Culbertson rejected such reading of *Tower*. *Culbertson* involved an oral partnership between Culbertson and his four sons with respect to the operation of a cattle herd that previously had been managed by a different partnership between Culbertson and a third party. The sons paid for their partnership interests, albeit partially through the income of the activity and partially through Culbertson's gifts (loan forgiveness). The eldest son, who had worked for the other partnership, provided services to the partnership until he joined the military. The next son in age joined the military immediately upon graduation and did not render any services to the partnership. The two remaining sons provided services to the business only during the summer months when school was not in session.

The Supreme Court stated the partnership test: "The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

The case was remanded to the Tax Court for it to determine, based on the Supreme Court's articulation of the test, which of the sons were partners. The Supreme Court stated that the test to determine whether a partnership exists or whether a person is a partner is not different just because it arises in a family context. Rather, when family is involved a closer examination is necessary to determine if things are what they purport to be. In other words, in the family context, to avoid the mere paper reallocation problem, the partner should be adding something to the mix.

The Law Today

As a general proposition, the interrelated issues concerning whether a partnership exists or whether a person is a partner revolve around the intent and conduct of the parties. *Culbertson* requires that the parties (i) intend to join together in some business or investment activity for the purpose of deriving a gain and sharing the resulting profits or losses, and then (ii) behave in a consistent manner. In other words, the parties intend to and actually join together and assume entrepreneurial risk.

Section 704(e), on the other hand, addresses directly the assignment of income principles that partnerships might otherwise tend to circumvent. Basically, in order for a person to be recognized as a partner in a capital intensive partnership and be allocated such person's purported share of the profits or losses, such person must own a capital interest in the partnership. Note, however, that holding a mere profits interest would not make one a partner under Section 704(e), although there may be enough indicia of partnership interest to constitute a partner under *Culbertson*.[17] *Culbertson* is important to those holding carried interests without any capital interest.

Addressing the issue of whether there can be a partnership when the standards of *Culbertson* are not met, the argument is made that based upon the *Moline Properties* case and Section 704(e), a partnership exists if there is either a business purpose or some minimal business activity and that any person who owns a capital interest in the partnership where capital is a material income-producing factor will be considered a partner. [18]

According to some commentators, "Properly understood, Section 704(e)(1) is not fundamentally inconsistent with *Culbertson*; on the contrary, it assumes the existence of a bona fide partnership (and a bona fide capital interest) and merely looks at real ownership of the capital interest to determine which of two potential parties — a transferor or a transferee — will be recognized as a partner."[19]

Others view partnership determination differently. For example, Professor Yale believes that while Section 704(e) may not overrule *Culbertson*, it does, together with *Moline Properties*, provide an alternative way of determining whether a partnership exists. According to Yale, "To sum up, a partnership will be respected for tax purposes if it satisfies *Culbertson*, that is, if 'the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. Satisfying *Culbertson*, although sufficient, should not be necessary, at least for capital-intensive partnerships. An entity also should be respected as a partnership if: (1) it conducts some trade, business, financial operation, or venture in which capital is a material income producing factor; (2) it is not properly classified as a corporation or trust; and (3) the putative partners are the true owners of equity interests in the entity."[20]

If the partnership is not a capital intensive partnership then Section 704(e) is inapplicable, and whether the purported partner is actually a partner is determined by *Culbertson*. Leaving aside for a moment the question of identifying the criteria to determine partner status, a broader inquiry is whether a partnership exists. That is, does Section 704(e) (1) determine if a partnership exists or must that determination be made by applying *Culbertson*?

