

## Louisiana Law Review

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Volume 44 | Number 3

January 1984

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### Repository Citation

Robert R. Casey and William M. Backstrom Jr., *The Louisiana Partnership and the Federal Income Tax - A Clashing of Codes*, 44 La. L. Rev. (1984)

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# THE LOUISIANA PARTNERSHIP AND THE FEDERAL INCOME TAX—A CLASHING OF CODES

Robert R. Casey\* and William M. Backstrom, Jr.\*\*

The passage of Acts 150, 151, and 152 of the 1980 Regular Session of the Louisiana Legislature<sup>1</sup> was a monumental step in bringing Louisiana's partnership law into that portion of the twentieth century following passage of the sixteenth amendment to the United States Constitution.<sup>2</sup> Nevertheless, Louisiana's partnership law has not as yet fully grown up to the level of the United States Internal Revenue Code of 1954.<sup>3</sup> Only by careful draftsmanship will a Louisiana partnership satisfy the requirements of both Louisiana substantive law and federal income tax law.

## STATUS OF PARTNERSHIP

Although Louisiana lawyers may be pleased that civilian concepts have been carried forward in the new Louisiana partnership law, it is often more important to the client that his partnership be treated as a partnership for federal income tax purposes. Otherwise, if an alleged partnership were treated for federal income tax purposes as an "association taxable as a corporation"<sup>4</sup> rather than a partnership, the federal income tax effects would be devastating. All income earned by the partnership would be taxed at the partnership level at regular corporate rates,<sup>5</sup> and partnership losses

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1. Act 150 of 1980 completely revised, amended, and reenacted title XI of book III of the Louisiana Civil Code of 1870, containing articles 2801 through 2890, and substituted and enacted a new title XI, "Partnership," containing articles 2801 through 2848. These articles contain provisions regarding Louisiana general partnerships and Louisiana partnerships in commendam. Act 151 of 1980 amended code title XI of code book III of title 9 of the Louisiana Revised Statutes by repealing chapter 1, "Partnerships," containing sections 3401 through 3406, and enacting a new chapter 1, "Central Registry for Contracts of Partnership," containing sections 3401 through 3408. These sections contain rules regarding the central registration of articles of partnership. Act 152 of 1980 amended code title XI of code book III of title 9 of the Louisiana Revised Statutes by enacting a new chapter 2, "Qualification of Foreign Partnerships," containing sections 3421 through 3427, and providing for the registration of foreign partnerships.

2. The sixteenth amendment permitted enactment of the federal income tax.

3. The Internal Revenue Code of 1954, as codified and amended in title 26 of the United States Code, will hereinafter be referred to as the "Code" in both the text and footnotes. All references to sections are to the Code.

4. Section 7701(a)(3) defines the term "corporation" to include an "association." However, the term "association" is not defined in the Code. The Treasury Regulations simply state that "[t]he term 'association' refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust." Treas. Reg. § 301.7701-2(a)(1) (1967) (emphasis added).

5. See I.R.C. § 11 (Supp. V 1981). This assumes that an organization that is treated as an association taxable as a corporation either has not made or is unable to make an

would not be passed on to the partners. Income distributions by the partnership would be taxed again to the partners and would not be deductible by the partnership.<sup>6</sup> Furthermore, redemptions of partnership interests and liquidating distributions by the partnership would trigger taxable capital gains or possibly ordinary income.<sup>7</sup> The partnership could also be subject to such delights as the personal holding company tax<sup>8</sup> or the accumulated earnings tax.<sup>9</sup>

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election under section 1362(a) to be taxed as an S corporation. Generally, pursuant to provisions of the newly-enacted Subchapter S Revision Act of 1982, an S corporation is not subject to federal income tax and shareholders are taxed much like partners in a partnership, *i.e.*, each item of income, loss, deduction, or credit is passed through to the shareholders and reported on their individual returns. *See* I.R.C. §§ 1363 & 1366 (West Supp. 1983). An S corporation is now required to compute its taxable income in the same manner as an individual except that items of income, deduction, loss, and credit are stated separately (and passed on to the shareholders) and certain deductions prescribed in section 703(a)(2) are disallowed.

6. Thus, income earned by the partnership would be taxed twice—once at the partnership level at regular corporate rates and once at the partner level at regular ordinary income rates that could range as high as 50%. *See* I.R.C. § 1 (Supp. V 1981).

7. Distributions in redemption of stock are treated as a distribution in payment in exchange for the stock if such distribution falls within one of the subparagraphs of section 302(b). As such, and assuming the stock is a capital asset in the hands of the shareholder, it is likely that the shareholder would receive capital gain treatment. However, in certain circumstances, such shareholder may still be faced with ordinary income treatment. If a corporation redeems all or a part of its stock and if section 302(a) is not applicable, the redemption will be treated as an ordinary distribution subject to the provisions of section 301. Such distributions are taxed as dividends to the extent of the corporation's current and accumulated earnings and profits. I.R.C. § 301(c)(1) (1976). The portion of such distribution not treated as a dividend is treated as a tax-free return of capital. I.R.C. § 301(c)(2) (1976). The excess of the amount of the distribution over the adjusted basis of the stock is treated as gain from the sale or exchange of property. I.R.C. § 301(c)(3) (1976).

In addition to the foregoing rules, if section 341 (the collapsible corporation rules) is applicable, a shareholder may be faced with ordinary income treatment upon the sale or exchange of his interest in the company. *See* B. BITTKER & J. EUSTICE, *TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 12 (4th ed. 1979). Also, if a corporation is completely liquidated within one calendar month and proper elections are made pursuant to section 333, a portion of the gain recognized by a shareholder could be taxed as ordinary income. Pursuant to section 333, a qualified electing shareholder must recognize any gain to the extent of the greater of (i) his ratable portion of the corporation's earnings and profits, or (ii) the amount of money and the value of stock or securities acquired by the corporation after December 31, 1953. A noncorporate shareholder must treat such gain as a dividend to the extent of such shareholder's ratable portion of post-1913 corporate earnings and profits; the remainder, if any, of the gain is taxable as capital gain. I.R.C. § 333(e) (1976). A corporate shareholder receives capital gain treatment for the entire amount of recognized gain. I.R.C. § 333(f) (1976).

8. I.R.C. §§ 541-547 (1976 & Supp. V 1981). These provisions generally provide that if at least 60% of a corporation's "adjusted ordinary gross income" is "personal holding company income," and if more than 50% in value of the stock of the corporation is owned directly or indirectly (applying certain constructive ownership rules) by or for five or fewer individuals, then a tax at the rate of 50% is imposed on the corporation's "undistributed personal holding company income."

9. I.R.C. §§ 531-537 (1976 & Supp. V 1981). The accumulated earnings tax is im-

If an enterprise is classified as a partnership for federal income tax purposes, however, the federal income tax effects are quite different. Items of income, gain, loss, deduction, and credit are passed through the entity and reported by the members of the partnership on their respective returns.<sup>10</sup> Some nonliquidating distributions to partners may be treated as guaranteed payments under section 707(c); distributions treated in this manner would be taxable to the recipient as ordinary income, although they would generally be deductible as ordinary and necessary business expenses of the partnership.<sup>11</sup> Other nonliquidating distributions usually result in no gain or loss to the recipient.<sup>12</sup> If any gain results, however, it is generally taxable as capital gain.<sup>13</sup>

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posed on every corporation (other than personal holding companies, foreign personal holding companies, and corporations exempt under section 501) "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed." I.R.C. § 532(a) (1976). A corporation will be considered to be formed or availed of for the "bad purpose" if earnings and profits of the corporation are permitted to accumulate beyond the reasonable needs of the business, unless the corporation proves otherwise by a preponderance of the evidence. I.R.C. § 533(a) (1976). Additionally, the "fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders." I.R.C. § 533(b) (1976). The accumulated earnings tax is imposed at a rate of 27-1/2% of the first \$100,000 of accumulated taxable income and 38-1/2% of accumulated taxable income in excess of \$100,000. I.R.C. § 531 (1976).

10. Section 701 provides that the partners, not the partnership, are liable for income tax in their individual capacities. Section 702(a) provides generally that each partner must account separately for his distributive share of certain specified gains and losses of the partnership, other items of income, gain, loss, deduction, or credit, and the partnership's taxable income or loss not subject to separate computation—the "bottom line." I.R.C. § 702(a)(8) (1976). Thus, unlike a *regular* corporation, a partnership is not a taxable entity; only the individual partners report and are taxed on items of partnership gains and losses on their separate tax returns. Thus, there is no double taxation.

11. Guaranteed payments that constitute capital expenditures must be capitalized and added to the basis of the partnership assets pursuant to section 263. See *Cagle v. Commissioner*, 63 T.C. 86 (1974), *aff'd*, 539 F.2d 409 (5th Cir. 1976); Rev. Rul. 75-214, 1975-1 C.B. 185.

12. I.R.C. § 731(a) (1976). Gain will be recognized by a partner upon distribution only to the extent any money distributed exceeds the adjusted basis of the distributee partner's interest in the partnership immediately before the distribution. I.R.C. § 731(a)(1) (1976). Loss will be recognized only with respect to certain distributions in liquidation of a partner's interest in the partnership. I.R.C. § 731(a)(2) (1976). A partnership will not recognize any gain or loss upon the distribution of property (including money) to a partner. I.R.C. § 731(b).

Different rules apply to certain liquidating distributions to a retiring partner or a deceased partner's successor in interest, as discussed *infra* text accompanying notes 136-45, and to the distribution of unrealized receivable items and substantially appreciated inventory items.

13. I.R.C. § 741 (1976). However, if the partnership owns unrealized receivables or substantially appreciated inventory items, as those terms are defined in section 751, gain recognized by the partners may be taxable as ordinary income. I.R.C. § 751 (1976 & Supp. V 1981). These rules are intended to prevent partners from converting potential ordinary income into capital gains by selling or exchanging partnership interests. Additionally, sec-

For federal income tax purposes, the Code defines a partnership to include: "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 [the Code], a corporation or a trust or estate."<sup>14</sup> This definition is much broader than the common law meaning of the term "partnership," and arrangements that are not commonly considered partnerships under state law may be partnerships for federal income tax purposes.<sup>15</sup> Conversely, an arrangement that constitutes a partnership under state law is not automatically treated as a partnership for federal income tax purposes.<sup>16</sup>

In order for an enterprise to constitute a partnership under Louisiana law, there must be a contract between two or more persons pursuant to which they agree "to combine their efforts or resources in determined proportions and to collaborate at mutual risk for their common profit or commercial benefit."<sup>17</sup> All entities that are treated as partnerships for federal income tax purposes would satisfy the "joint profit sharing" requirement of Louisiana law.<sup>18</sup> However, simply because an enterprise is a partnership under Louisiana law does not automatically make it a partnership for federal income tax purposes.

An organization will be classified as an association taxable as a corporation for federal income tax purposes only if certain criteria<sup>19</sup> are met; the organization's classification under state law is immaterial.<sup>20</sup> The applicable Treasury Regulations list six major characteristics of a corporation: (i) the existence of associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests.<sup>21</sup> An organization will be treated as an association taxable as a corporation if, after considering

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tion 751(b) provides for the treatment of certain distributions which alter a partner's interest in unrealized receivables and substantially appreciated inventory items. *See generally* W. MCKEE, W. NELSON & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 25.03 (1977) (hereinafter cited as MCKEE, NELSON & WHITMIRE).

14. I.R.C. § 761(a) (Supp. V 1981).

15. *See* Treas. Reg. § 1.761-1 (1982); Treas. Reg. §§ 301.7701-1(c), -3(a) (1967).

16. Treas. Reg. § 301.7701-1(c) (1967).

17. LA. CIV. CODE art. 2801.

18. The Treasury Regulations indicate that the presence of associates in the venture and an objective to carry on a business activity and divide the gains therefrom are generally common to both partnerships and corporations. Treas. Reg. § 301.7701-2(a)(2) (1967). Therefore, if an enterprise is treated as a partnership for federal income tax purposes, such enterprise must necessarily consist of one or more persons who have the common objective to carry on a business and to share in the profits generated by such business. Thus, the requirements of Civil Code article 2801 should be satisfied also.

19. Treas. Reg. § 301.7701-2 (1967).

20. *Id.* § 301.7701-1(c) (1967).

21. *Id.* § 301.7701-2(a)(1) (1967).

all of the facts and circumstances, the organization's characteristics cause it to more nearly resemble a corporation than a partnership.<sup>22</sup> Although the Treasury Regulations state that "other factors" may be considered in conjunction with the six "major characteristics" listed above,<sup>23</sup> the Internal Revenue Service has recently conceded that only the six major characteristics will be considered.<sup>24</sup>

The first two characteristics, the existence of associates and an objective to carry on business for joint profit, are common to both partnerships and corporations and are neutral in distinguishing the two types of entities for federal income tax purposes.<sup>25</sup> Thus, if an organization has associates and an objective to carry on business for joint profit, whether that organization will be classified as an association taxable as a corporation will usually depend upon whether the organization possesses more than two of the other four major corporate characteristics.<sup>26</sup> If such an organization lacks two or more of the remaining four major corporate characteristics, it will be classified as a partnership for federal income tax purposes.

### *Continuity of Life*

An organization does not possess the corporate characteristic of continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member causes a dissolution of the organization.<sup>27</sup> If the retirement, death, or insanity of a general partner of a limited partnership causes its dissolution unless the remaining general partners or all remaining partners elect to continue the partnership, then the corporate characteristic of continuity of life will not be present.<sup>28</sup> For this purpose, the term "dissolution" means "an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law."<sup>29</sup> Thus, if any of the events described above causes a dissolution of a partnership under local law, the corporate characteristic of continuity of life does not exist.

The regulations also provide that where the term of an organization

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22. *Id.* § 301.7701-2(a)(3) (1967).

23. *Id.* §§ 301.7701-2(a)(1), -2(a)(3) (1967).

24. In *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.* 1979-1 C.B. 1, the United States Tax Court indicated that for the sake of predictability it would not consider other factors for purposes of classifying an enterprise "unless their materiality [is] unmistakable." *Id.* at 185, n.22. Following *Larson*, the Internal Revenue Service issued revenue ruling 79-106, 1979-1 C.B. 448, which lists seven factors that will not be considered as "other factors" for purposes of classifying certain unincorporated enterprises.

25. Treas. Reg. § 301.7701-2(a)(3) (1967).

26. *Id.*

27. *Id.* § 301.7701-2(b)(1) (1967).

28. *Id.* See generally MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 3.06[4][a].

29. *Id.* § 301.7701-2(b)(2) (1967).

is for a stated period of time or until the completion of a stated transaction, pursuant to an agreement among the parties or by local law, continuity of life does not exist if the effect of the agreement or local law is that any member has the "power," although not necessarily the contractual "right," to dissolve the partnership.<sup>30</sup> The regulations further provide that a general partnership, subject to a statute which corresponds to the Uniform Partnership Act, or a limited partnership, subject to a statute which corresponds to the Uniform Limited Partnership Act or the revised Uniform Limited Partnership Act, both lack continuity of life.<sup>31</sup> However, because Louisiana partnership law does not correspond to the Uniform Partnership Act, the Uniform Limited Partnership Act or the revised Uniform Limited Partnership Act, this provision of the regulations is inapplicable to Louisiana partnerships.

Louisiana Civil Code article 2826 now provides that a partnership will be terminated upon the occurrence of one of the following events: (i) the unanimous consent of all partners, (ii) a judgment of termination, (iii) the granting of an order for relief to the partnership under chapter 7 of the Bankruptcy Code, (iv) the reduction of its membership to one person, (v) the expiration of a specified term, if any, or (vi) the attainment of, or the impossibility of attainment of, the object of the partnership. A partnership also terminates in accordance with provisions of the partnership agreement.<sup>32</sup>

As previously noted, the Treasury Regulations provide that continuity of life does not exist if the death, insanity, or retirement of a general partner will cause a limited partnership to dissolve, unless the remaining general partners or all of the remaining members agree to continue the partnership.<sup>33</sup> A Louisiana partnership in commendam is not subject to a statute corresponding to the Uniform Limited Partnership Act or the revised Uniform Limited Partnership Act, and the 1980 version of Civil Code article 2826 did not provide for termination of a Louisiana partnership in commendam upon any of the events set forth in the Treasury Regulations. Until the law was changed retroactively in 1981,<sup>34</sup> every Loui-

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30. *Id.* § 301.7701-2(b)(3) (1967).

31. *Id.* All references to the Uniform Partnership Act, §§ 1-43, 6 U.L.A. 1-544 (1914), throughout the regulations regarding the classification of associations are also deemed to refer to the revised Uniform Limited Partnership Act, §§ 101-1105, 6 U.L.A. 173-229 (Supp. 1976). See *Treas. Reg.* § 301.7701-2(a)(5), T.D. 7889, 1983-22 I.R.B. 16.

32. LA. CIV. CODE art. 2826.

33. *Treas. Reg.* § 301.7701-2(b)(1) (1967).

34. Section 1 of Act 797 of 1981 amended and reenacted Civil Code article 2826 by providing that a partnership also terminated upon the "retirement from the partnership, or the death, interdiction, or dissolution of any general partner unless the partnership is continued by the remaining general partners under a right to do so stated in the contract of partnership or with the consent of all of the remaining general partners." The provisions of Act 797 of 1981 became effective September 11, 1981, but applied to all partnerships

siana partnership in commendam that was formed without providing for termination upon the occurrence of any one of the terminating events included in the Treasury Regulations or without allowing at least one member to terminate it at will possessed the corporate characteristic of continuity of life.

In 1982, however, the Louisiana Legislature amended Civil Code article 2826<sup>35</sup> by deleting the language that had been added in 1981 and by adding the following paragraph:

A partnership in commendam, however, terminates by the retirement from the partnership, or the death, interdiction, or dissolution, of the sole or any general partner unless the partnership is continued with the consent of the remaining general partners under a right to do so stated in the contract of partnership or if, within ninety days after such event, all the remaining partners agree in writing to continue the partnership and to the appointment of one or more general partners if necessary or desired.<sup>36</sup>

With this addition, a Louisiana partnership in commendam now lacks the corporate characteristic of continuity of life, provided there are no contrary provisions in the partnership agreement.

All Louisiana partnerships other than partnerships in commendam, however, appear to continue to possess the corporate characteristic of continuity of life, absent provisions in the partnership agreement that comply with the Treasury Regulations.

### *Centralized Management*

If the partnership agreement or applicable state law grants the continuing, exclusive authority to make management decisions regarding the operation of a partnership to one or more persons in a manner similar to a board of directors of a corporation, the partnership will possess the corporate characteristic of centralized management.<sup>37</sup> Centralized management can be established in a person or group of persons "by election to office, by proxy appointment, or by any other means which has the effect of concentrating in a management group continuing exclusive

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existing on that date without divesting, however, vested rights or impairing contractual obligations. The provisions of Act 797 of 1981 were subsequently repealed, however, by Act 273 of 1982, which became effective on July 18, 1982.