"Significantly, the purported contradiction between *Culbertson* and Section 704(e) (1) was not discovered until fairly recently. The predecessor of Section 704(e)(1) was enacted in 1951, and during the ensuing six decades, courts have regularly applied *Culbertson*, looking at all relevant facts and circumstances to determine whether a partnership has sufficient reality to be respected for tax purposes. If Congress intended to overrule *Culbertson* and redefine the threshold for partnership validity, that purpose was artfully concealed. Instead, it seems far more likely that Section 704(e)(1) was intended merely to resolve the narrow question whether the transferor or the transferee of a donated capital interest in a capital-intensive partnership should be treated as the real owner and hence as a partner. This modest reading of Section 704(e) (1) is consistent with the provision's language and legislative history. It also explains why courts continue to rely on *Culbertson* as the general test of partnership validity and why the cases arising under Section 704(e) (1) focus narrowly on whether a transferor or a transferee is the real owner of a capital interest in an otherwise valid partnership. There appears to be no fundamental inconsistency between *Culbertson* and Section 704(e) (1), and accordingly there is no need to decide which 'trumps'' the other [footnotes omitted]."[21]

Culbertson requires that in order for a partnership to exist, the persons involved in the entity must have the necessary motivation to join together with respect to a particular business or financial activity for the purposes of sharing the profits and/or losses from such activity. Citing its decision in *Tower,* the *Culbertson* Court stated that the "… question whether the family partnership is real for income-tax purposes depends upon 'whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.'"

The Court then stated that "[t]he question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case,[22] but whether, considering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[23]

On the other hand, Section 704(e), which literally does not deal with the issue of whether a partnership exists, requires that the purported partners must actually "own" their respective interests in the partnership. Thus, *Culbertson* ostensibly involves whether there is a partnership in the first place and Section 704(e) involves whether an interested person is a partner. Understanding that you would need at least two such persons to have a partnership, we are basically dealing with a chicken and egg conundrum.[24]

Check-the-Box

To complicate matters further, there is the impact of the check-the-box regulations. The ultimate issue is which rules apply in determining whether there is a partnership, i.e., which of *Culbertson,* Section 704(e) and/or check-the-box controls? Basically, check-the-box, as it applies to a multi-owner domestic unincorporated entity, characterizes such entity (e.g., partnership, limited liability company or business trust) as a partnership for US tax purposes unless it elects to be treated as a corporation. In other words, the existence of the partnership, limited liability company or business trust is the predicate to having the ability to make the election. [25]

Donors and Donees

Section 704(e) also applies to family member purchasers and all donees of partnership interests. The provision is based on and follows the general principles of the assignment of income doctrine. That is, income derived from property is taxable to the owner of the property, and income from the performance of services is taxable to the performer of such services. In order for any such purchaser or donee to be considered a partner, such purchaser or donee must exercise appropriate dominion and control over the partnership interest so that such person "owns" the interest. If such person is treated as the owner, he or she will be allocated his or her *pro rata* share of the partnership income so long as the seller or donor of the interest has been allocated such portion of the profits that represents reasonable compensation for the services that the seller or donor performed for the partnership.[26]

Conclusion

Whether applying the subjective test under *Culbertson*, or the objective test under Section 704(e), the *Castle Harbour* cases have thus far made clear that where a purported partner's upside and downside are *de minimus*, such "partner" will not be respected as such for tax purposes.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Dana Mark
Jeffrey Galant

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[1] *Commissioner v. Culbertson*, 337 U.S. 733 (1949). Although *Culbertson* is an income tax case and section 704(e) is an income tax provision, it is noteworthy that the *Culbertson* factors are applied to the determination of partnership status in transfer tax cases. This is consistent with section 7701(a) (2) which defines a partnership for all tax purposes, not just income tax. For example, see *Estate of Winkler*, T.C. Memo 1997-4; *Estate of Davenport*, T.C. Memo 1997-390; *Estate of Bongard*, 124 T.C. 95 (2005); *Britt's Estate v. Commissioner*, 190 F.2d 946 (5th Cir., 1951); *Estate of Thompson v. Commissioner*, 382 F.3d 367 (3rd Cir., 2004).

[2] All statutory references are to the Internal Revenue Code of 1986, as amended.

[3] Section 704(e) applies to all partnerships, not just family partnerships. *Evans v. Commissioner*, 54 T.C. 40 (1970) aff'd 447 F 2d 547 (7th Cir.) (acq.)