35. 1982 La. Acts, No. 273, § 1.

36. LA. CIV. CODE art. 2826, para. 3. This language was derived from section 20 of the Uniform Limited Partnership Act which provides as follows: "The retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners (a) under a right so to do stated in the certificate, or (b) with the consent of all members." 6 U.L.A. 604 (1916).

37. Treas. Reg. § 301.7701-2(c)(1) (1967).



authority to make management decisions."<sup>38</sup> Such a management group must possess the sole authority to transact ordinary business (as opposed to the performance of ministerial acts) on behalf of the partnership without the approval of the other members.<sup>39</sup>

The Treasury Regulations specifically provide that because of the mutual agency relationship between partners in a general partnership subject to a statute similar to the Uniform Partnership Act, such a partnership cannot have centralized management.<sup>40</sup> This results from the fact that the act of any partner in the ordinary course of partnership business generally binds the partnership. Although Louisiana has not specifically adopted the Uniform Partnership Act, the concept of a mutual agency relationship among the partners in a Louisiana general partnership, similar to that established by section 9 of the Uniform Partnership Act, is now found in Civil Code articles 2814 and 2816.<sup>41</sup> As a result, it is likely that a Louisiana partnership having no partners in commendam will lack the corporate characteristic of centralized management.<sup>42</sup> This result follows

38. *Id.* § 301.7701-2(c)(2) (1967).

39. *Id.* § 301.7701-2(c)(3) (1967).

40. *Id.* § 301.7701-2(c)(4) (1967). Section 9 of the Uniform Partnership Act provides, in part, as follows:

(1) Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

(2) An act of a partner which is not apparently for the carrying on of the business of the partnership in the usual way does not bind the partnership unless authorized by the other partners.

6 U.L.A. 132 (1914). See also UNIF. LTD. PARTNERSHIP ACT § 20, 6 U.L.A. 604 (1916) quoted *supra* note 36.

41. For a discussion of the concept of mutual agency as established by Civil Code article 2814, see Note, *Louisiana's New Partnership Provisions: A Review of the Changes and Some Continuing Problem Areas*, 42 LA. L. REV. 1429, 1431-32 (1982).

42. Even though Civil Code article 2807 provides that decisions regarding the management and operation of the partnership must be made by a majority of the partners unless the parties agree otherwise, it is not entirely clear whether such provision will result in centralized management. Since each partner in a Louisiana general partnership is a mandatory of the general partnership for all acts in the ordinary course of a partnership's business, other than the alienation, lease, or encumbrance of an immovable, it is doubtful that a Louisiana general partnership will have the corporate characteristic of centralized management. Since *any* general partner can bind the partnership and other partners with respect to most matters in the ordinary course of the partnership's business, no person or group of persons has the *exclusive* authority to make management decisions. See Treas. Reg. § 301.7701-2(c)(1), (3) (1967). For instance, if a majority of the partners of a general partnership voted against a particular transaction affecting the management or operation of the partnership, but a partner nonetheless entered into the transaction, the partnership would still be bound; thus, the majority would not have exclusive control over management of

even if the general partners appoint one or more persons as managing general partners, because the other general partners have the power to bind the partnership with respect to transactions in the ordinary course of the partnership's business or which benefit the partnership.<sup>43</sup>

The Treasury Regulations also provide that partnerships subject to a statute corresponding to the Uniform Limited Partnership Act generally do not have centralized management.<sup>44</sup> However, centralized management exists in such a partnership if substantially all of the interests in the partnership are owned by the limited partners.<sup>45</sup> The same rule should apply to Louisiana partnerships in commendam, although there is no jurisprudence to date on this point. The Internal Revenue Service's private rulings on the status of Louisiana partnerships in commendam have relied solely on lack of continuity of life and limited liability for classifying such entities for federal income tax purposes.<sup>46</sup>

On October 27, 1980, the Treasury Department proposed a modification to the existing association regulations<sup>47</sup> to provide that references to the Uniform Limited Partnership Act were also to be read as references to the revised Uniform Limited Partnership Act.<sup>48</sup> At the same time, however, an additional factor was added by the proposed regulations to the effect that if the limited partners have the right to remove the general partner, all of the facts and circumstances will be taken into account in

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the partnership, and centralized management would not exist. On the other hand, an argument could be made that, because the Civil Code provides that management decisions must be made by a majority of the partners, centralized management exists. Several courts have rejected this argument, however, and it is further weakened by the fact that, unless otherwise provided by agreement between the parties, a Louisiana general partnership establishes a mutual agency among the parties. Such a "mutual agency" relationship is contrary to the concept of centralized management in certain circumstances, because no person or group of persons has exclusive management authority. See *supra* text accompanying note 40.

43. LA. CIV. CODE arts. 2814, 2816. "A partner who has no authority to act for the partnership due to a stipulation in the partnership agreement can bind the partnership if the third person with whom he deals neither knows nor has reason to know of the partner's lack of authority to bind the partnership." LA. CIV. CODE art. 2814, comment (a).

44. Treas. Reg. § 301.7701-2(c)(4).

45. *Id.* At one time the Internal Revenue Service took the position that if the interests of general partners total at least 20% of all partnership interests, the limited partners should not be considered as owning substantially all of the interests in the partnership. See *Points to Remember*, 25 TAX LAW. 177, 179 (1971) [hereinafter cited as *Points*]. Whether or not this is the present position of the Internal Revenue Service is uncertain.

46. IRS Letter Ruling 8250041 (Sept. 13, 1982), 1982 PRIV. LTR. RUL. (P-H) ¶ 4499; IRS Letter Ruling 8245046 (Aug. 11, 1982), 1982 PRIV. LTR. RUL. (P-H) ¶ 6287; IRS Letter Ruling 8226132 (Mar. 31, 1982), 1982 PRIV. LTR. RUL. (P-H) ¶ 6367; IRS Letter Ruling 8152057 (Sept. 30, 1981), 1981 PRIV. LTR. RUL. (P-H) ¶ 6792; IRS Letter Ruling 8124153 (Mar. 23, 1981), 1981 PRIV. LTR. RUL. (P-H) ¶ 6665.

47. Treas. Reg. § 301.7701-2 (1967).

48. Proposed Treas. Reg. § 301.7701-2(a)(5) (1983). These regulations were adopted on April 25, 1983. T.D. 7889, 1983-22 I.R.B. 16.

determining whether or not the partnership has centralized management.<sup>49</sup> Those regulations also provided that a substantially restricted right of the limited partners to remove the general partner (*e.g.*, in the event of the general partner's gross negligence, self-dealing, or embezzlement) would not in itself cause the partnership to have centralized management.<sup>50</sup>

Civil Code article 2820 allows a partnership to expel a partner by majority vote for "just cause," unless otherwise provided in the partnership agreement. The comments to article 2820 give as examples of "just cause" a partner's failure to perform his obligations, engaging in activities which prejudice the partnership's business, and the willful or repeated breach of the partnership agreement.<sup>51</sup>

Applying the foregoing rules, most Louisiana partnerships in *commendam* are likely to possess the corporate characteristic of centralized management since usually only a small portion of the partnership is owned by the general partners.<sup>52</sup> This is true whether or not the partners in *commendam* are able to expel the general partner. However, where the general partner's interest is substantial, the existence of the power of expulsion may be relevant to the existence of centralized management. Nevertheless, it appears that the expulsion power set forth in Civil Code article 2820 is a "substantially restricted" one within the meaning of the association regulations so that its existence should be of no consequence to the classification of a Louisiana partnership in *commendam* for federal income tax purposes.

### *Limited Liability*

For federal income tax purposes, the Treasury Regulations provide that the corporate characteristic of limited liability exists

if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek per-

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49. Treas. Reg. § 301.7701-2(c)(4), T.D. 7889, 1983-22 I.R.B. 16. Thus, even if a general partner owns a substantial interest in a limited partnership, centralized management may exist if the limited partners possess the power to remove a sole general partner and elect a successor general partner. See *Zuckman v. United States*, 524 F.2d 729 (Ct. Cl. 1975); *Larson v. Commissioner*, 66 T.C. 159, 178-79 (1976), *acq.* 1979-1 C.B. 1.

50. *Id.*

51. LA. CIV. CODE art. 2820, comment (a).

52. See *Points*, *supra* note 45, at 179 (limited partners should not be considered as owning substantially all of the partnership interests if the general partners own at least 20% of all of the partnership interests). In most syndicated limited partnerships, the general partners rarely own in excess of 20% of the total partnership interests. Therefore, it is likely such partnerships will have the corporate characteristic of centralized management, and the other three tests (especially limited liability and continuity of life) become much more important. See private letter rulings cited *supra* note 46.

sonal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim.<sup>53</sup>

The regulations further provide that in the case of a general partnership subject to a statute corresponding to the Uniform Partnership Act, personal liability exists with respect to each general partner.<sup>54</sup>

With respect to limited partnerships, the Treasury Regulations provide that personal liability does not exist with respect to a general partner (individual or corporate) who has "no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization *and* [who] is merely a 'dummy' acting as the agent of the limited partners."<sup>55</sup> The United States Tax Court<sup>56</sup> and the United States Court of Claims<sup>57</sup> have confirmed the conjunctive nature of the limited liability test. Therefore, in order for the characteristic of limited liability to exist, the general partners (individual or corporate) of a limited partnership must be "dummies" *and* lack substantial assets.

Acknowledging the conjunctive test described above, the Court of Claims in *Zuckman v. United States*<sup>58</sup> noted that if a corporate general partner were merely acting as the agent of the limited partners, the limited partners, as principals, would be treated as general partners and would be personally liable for partnership debts.<sup>59</sup> If the general partner is not merely acting as a dummy or agent of the limited partners, but is managing in his own right, personal liability for the partnership debts exists with respect to him; thus, some member of the organization will always be personally liable for the debts. Following the "agent" analysis applied in *Zuckman*, then, it would appear impossible for the corporate characteristic of limited liability ever to exist in a limited partnership. If the general partner is not merely acting as a dummy or agent of the limited partners, but is managing in his own right, personal liability for the partnership debts exists with respect to him; if, on the other hand, the general partner is acting as an agent for the limited partners, the limited partners will be treated as general partners and they will be personally liable for the partnership debts. Thus, some member of the organization will always be personally liable for the debts.

The Treasury Regulations provide very little guidance as to what con-

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53. Treas. Reg. § 301.7701-2(d)(1) (1967).

54. *Id.*

55. *Id.* § 301.7701-2(d)(2) (1967) (emphasis added).

56. *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.* 1979 1-C.B. 1.

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

58. *Id.* at 741.

59. See Treas. Reg. § 301.7701-2(d)(2) (1967) ("Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as principals of such general partner, personal liability will exist with respect to such limited partners.').

stitutes "substantial assets" for purposes of the limited liability test. However, the Internal Revenue Service has in a series of revenue procedures<sup>60</sup> set forth certain specified tests that must be satisfied before it will rule on whether a limited partnership having a sole corporate general partner will be treated as a partnership. Two of the criteria set forth in those revenue procedures are: (1) The sole corporate general partner's net worth (at current fair market value) at all times during the existence of the partnership, apart from its interest in the partnership, must be represented to be equal to (a) 15% of total contributions to the partnership (up to \$250,000 of net worth) where the total contributions are \$2,500,000 or less and (b) 10% of total contributions to the partnership where total contributions exceed \$2,500,000. This test is applied cumulatively with respect to all partnerships in which the corporation acts as general partner; and (2) the limited partners, individually or in the aggregate, may not own (directly or indirectly through attribution)<sup>61</sup> more than 20% of the value of the outstanding capital stock of the corporate general partner or any of its affiliates.<sup>62</sup>

If the net worth requirement is not met, it would appear that the Internal Revenue Service would not rule on whether the limited partnership in question possessed limited liability even if the second criterion (the control or "agency" test) was satisfied. Thus, at least for rulings purposes, it appears the Internal Revenue Service interprets the substantial net worth and agency tests of section 301.7701-2(d)(2) of the Treasury Regulations in the disjunctive rather than the conjunctive. This ruling position appears to conflict with the Tax Court, Court of Claims and the Treasury Regulations, each of which applies the agency and net worth tests conjunctively.

Because the Internal Revenue Service's disjunctive interpretation may be correct, although this is unlikely, Louisiana's partnership law should be examined in light of such interpretation. Civil Code article 2817 provides that "[a] partner is bound for his virile share of the debts of the partnership." The comments to article 2817 provide that in delictual matters, the general partners' liability is solidary.<sup>63</sup> In contractual matters, however, a creditor who desires that partners be liable in solido for a debt of the partnership must "obtain express agreement from the part-

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60. See Rev. P. 72-13, 1972-1 C.B. 735; Rev. P. 74-17, 1974-1 C.B. 438; Rev. P. 75-16, 1975-1 C.B. 676.

61. I.R.C. § 318 (1976). Although there is no statutory authority for applying the attribution rules of section 318, the Internal Revenue Service has done so for ruling purposes. See IRS Letter Ruling 8036033 (June 11, 1980), 1980 PRIV. LTR. RUL. (P-H) ¶ 6557 (section 318 attribution rules applied). There is some doubt as to whether the attribution rules of section 318 should apply. See MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 3.07[2].

62. Rev. P. 72-13, 1972-1 C.B. 735.

63. LA. CIV. CODE art. 2817, comment (c).

ners to the effect that they are solidarily liable for the debt."<sup>64</sup> Thus, unless otherwise provided in the articles of partnership, the personal liability of each general partner in a partnership having more than one general partner is limited to his virile share of partnership debts, although the liability of all general partners taken together is not so limited. However, there is no reference in the Civil Code as to whether a provision in the articles of partnership to the effect that partners are solidarily liable for partnership debts will be effective as to creditors, although the comments to article 2817 support the proposition.<sup>65</sup>

The Internal Revenue Service has on occasion required, as a condition to issuance of a private letter ruling with respect to a Louisiana partnership (general or in commendam) having more than one general partner, a provision in the partnership agreement to the effect that all general partners agree to be liable in solido (after exhaustion of partnership assets) for debts on which the partnership had personal liability.<sup>66</sup> The rationale is that virile share liability prevents a creditor from collecting his entire debt from any one general partner, thus limiting the liability of each general partner. This position is probably erroneous, particularly in light of the fact that contractual liability under the Uniform Partnership Act is joint and not several as among the general partners;<sup>67</sup> only tort liability is joint and several among them.<sup>68</sup> Nevertheless, caution would dictate a provision in any partnership agreement where there is more than one general partner to the effect that the general partners agree to be liable

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64. LA. CIV. CODE art. 2817, comment (c).

65. Unlike other Civil Code articles dealing with Louisiana partnerships, article 2817 makes no provision for modifying the rules of article 2817 by agreement among the partners. Therefore, it is not entirely clear whether the partnership can provide that general partners in a partnership (general or in commendam) are solidarily liable for debts of the partnership. Since a partnership is created by contract, as provided in Civil Code article 2801 and comment (a) thereto, it would follow that the parties are free to contract as they wish so long as the partnership agreement does not violate public policy. This theory is supported by Civil Code article 2802 which provides in pertinent part that: "The contract of partnership is governed by the provisions in the Title: *Of Conventional Obligations*, in all matters that are not otherwise provided for by this Title."

Comment (b) to article 2802 further supports the position that the parties are free to depart from provisions of the Civil Code that do not concern matters of public policy. Although comment (b) to article 2802 seems to indicate that the sharing of debts is a matter of public policy, it appears highly unlikely that a court would construe a provision in a partnership agreement which gives creditors greater rights as violative of public policy. Comment (c) to article 2817 provides that only by express agreement from the partners can they be liable solidarily for a debt. The partnership agreement would appear to be an adequate document for such expression.

66. IRS Letter Ruling 8245046 (Aug. 11, 1982), 1982 PRIV. LTR. RUL. (P-H) ¶ 6287; IRS Letter Ruling 8226132 (Mar. 31, 1982), 1982 PRIV. LTR. RUL. (P-H) ¶ 6367; IRS Letter Ruling 8152057 (Sept. 30, 1981), 1981 PRIV. LTR. RUL. (P-H) ¶ 6792.

67. UNIF. PARTNERSHIP ACT, § 15(b), 6 U.L.A. 174 (1914).

68. *Id.* § 15(a), at 174.

in solido for all liabilities (tort, contractual, or otherwise) of the partnership, other than *in rem* or nonrecourse liabilities.<sup>69</sup>

### *Free Transferability of Interests*

The corporate characteristic of free transferability of interests exists if each of the members of an organization, or those members owning substantially all of the interests in an organization, has the power, without the consent of other members of the organization, to substitute for themselves a person who is not a member of the organization.<sup>70</sup> Thus, if a member of an organization is not free to convey to another person all of the attributes of an interest in a partnership without the consent of other partners, the corporate characteristic of free transferability of interests does not exist.<sup>71</sup>

Under Louisiana law as it existed prior to 1980, a partner could donate or sell his or its rights to share in the profits of the partnership with a third person with respect to his partnership, but the donee or vendee of such rights did not on that account become a partner.<sup>72</sup> Additionally, Civil Code article 2871, before its repeal in 1980, provided that a partner could enter into a partnership interest. This arrangement could be consummated without the consent of other partners in the partnership, but the partner could not make the third person a partner in the original partnership without the consent of the other partners.<sup>73</sup>

Under current Louisiana law, the substance of old Civil Code article 2871 has been carried forward into new Civil Code article 2812, which provides that a partner may "share" his interest in a partnership with a third party (presumably by way of an assignment of a portion of the profits, gains and losses attributable to the interest in question) without the consent of the other partners. However, the sharing partner cannot make the third person a member of the partnership without the consent of the other partners. Unfortunately, Act 150 of 1980 did not carry over the substantive provisions of old Civil Code article 2815, which specifically prohibited a third-party assignee of a partnership interest from becoming

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69. The addition of a provision requiring contribution among the general partners (on a per capita basis or in accordance with whatever ratio the partners can agree upon) should not prevent a solidary liability provision from being effective for this purpose.