[4] "In general, capital is considered a material income-producing factor if a substantial portion of the gross income of the partnership's business is attributable to the use of capital. Further, capital will not usually be considered a material income-producing factor where the income of the business consists principally of fees, commissions, or compensation for personal services performed by the partnership's members or employees. On the other hand, capital is ordinarily a material income-producing factor if operation of the business requires substantial inventories or substantial investment in plant, machinery, or other equipment. *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 126-127 (1977); sec. 1.704-1(e) (1) (iv), Income Tax Regs." See *Estate of Kanter*, T.C. Memo 2007-21.

[5] Family partnerships
(1) Recognition of interest created by purchase or gift
A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any

other person.

(2) Distributive share of donee includible in gross income
In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) Purchase of interest by member of family
For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons."

[6] Section 340 of the Revenue Act of 1951 added section 191 to the 1939 Code and modified section 3797(a) (2). Section 3797 was the definitions section of the 1939 Code, and paragraph (a) (2) contained the definitions of partner and partnership. The text of section 3797(a) (2) is set out below. The italicized final sentence was the 1951 modification. That sentence is now codified at section 704(e) (1).

SEC. 3797. DEFINITIONS.
(a) When used in this title, where not otherwise wise distinctly expressed or manifestly incompatible with the intent thereof
* * *
(2) PARTNERSHIP AND PARTNER. — The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization. *A person shall be recognized as a partner for income tax proposes if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.*

Section 191 added the family partnership rules now codified at section 704(e) (2) and (3). Roughly speaking, these latter rules validate the distributive share of a donee or purchaser of a partnership interest when the gift or purchase is from a family member, provided that the partnership sharing arrangement allows for reasonable compensation for services rendered or capital supplied by the donor or seller.

[7] Note that the Treasury Regulations under Section 704(e) seems to require a

business purpose. Section 1.704-1(e) (1) (iii) provides: "A donee or purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e) (1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes, and the donee or purchaser is the real owner of such interest. To be recognized, a transfer must vest dominion and control of the partnership interest in the transferee."

[8] 319 U.S. 436 (1943).

[9] *TIFD III-E Inc. v. United States*, No. 10-70-CV (2d Cir. 2012).

[10] For example, the Section 704(b) allocation requirements were held to have been met.

[11] The Banks participation in the partnership was supposed to last for eight years and over such period the Banks interests were to be reduced by distributions from the partnership. At the end of the period the Banks would be fully redeemed. However, the liquidation of the Banks interests occurred in the fifth year (1998) due to a U.S. tax law change that would otherwise have nullified the partnership.

[12] "Considering all the facts – the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purpose for which it is used, and any other facts throwing light on their intent – the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." *Commissioner v. Culbertson*, 337 U.S. 733 at 742 (1949). For purposes of their own internal reporting, the banks considered their investments in Castle Harbour to be debt.

[13] "[Section 704(e) (1)] commands that these minor children are to be recognized as partners if they own a capital interest in the partnership. The test is no longer whether the parties acted in good faith with a business purpose in joining together to conduct the partnership business. This was the test set forth in *Commissioner v. Culbertson*, which was decided before present section 704(e) (1) was a part of the Code."

[14] Apparently, a partnership existed prior to the admission of the Banks. The partnership, as mentioned above, was among various subsidiaries of GE Capital. It appears that this part of the arrangement was not challenged by the government.

[15] Perhaps if you view the facts as Judge Underhill did the Banks had enough upside and downside to be considered partners under *Culbertson*.

[16] 327 U.S. 280 (1946).

[17] "Although Code Section 704(e) originally was intended to address family limited partnerships, there is no indication (regardless of the heading under which it falls) that the current version is limited in any way to any particular type of

partnership. As a result, for a partnership, like a venture capital fund, in which capital is a material income-producing factor, one must determine whether the purported owner has a capital interest. While debate can take place over how much of a capital interest is required, if a general partner contributes 1% to 5% of the capital of a fund, this should be sufficient."