70. Treas. Reg. § 301.7701-2(e)(1) (1967).

71. Compare *id.* § 301.7701-3(b)(2), example (1) (1967) with *id.* § 301.7701-3(b)(2), example (2) (1967).

72. LA. CIV. CODE art. 2815 (as it appeared prior to its repeal by 1980 La. Acts, No. 150, § 1).

73. LA. CIV. CODE art. 2871 (as it appeared prior to its repeal by 1980 La. Acts, No. 150, § 1); see also *Bayou Verret Land Co. v. United States*, 450 F.2d 850 (5th Cir. 1971); *United States v. Atkins*, 191 F.2d 146 (5th Cir. 1951), *cert. denied*, 343 U.S. 941 (1952).

a partner unless the other partners consented thereto. This omission leaves some doubt as to whether an assignee, vendee, or donee of a partnership interest can become a substituted partner without the consent of the other partners, in the absence of a provision in the partnership agreement to the contrary. Consequently, Louisiana partnership agreements should specifically provide that no partner may transfer all or part of his interest in the partnership to another and thereby automatically make his transferee a substituted partner without the consent of all of the other partners, or at least the other general partners. Such a provision should prevent the partnership from possessing the corporate characteristic of free transferability of interests.

For purposes of other federal income tax provisions (*e.g.*, allocations of income, gains, losses, and deductions), such an assignee could be treated as a partner.<sup>74</sup> However, because he would have no right to vote with respect to the interest assigned, or otherwise exercise any management rights which follow the partnership interest, he would not be a partner under Louisiana law.<sup>75</sup> Consequently, the corporate characteristic of free transferability of interests should not exist.

#### BASIS

Section 704(d) provides that a partner's distributive share of partnership losses may be deducted only up to the adjusted basis of his interest in the partnership at the end of the partnership year in which such loss occurred. Any excess loss over his adjusted basis may be carried forward and deducted at the end of the partnership year in which his basis is increased.<sup>76</sup> A partner's initial basis in his partnership interest is the sum

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74. See *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971); Rev. Rul. 77-137, 1977-1 C.B. 178. In revenue ruling 77-137, an unadmitted assignee of a limited partnership interest was treated as a partner for federal income tax purposes since the assignee "acquired substantially all of the dominion and control over the limited partnership interest." This statement probably resulted from the fact that the assignor agreed to exercise any residual rights (*e.g.*, the rights to obtain information and inspect the partnership's books and records) in favor of the assignee.

At least one practitioner has expressed some concern that the Internal Revenue Service might extend the scope of revenue ruling 77-137 to provide that virtually every limited partnership will possess the corporate characteristic of free transferability even though the partnership agreement (or local law) provides that a limited partner cannot cause his assignee to become a substituted limited partner. *Shop Talk*, 47 J. TAX'N 127 (1977). If the Internal Revenue Service were to adopt such a position, partnership agreements should probably prohibit any assignments whatsoever. However, the ruling probably stands only for the proposition that a person may be a partner for tax purposes without being a partner under local law. The corporate characteristic of free transferability of interest is likely present only when the transferor can automatically make his assignee a substituted partner.

75. LA. CIV. CODE art. 2812.

76. I.R.C. § 704(d) (Supp. V 1981).



of the amount of money and the adjusted basis of the property contributed to the partnership by him.<sup>77</sup>

Partnership liabilities also play an important role in determining a partner's basis in his partnership interest. Section 752(a) treats each partner's share of the partnership's debt as a contribution of money to the partnership, which increases the partner's basis in his partnership interest pursuant to section 722. On the other hand, any decrease in a partner's share of partnership liabilities is treated as a distribution of money under section 752(b), decreasing the partner's basis of his partnership interest pursuant to section 733.

A key element in applying the foregoing rules is the determination of a partner's share of partnership liabilities. The Code does not make any provision for such determination. The Treasury Regulations, however, provide that liabilities of a partnership are generally shared by the partners in the ratio in which they share "losses" under the partnership agreement, except that a limited partner's share of recourse liabilities does not exceed the difference between his actual contribution to the partnership and the total contribution he is required to make under the limited partnership agreement.<sup>78</sup> If no partner has any personal liability with respect to a partnership debt (*i.e.*, a nonrecourse debt), all partners, general and limited, share such liability in the same proportion as they share partnership "profits."<sup>79</sup>

Civil Code article 2840 provides that a partner in commendam must agree to make a contribution to the partnership in the form of money, things or the performance of nonmanagerial services. A partner in commendam is liable for the obligations of the partnership only to the extent of the portion of his agreed contribution that has not been made to the partnership. If he does not make the contribution, or contributes only part of it, he remains obligated to contribute money or other things equal in value to that portion of the stated value he agreed to contribute, but which he has not contributed.

Section 1.752-1(e) of the Treasury Regulations provides that in the case of a limited partnership, a limited partner's share of partnership liabilities may not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. Thus, if

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77. I.R.C. § 722 (1976). This section also provides for increases in the contributing partner's adjusted basis for any gain recognized on the contribution. However, the intent of the basis adjustment for any gain recognized was with respect to gain recognized under section 721(b) dealing with partnerships which would be treated as investment companies under section 351(b) if they were incorporated.

78. Treas. Reg. § 7.752-1(e) (1960).

79. *Id.*

a limited partner has contributed all that he agreed to contribute, he would not share in any portion of the recourse debts of the partnership, and would not be entitled to any increase in the basis of his partnership interest as a result of partnership recourse liabilities.

A personal guarantee of partnership recourse debt, without an agreement to contribute additional funds, is insufficient to allow the limited partners to share in the recourse debts of the partnership.<sup>80</sup> However, if a limited partner agreed to contribute additional funds to the partnership, he would be entitled to share in partnership recourse debts for basis purposes. Unfortunately, such an agreement may expose the limited partner to tort claims as well as to claims of recourse lenders pursuant to Civil Code article 2840.

An agreement by the limited partners to indemnify the general partner against a portion of the recourse debts of the partnership was the subject of Revenue Ruling 69-223.<sup>81</sup> The Internal Revenue Service declared that because the limited partner's obligation was not directly to the partnership, he was not liable to the recourse creditors of the partnership under section 17(1) of the Uniform Limited Partnership Act; thus, he could not share in partnership recourse debt for basis purposes. Similarly, under Civil Code article 2840, a partner in commendam is liable for the obligations of the partnership only to the extent of his agreed contribution to the partnership. For this reason, an agreement to indemnify a general partner apparently would not result in liability on the part of the partner in commendam to the third-party creditors of the partnership. Therefore, such an agreement would not allow the partner in commendam to share in recourse debts of the partnership for basis purposes.

A final instance in which a partner in commendam may be entitled to share in the recourse liabilities of the partnership arises if he receives a distribution of part of the capital or undistributed profits of the partnership in commendam, which distribution renders the partnership insolvent. In this instance, Civil Code article 2842 requires that the partner in commendam must restore the amount received together with interest at the legal rate.<sup>82</sup> If such a partner is not forced to restore such amount, partnership creditors may proceed under Civil Code article 2842 to compel him to contribute the amount to the partnership. Although amounts required to be contributed by a partner in commendam in this instance are not technically part of the agreed contribution of the limited partner, it is arguable that he should be able to share in the recourse debts of the

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80. *Brown v. Commissioner*, 40 T.C.M. (CCH) 725 (1980), *aff'd*, 51 A.F.T.R.2d (P-H) ¶ 83-315 (9th Cir. 1982).

81. 1969-1 C.B. 184.

82. The provisions contained in article 2842 are similar to section 17(4) of the Uniform Limited Partnership Act.

partnership incurred prior to the distribution. The reason is that the limited partner would be directly liable to the recourse creditors for the amount of any distribution which causes the partnership to be insolvent to the same extent that he would have been liable to the recourse creditors of the partnership if he had originally contributed less than he was obligated to contribute to the partnership. However, there appears to be no authority on this point.

#### ALLOCATIONS

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is generally determined in accordance with the partnership agreement. However, section 704(b) provides that if the partnership agreement does not provide for the determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or if such allocation lacks "substantial economic effect," then this distributive share of such items is determined in accordance with his interest in the partnership, taking into account all of the facts and circumstances.

Until recently, the Treasury Department had provided very little guidance for determining when allocations will be considered to have substantial economic effect and for determining the extent of a partner's interest in a partnership for purposes of reallocating special allocations. On March 8, 1983, however, regulations were proposed providing rules for determining when allocations have "substantial economic effect."<sup>83</sup> The proposed regulations generally provide that an allocation must have "economic effect" and that the economic effect must be substantial in order for such allocation to be recognized for federal income tax purposes.<sup>84</sup> If an allocation does not have substantial economic effect, it will, nonetheless, be respected to the extent it is consistent, or is deemed to be consistent, with each partner's interest in the partnership.<sup>85</sup> If an allocation is not consistent with a partner's interest in the partnership, each partner's distributive share of partnership income, loss, deduction,

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83. Proposed Treas. Reg. § 1.704-1(b)(1)(i) (1983). At this writing, the proposed regulations have not been adopted by the Treasury Department. The final regulations may be adopted in a modified form and may differ from those discussed in this article. The proposed regulations are generally effective for taxable years beginning after December 31, 1983. However, the fundamental principles of the proposed regulations regarding the substantial economic effect test are generally applicable for partnership taxable years beginning after December 31, 1975. See *id.* For discussion of the history of the substantial economic effect test, see generally MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 10.01; 3 A. WILLIS, PARTNERSHIP TAXATION § 82.02 (2d ed. 1976).

84. Proposed Treas. Reg. § 1.704-1(b)(1)(i) (1983).

85. *Id.* An allocation is deemed to be consistent with the partners' interests in the partnership if one of the special rules contained in section 1.704-1(b)(4) of the proposed regulations is applicable. *Id.*

or credit will be redetermined in accordance with his interest in the partnership.<sup>86</sup>

According to the proposed regulations, allocations of profits, gains, losses, and deductions will have economic effect only if:

(a) The allocation is reflected in an appropriate increase or decrease in a partner's capital account;

(b) Liquidation proceeds are, throughout the term of the partnership, to be distributed in accordance with the partner's capital account balances; and

(c) Any partner with a deficit balance in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit, with the amount contributed by that partner to be distributed to the other partners in accordance with their positive capital account balances. However, if a partner is not required to restore the deficit in his capital account balance on liquidation, the partnership's allocations of profits and losses to him will be recognized until his capital account falls into a deficit position.<sup>87</sup>

If these requirements are satisfied so that an allocation is deemed to have economic effect and such economic effect is substantial,<sup>88</sup> the allocation will be respected for federal income tax purposes.

In order for allocations to have substantial economic effect, the proposed regulations generally require that capital accounts be maintained for each partner in accordance with "tax accounting principles."<sup>89</sup> Capital accounts are established using the amount of cash and the adjusted basis of contributed property (net of liabilities assumed by the partnership and liabilities to which such contributed property is subject),<sup>90</sup> although fair market value may be used if the contributor is allocated the pre-contribution appreciation or depreciation in the property's value when it is actually

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86. *Id.* A partner's interest in the partnership is determined by taking into account all the facts and circumstances relating to the economic arrangement of the partners. Unless the facts and circumstances indicate otherwise, there is a presumption that all the partners' interests in the partnership are equal (determined on a per capita basis). *See id.* § 1.704-1(b)(3).

87. *Id.* § 1.704-1(b)(2)(ii). The determination of whether an allocation has economic effect is made as of the end of the partnership taxable year to which an allocation relates. *Id.*

88. The regulations require that the economic effect of an allocation must be substantial when considered together with all prior and expected allocations for all taxable years. *Id.* § 1.704-1(b)(2)(iii). Generally, this requires that the magnitude and likelihood of the economic consequences must not be outweighed by the shift in tax consequences resulting from special allocations, especially tax consequences resulting from the interaction of the special allocation with the partners' nonpartnership tax attributes. However, allocations will not be substantial if "there is a strong likelihood that the economic effect of the allocation (or allocations) will be transitory due to largely offsetting allocation (or allocations)." *Id.* For examples of the "substantiality" test, see *id.* § 1.704-1(b)(5), examples 2(ii), 5, 7(ii), 8(ii).

89. *Id.* § 1.704-1(b)(2)(iv)(a).

90. *Id.*

realized and recognized.<sup>91</sup> In order to follow tax accounting principles, a partner's capital account must be (a) credited with cash contributions, the adjusted basis of contributed property (net of liabilities assumed or encumbering contributed property) and the partner's distributive share of all partnership income (including exempt income) and gain (or each item thereof), and (b) debited with cash distributions, the adjusted basis of distributed property (net of liabilities assumed by the partner or encumbering the distributed property), the partner's distributive share of partnership loss and deduction (or item thereof) and the partner's distributive share of expenditures of the partnership that are not deductible and not chargeable to his capital account.

Under the proposed regulations, failure to satisfy the capital account analysis rules will not necessarily result in the failure of an allocation to satisfy the substantial economic effect test. The proposed regulations provide a "safe harbor" if the partnership agreement contains provisions that "would in all cases (irrespective of the economic performance of the partnership) produce the same results as if the [capital account] requirements . . . had been satisfied."<sup>92</sup> This safe harbor is consistent with the concept contained in the present regulations that an allocation has substantial economic effect if it affects the dollar amount of a distribution upon liquidation of the partnership.<sup>93</sup> It should make no difference whether such effect is created by the establishment and maintenance of capital accounts or otherwise, although use of the capital account mechanism assures certainty under all circumstances.

In addition to the general rules described above, the proposed regulations contain specific provisions that may have an impact on Louisiana partnerships organized to hold real property or oil and gas interests. These rules relate specially to the use of nonrecourse financing in typical real estate tax shelter partnerships<sup>94</sup> and the allocation of basis of mineral properties for purposes of computing the depletion allowance for an oil and gas investment partnership.<sup>95</sup>

The proposed regulations take the general view that allocations of loss or deductions (*e.g.*, depreciation deductions) attributable to nonrecourse debt secured by partnership property do not have substantial economic effect since the creditor actually bears the economic burden of any loss or deduction attributable to such nonrecourse debt.<sup>96</sup> Accord-

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91. *Id.* § 1.704-1(b)(4)(i).

92. *Id.* § 1.704-1(b)(2)(iv)(b).

93. Treas. Reg. § 1.704-1(b)(2) (1960).

94. Proposed Treas. Reg. § 1.704-1(b)(4)(iv) (1983).

95. *Id.* § 1.704-1(b)(4)(v).

96. *Id.* § 1.704-1(b)(4)(iv). There are, however, three safe harbor rules for allocating losses attributable to nonrecourse debt. *See infra* text accompanying note 99.

ingly, such allocations must be made in accordance with the partner's interest in the partnership.

A loss or deduction is attributable to nonrecourse debt that is secured by partnership property to the extent the outstanding principal balance of the debt (excluding any part thereof that would not be treated as an amount realized under Code section 1001 and section 1.1001-2(a) of the Treasury Regulations on a foreclosure) *exceeds* the adjusted basis of the property.<sup>97</sup> The excess is referred to as the "minimum gain" since it represents the minimum gain that would be realized for federal income tax purposes on a foreclosure. Thus, until the adjusted basis of the secured property is reduced below the nonrecourse mortgage balance, the losses and deductions are not attributable to a nonrecourse debt and the substantial economic effect rules apply—the losses and deductions may still have substantial economic effect with respect to the partners.<sup>98</sup> Thereafter, such losses and deductions do not have substantial economic effect and must be allocated in accordance with the partner's interest in the partnership.

Losses and deductions attributable to nonrecourse debt will be deemed to be in accordance with a partner's interest in the partnership if any one of the following safe harbor rules apply:

(1) The three requirements of the substantial economic effect test (including the deficit makeup requirement) of Section 1.704-1(b)(2)(ii)(a), (b) and (c) of the Proposed Treasury Regulations are satisfied.

(2) The capital account equivalence test in Section 1.704-1(b)(2)(ii)(b) of the Proposed Treasury Regulations is satisfied.

(3) The partnership would satisfy the substantial economic test but for the fact that it does not contain a deficit payback provision and both:

(a) the allocation of loss or deduction (or item thereof) attributable to non-recourse debt does not cause the sum of the deficit capital balances to the partner or partners receiving such allocation (exclusive of the portion that must be restored on liquidation) to exceed the minimum gain (determined as of the end of the year of the allocation), and

(b) the partnership agreement requires the allocation of income or gain to the partner or partners with deficit capital account balances in an amount no less than the minimum gain, if any, and at a time no later than the time at which the minimum gain

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97. Proposed Treas. Reg. § 1.704-1(b)(4)(iv) (1983).

98. *Id.* § 1.704-1(b)(5), example 17(i).

is reduced below the sum of the deficit capital account balances.<sup>99</sup>

The first safe harbor will probably be of little importance since most limited partners in a leveraged tax shelter real estate partnership will be unwilling to restore any deficit in their capital accounts or unable to do so without sacrificing the protection of the limited liability they desire. Likewise, the uncertainty of the second safe harbor will probably render it virtually useless. The third safe harbor, however, provides a practical planning tool and would probably be relied on extensively if it were adopted in the final regulations, although adoption of this safe harbor provision is uncertain at the present time.

Civil Code article 2833 provides that after payment of all creditors upon the dissolution of a partnership, "the capital contributions shall be restored to the partners."<sup>100</sup> Any surplus is then divided among the partners based upon their respective interests in the partnership. Under Louisiana law, there is neither a requirement that a partner, general or limited, restore any deficit in his capital account balance on liquidation of the partnership, nor that a capital account mechanism must be established. Thus, absent specific provisions in a partnership agreement establishing and maintaining capital accounts, providing for special gain allocations (in the case of nonrecourse debt) or restoration of negative capital accounts, and regulating the distribution of assets on liquidation, allocations in a Louisiana partnership may not always have substantial economic effect and may therefore be disregarded for federal income tax purposes.

Assume that *A* and *B* form a Louisiana partnership to own an office building for rental purposes. *A* contributes \$100,000 to the partnership. *B* contributes nothing, but agrees to manage the building and to guarantee the permanent *in rem* loan in the amount of \$900,000—a loan on which neither the partnership nor *A* has any personal liability. The partners agree to allocate the first \$100,000 of losses and depreciation deductions to *A*, with the balance of profits, gains, losses, deductions, and cash distributions to be shared equally between *A* and *B*. The partnership agreement does not establish capital accounts, does not contain a requirement that liquidating distributions be made in accordance with the positive capital account balances of the partners, and does not require either partner to restore a deficit capital account balance. During its existence, the partnership incurs net taxable ordinary losses of \$600,000 and makes total cash distributions to *A* and *B* of \$100,000. Finally, the building is sold for \$1,000,000, resulting in a capital gain of \$800,000 to the partnership. The balance of the mortgage (\$800,000) is also discharged.

Pursuant to Civil Code article 2833, the first \$100,000 of the net cash

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99. *Id.* § 1.704-1(b)(4)(iv).