If Code Section 704(e) does not apply – for example, in the case of service partnerships or owners of a capital-intensive partnership who do not hold a capital interest – partner status is determined under case law. Under the leading cases, the courts look to "whether the parties really and truly intended to join together for the purpose of carrying on business and dividing the profits or losses or both. The factors considered include whether the purported partner possesses a proprietary profit share, shares in venture losses, has a capital interest, has the right to participate in management, provides substantial services and is held out as a partner to third parties, in partnership agreements or on partnership tax returns."

"Because of the entrepreneurial risk that general partners of venture capital funds encounter, the sharing of profits and losses, and their management of the funds, partner status should be accorded them. If, however, a general partner arranged its affairs with its investors so as to eliminate its entrepreneurial risk within the venture capital fund enterprise, then the IRS would have a solid basis for challenging the general partner's carried interest as a partner interest, and treating it instead as generating compensatory service income."

See Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds (2007)* draft article.

[18] A brewing controversy concerns the extent to which *Culbertson* applies to capital intensive partnerships in light of the enactment of Section 704(e). The issue has been joined in recent litigation involving tax shelter partnerships. Intent to form a partnership and conduct consistent with such intent are the hallmarks of *Culbertson*. That is, in order for a partnership to exist the participants must intend to join together in some profit making activity and then must act in a manner consistent with such intent. On the other hand, ownership (i.e., control) of capital interests and business purpose or activity is enough to support partnership status under the lesser threshold of Section 704(e) and *Moline Properties*. See, Burke & McCouch, *Illusory Partnership Interests and the Anti-Avoidance Rule*, 132 Tax Notes 813 (Aug. 22, 2011) (hereinafter, "Burke & McCouch"). quoting disapprovingly from McKee et al., *Federal Taxation of Partnerships and Partners*, para. 1.05[4][a], at 1-41, ("If a putative partnership conducts a real enterprise in which putative partners share capital ownership, tax avoidance motives for the formation of the partnership or for a person becoming a partner are irrelevant."); *id.* at para. 3.03[1][b], at 3-33 (observing that "business purpose is unnecessary for entity recognition if the entity conducts business activity," but "where no activity is conducted, business purpose is required," and listing "evading a state restriction" and "avoiding federal estate tax" as valid

business purposes.") Basically, McKee et al. takes the position that section 704(e) overrides *Culbertson*. McKee et al. supports the view that *Moline Properties* is the controlling authority as to when an entity will be recognized for tax purposes. The *Moline* threshold for recognizing a corporate entity for tax purposes was reached if there was either a business purpose for the corporation or minimal business activity in the corporation. In *Moline*, it was the taxpayer who was trying to ignore the corporation.

[19] Burke & McCouch.

[20] Yale, *Defining 'Partnership' for Federal Tax Purposes*, 132 Tax Notes 589 (May 9, 2011).

[21] See Burke & McCouch, 815-816.

[22] The Tax Court mistakenly read *Tower* and *Lusthaus* v. *Commissioner,* 327 U.S. 293 (1946), "as setting out two essential tests of partnership for income-tax purposes: that each partner contribute to the partnership either vital services or capital originating with him."

[23] In other words, the determination of whether a partnership exists is a facts and circumstances inquiry.

[24] Questions of economic substance, sham and debt versus equity underlie the issue of partnership status.

[25] "Any transaction involving an entity classified under the check-the-box regulations also will be subject to the partnership antiabuse rule [Treasury Regulation section 1.704-2], which draws on *Culbertson* and related common law doctrines. It would be strange indeed if the check-the box regulations promulgated in 1996 were intended *sub silentio* to override the C*ulbertson* standard embodied in the antiabuse rule promulgated just two years earlier. While the check-the-box regulations may have repercussions that were not foreseen by their drafters, there is no indication that they were intended to change the *Culbertson* test for partnership validity [footnotes omitted]." Burke & McCouch, 819.

[26] Actually, such owner's share need only be in proportion with the donor's share as based upon their respective donated and remaining invested capital. See Section 704(e) (2).