100. LA. CIV. CODE art. 2833, para. 2.

available for liquidating distributions would be distributed to *A* to restore his capital contribution, and the balance would be divided equally between *A* and *B*. Thus, *A* receives a total of \$150,000 and *B* receives a total of \$50,000. If the partnership agreement had provided for the establishment and maintenance of capital accounts in accordance with the proposed regulations, however, and if the liquidating distributions had been made in accordance with each partner's capital account balance, *A* and *B* each would have received \$100,000, computed as follows:

	Capital Accounts	
	<i>A</i>	<i>B</i>
Initial Contributions	\$ 100,000	\$ -0-
First \$100,000 of Losses	(100,000)	-0-
Balance of Losses	(250,000)	(250,000)
Operating Cash Distributed	(50,000)	(50,000)
Gain on Sale of Building	400,000	400,000
Balance <i>before</i> Liquidating Distribution	<u>\$ 100,000</u>	<u>\$ 100,000</u>

Thus, the allocation of \$50,000 of the first \$100,000 of losses to *A* lacks substantial economic effect, since Louisiana law and the partnership agreement provide that *A* would actually receive \$150,000 on liquidation and *B* would actually receive \$50,000 on liquidation. Following a capital account analysis, however, each of them would have received \$100,000. Therefore, \$50,000 of losses would be reallocated from *A* to *B*.<sup>101</sup>

Although in many simple partnerships the mechanism provided in Civil Code article 2833 may produce results consistent with the capital account balance mechanism contained in the proposed regulations, a different result may follow where capital contributions by the partners are made in kind rather than in cash, since the "capital contributions" themselves, and not their value, must be restored on liquidation pursuant to Louisiana law.<sup>102</sup> Only by coincidence would allocations of profits, gains, and losses have substantial economic effect and be recognized for federal income tax purposes.

If partners desire particular assets to be distributed to particular partners upon liquidation of the partnership, the partnership agreement should allocate gains and losses that would be realized on a sale of its properties among the partners so that their capital account balances would be increased or decreased at liquidation to the values of the assets to be distributed to them with the full fair market value of the distributed assets being charged against their capital account balances when they are

101. Proposed Treas. Reg. § 1.704-1(b)(1)(i) (1983).

102. LA. CIV. CODE art. 2833, para. 2.



distributed.<sup>103</sup> If such a distribution would force the partner's capital account balance into a deficit position or increase the deficit balance in his capital account (after taking into account his share of the unrealized appreciation or depreciation in all distributed assets), he should be required to contribute cash to the partnership equal to the resulting deficit before any asset is distributed to him.<sup>104</sup> Any remaining noncash assets and cash should then be distributed to the partners in accordance with their positive capital account balances.

Although it is not absolutely clear from a reading of the Civil Code, partners should be able to provide in the partnership agreement that liquidating distributions are to be made in a manner different from that described in Civil Code article 2833. Partners are free to include provisions in the partnership agreement that alter the effect of the Civil Code, provided such provisions do not violate public policy.<sup>105</sup> Although comment (b) to article 2802 specifically cites Civil Code article 2833 as a provision that concerns matters of public policy (*i.e.*, the protection of creditors of a partnership), the reference is probably only to the first paragraph of article 2833 (dealing with distributions to creditors); thus, the other provisions of article 2833 can probably be varied by the partners.

#### OPTIONAL ADJUSTMENT TO BASIS RULES

Section 743(a) of the Code provides generally that the basis of partnership property will not be adjusted on the transfer of an interest in a partnership by sale or exchange or on the death of a partner, unless the optional adjustment to basis election has been made by the partnership.<sup>106</sup> However, if an election to adjust basis is in effect for the taxable year in which a partnership interest is transferred, the transferee partner is treated as if he acquired a direct interest in partnership assets, thus obtaining a basis in such assets equal to the amount paid for the partnership interest. Specifically, section 743(b) of the Code provides that the basis of partnership assets will be adjusted for the difference between the transferee partner's basis in the partnership interest and such partner's "proportionate share of the adjusted basis of the partnership property."<sup>107</sup> The adjustment to the basis of partnership assets applies only with respect to the transferee partner.

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103. See Proposed Treas. Reg. § 1.704-1(b)(c)(2) (1983) (allows preliquidation adjustments to capital account balances to take into account unrealized appreciation or depreciation in assets distributed in kind).

104. *Id.* § 1.704-1(b)(2)(ii)(c).

105. LA. CIV. CODE art. 2802, comment (b).

106. I.R.C. § 754 (1976); Treas. Reg. § 1.754-1, T.D. 7208, 1972-1 C.B. 396.

107. I.R.C. § 743(b) (1976). For rules regarding the computation of the transferee partner's proportionate share of the adjusted basis of partnership property, see Treas. Reg. § 1.743-1(b) (1960); see also MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 24.02[1].

To illustrate the operation of the optional adjustment to basis rules, assume XYZ Partnership has assets with an adjusted basis of \$300 and a fair market value of \$900. Assume further that Z sells his one-third interest to A for \$300. A's adjusted basis in his partnership interest will be \$300, the total amount paid to Z for a one-third interest in the partnership.<sup>108</sup> If a valid election under section 754 of the Code is in effect for the year in which A is admitted to the partnership, or if one is made upon the transfer of the interest to A, the basis in the partnership assets with respect to A will be \$300.<sup>109</sup> If the assets are depreciable, A's share of the depreciation deductions would be computed using \$300 as the depreciable base. Similarly, if a partnership asset is sold, A's gain could be decreased or his loss increased. On the other hand, if the purchase price for Z's interest had been less than his proportionate share of the basis of partnership assets, A's initial basis in his partnership interest would be less than his proportionate share of the basis of partnership assets. If a section 754 election were in effect, the basis of the partnership assets with respect to A would be adjusted downward.

Civil Code article 2812 provides that a partner may "share his interest" in a partnership with a third party without the consent of the other partners.<sup>110</sup> The partner cannot, however, make the third party a partner without the consent of the other partners.<sup>111</sup> Prior to the revision, Civil Code article 2815 had specifically provided that a donee or vendee of a partnership interest would not become a partner.<sup>112</sup> In addition, the predecessor to the present article 2812 provided that a partner could enter into a partnership with a third party to share a partnership interest, but the third party did not become a partner in the partnership for state law purposes.<sup>113</sup> Thus, under Louisiana law as it existed prior to 1980, it was clear that a third party would not become a partner in

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108. I.R.C. § 1012 (1976).

109. This adjustment is computed as follows:

Adjusted Basis of A's Interest	\$ 300
A's Share of Adjusted Basis of Partnership	
Assets (1/3 of \$300)	(100)
Amount of Adjustment	200
Plus A's 1/3 of Original Adjusted Basis	<u>100</u>
	\$ 300

The amount of the special basis adjustment must then be allocated among the partnership assets according to the rules contained in section 755 of the Code and the regulations thereunder. See generally MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 24.04; 3 A. WILLIS, *supra* note 83, §§ 104.1-11.

110. See *supra* text accompanying note 75.

111. LA. CIV. CODE art. 2812.

112. LA. CIV. CODE art. 2815 (as it appeared prior to its repeal by 1980 La. Acts, No. 150, § 1).

113. LA. CIV. CODE art. 2871 (as it appeared prior to its repeal by Acts 1980, No. 150, § 1).

a partnership for state law purposes regardless of whether such third party acquired all or a portion of the partnership interest by purchase, donation, or otherwise.

The law is less clear today, however, since the substance of old article 2815 was not incorporated in the new law. It is clear under current law that the sharing of an interest with a third party will not make the third party a partner unless the other partners approve.<sup>114</sup> It is not clear, however, whether the sale, donation, or other disposition of a partner's entire interest (including any residual rights such as the right to inspect partnership books and records) in a partnership falls within the scope of article 2812. If a partner can "share" his entire partnership interest, it is arguable that article 2812 will apply if a partner sells, donates, or otherwise disposes of his entire interest in a partnership.

Whether a transferee of an interest in a Louisiana partnership is a partner for federal income tax purposes is not entirely clear. Potential problems may be avoided, however, by including special provisions in the partnership agreement for the admission of transferee partners. Guidance as to those special provisions can be found in two Revenue Rulings and at least one case. In Revenue Ruling 77-137,<sup>115</sup> the Internal Revenue Service ruled that an assignee of a partnership interest would be treated as a partner for federal income tax purposes even though the general partners refused to actually admit him as a limited partner. The reason was that he "acquired substantially all of the dominion and control over the limited partnership interest."<sup>116</sup> It is important to note that the assignor assigned his entire partnership interest and further agreed to exercise any residual powers in favor of the assignee, giving the assignee dominion and control over the limited partnership interest.

In Revenue Ruling 79-124,<sup>117</sup> a partner who was domiciled in a community property state died, and his surviving spouse continued to own one half of the partnership interest, although she was not admitted as a substituted partner under applicable state law. The decedent's estate was substituted as a partner with respect to the decedent's one-half interest. The Internal Revenue Service ruled that for purposes of section 743(b), the entire partnership interest (both the decedent's half, which was actually transferred to his estate, and his spouse's half, which was not actually transferred) was deemed to have been transferred upon the partner's death.

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114. LA. CIV. CODE art. 2812.

115. 1977-1 C.B. 178.

116. Under the Uniform Partnership Act and the Uniform Limited Partnership Act, such residual rights include the right to obtain partnership information and inspect partnership books and records. See UNIF. PARTNERSHIP ACT § 27(1), 6 U.L.A. 353 (1914); UNIF. LTD. PARTNERSHIP ACT §§ 10, 19(3), 6 U.L.A. 590, 603 (1916).

117. 1979-1 C.B. 225.

Therefore, adjustments to the basis of the partnership's properties were made with respect to both the estate's and the surviving spouse's interests in the partnership. The Internal Revenue Service also concluded that the same results would obtain on the death of the nonpartner spouse. Even though the surviving spouse was not technically a partner under state law, the Internal Revenue Service treated her as a partner for purposes of section 743(b).

In *Evans v. Commissioner*,<sup>118</sup> Evans was a partner in a two-man partnership with his brother-in-law. Without the knowledge or consent of his brother-in-law, Evans assigned his entire partnership interest to a corporation owned solely by Evans. For several years, partnership returns reflected Evans, and not his corporation, as a partner. Furthermore, no third parties were notified of the assignment.

Evans argued, and the Seventh Circuit agreed, that the corporation became a partner for federal income tax purposes because it became the true owner of a capital interest in the partnership in which capital was a material income-producing factor. The court ruled further that services performed by Evans with respect to his former partnership interest were performed as an agent for Evans' corporation. Therefore, the corporation was treated as a partner for federal income tax purposes, even though Evans's brother-in-law never consented to the admission of the corporation as a partner.

Consistent with Revenue Ruling 77-137, the Seventh Circuit emphasized the importance of the fact that Evans had assigned his entire partnership interest to his corporation. If he had assigned less than his entire interest, it is likely that a subpartnership arrangement would have been created for federal income tax purposes.<sup>119</sup> In that case, the assignee would become a partner in the subpartnership; while both he and the assignor would be entitled to share in a proportionate amount of income, gains, and losses of the operating partnership, the assignee would clearly not become a partner in the operating partnership for federal income tax purposes.

The foregoing authorities provide strong, though not conclusive, support for the proposition that an assignee of a partnership interest who is not admitted as a partner will always be treated as a partner for federal income tax purposes. However, it may be necessary for the assignee to acquire substantially all of the dominion and control over the partnership interest to obtain treatment as a partner. To accomplish this, the conveyance from the assigning partner to the assignee should provide that the assignor conveys all of his right, title, and interest in and to the entire partnership interest. The agreement should also provide that the assignor

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118. 447 F.2d 547 (7th Cir. 1971), *aff'g* 54 T.C. 40 (1970).

119. See, e.g., *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850 (5th Cir. 1971).

agrees to exercise any residual rights or powers in favor of the assignee.<sup>120</sup> Nevertheless, Revenue Ruling 79-124 treated a surviving spouse as a partner for tax purposes despite the fact that she had no dominion or control over any portion of the partnership interest in question. It is likely that any assignee of a partnership interest will be treated as a partner for federal income tax purposes, whether or not complete dominion or control is conveyed, and particularly if no residual control rights are retained by the assignor (as in the case of an assignment from a deceased partner to his estate).

#### DEATH OF A PARTNER

A partner in a Louisiana partnership ceases to be a member of the partnership, *inter alia*, upon his death.<sup>121</sup> A Louisiana partnership having no in commendam partners, however, does not terminate upon the death of a partner unless only one partner remains. Conversely, unless otherwise agreed to by all remaining partners, a Louisiana partnership in commendam terminates upon the death of the sole or any general partner (but not a limited partner), unless the partnership is continued thereafter.

Upon termination of membership by death, the partner's successors do not become partners, but they do succeed to the deceased partner's interest in the partnership.<sup>122</sup> As such, the successors are entitled to receive from the partnership an amount equal to the value of the deceased partner's interest.<sup>123</sup>

Although there are no Civil Code provisions which specifically allow partners to modify the foregoing rules by mutual agreement, partners can likely agree to admit successors of a deceased partner as members of the partnership or agree not to distribute to the heirs of a deceased partner an amount equal to the value of the decedent's interest. As discussed earlier,<sup>124</sup> the provisions of chapter 4 of title XI of book III of the Louisiana Civil Code of 1870 (which includes Civil Code articles 2818 through 2825) are generally suppletive and can be modified by the parties to the agreement provided such modifications do not affect matters of public policy. This conclusion is further supported by language contained in comment (c) to Civil Code article 2818, which provides in part: "*In the absence of contrary agreement*, the heirs of the deceased partner do not become partners but only inherit the interest of the deceased partner, which en-

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120. See *supra* note 116. Similar provisions appear in Civil Code Article 2813 which gives a *partner* the right to obtain partnership information and inspect partnership books and records. A mere assignee does not have such rights. See LA. CIV. CODE art. 2812.

121. LA. CIV. CODE art. 2818.

122. LA. CIV. CODE art. 2818, comment (c).

123. LA. CIV. CODE art. 2823.

124. See *supra* text accompanying note 65.

titles them to be paid as provided in Articles 2823, et seq., *infra*."<sup>125</sup>

#### *Continuation of Deceased Partner's Interest*

The operation of Louisiana law could have unexpected economic and tax impacts on a partnership upon the death of one of its partners unless careful planning is followed. For example, if a Louisiana general partnership owns an apartment building and one partner dies, the successors to the deceased partner are entitled to a cash payment for the value of the deceased partner's interest on the date of death unless an alternate arrangement has been made among the parties. If the surviving partners are unwilling or unable to fund the liquidation of the deceased partner's interest, either by additional cash contributions or by borrowing the necessary funds, and alternative funding methods such as life insurance policies on the lives of the partners have not been arranged, the partnership could be forced to sell a portion of its investment to satisfy its obligation to the deceased partner's successors. This could severely diminish the value of the partnership property, create severe restrictions on cash flow, and even force the partnership to completely dissolve.

The results are similar in the case of a typical real estate tax shelter limited partnership, where the immovable property is usually heavily mortgaged and the only source of cash (other than additional cash contributions or sales or refinancing proceeds) is rental income. Unless the partnership agreement provides otherwise, a deceased limited partner's successors are entitled to a cash payment for the value of the deceased partner's interest. In such a situation, available cash would generally fall short of the amount necessary to satisfy the partnership's obligation to the successors in interest under Civil Code article 2823, and it would be virtually impossible to dispose of the property. Thus, most tax shelter limited partnership agreements should provide that a deceased partner's successor has no right to have the deceased partner's interest valued and redeemed, and that the successor will be treated as an assignee of the partnership interest unless and until steps are taken to admit the assignee as a member of the partnership. As an assignee, he should be treated as a partner for federal income tax purposes.<sup>126</sup>

If a valid election is made pursuant to section 754 or is otherwise in effect, the basis of the partnership assets with respect to the successor partner will be increased if the successor partner's basis in his partnership interest exceeds his proportionate share of the adjusted basis of the partnership assets. The basis of the partnership assets with respect to the successor partner will be decreased if such adjusted basis is lower than such proportionate share of the adjusted basis of partnership assets. If the

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125. Emphasis added.

126. See *supra* text accompanying notes 115-20.

adjustment is upward, the successor partner will be entitled to increased depreciation deductions (if the partnership owns depreciable assets) or possibly greater cost depletion deductions (if the partnership owns depletable mineral properties),<sup>127</sup> and will recognize less gain (or more loss) upon the sale of such assets. Of course, the opposite results follow if the adjustment is downward.

One possible adverse consequence which should be considered in connection with the substitution of a deceased partner's successor as a partner results from the fact that the tax year of the partnership will not close at the date of his death, but will close at the end of the partnership taxable year absent a sale or liquidation of the deceased partner's entire partnership interest or a termination of the partnership.<sup>128</sup> However, the partnership taxable year will close with respect to the deceased partner's successor if the successor sells or exchanges the entire partnership interest or such interest is liquidated.<sup>129</sup>

Therefore, the deceased partner's distributive share of income and deductions of the partnership for the entire partnership taxable year that includes the deceased partner's date of death will not be included in his final return, but will be included in a separate return of the deceased partner's successor.<sup>130</sup> This could result in a mismatching of income and deductions with respect to the decedent's final income tax return since the decedent may not have sufficient income from sources other than the partnership to offset deductions and exemptions generated by the partnership.<sup>131</sup>

For example, if the decedent is a single individual, his distributive share of partnership income and deductions for the entire partnership taxable year in which he dies would be included in his successor's return. If the decedent had substantial deductions other than those generated by the partnership and his only source of income was from the partnership, the benefit of the deductions would be lost if partnership income was shifted to the successor's federal income tax return. Conversely, if the decedent had substantial income from sources other than the partnership that was to be offset by deductions generated by the partnership, the deductions would be shifted to the successor in interest and would create adverse tax consequences with respect to the deceased partner's final return.<sup>132</sup> If the decedent is married on the date of death and his spouse

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127. Treas. Reg. § 1.743-1(b)(2)(iii) (1960).

128. See I.R.C. §§ 706(c)(1), 706(2)(A) (1976). If the death of a partner results in the termination of the partnership, the partnership taxable year closes with respect to all partners. See I.R.C. § 708(b)(1)(A) (1976); Treas. Reg. § 1.706-1(c)(3)(i) (1960).

129. I.R.C. § 706(c)(2)(A) (1976); Treas. Reg. § 1.706-1(c)(3)(i) (1960).

130. Treas. Reg. § 1.706-1(c)(3)(ii) (1960).

131. See *id.* § 1.706-1(c)(3)(iii); MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 23.01[2].

132. See, e.g., Estate of Hesse v. Commissioner, 74 T.C. 1307 (1980).

succeeds to the partnership interest prior to the end of the partnership taxable year, the successor spouse would include the decedent's distributive share of income and deductions of the partnership on a final year joint return.<sup>133</sup> If the partnership interest is an item of community property, however, the spouse would in any event include at least one half of the partnership interest's distributive share of income or loss in her taxable year in which the partnership's taxable year ends.<sup>134</sup>

### *Liquidation of a Decedent's Interest*

If a partnership agreement does not provide that a deceased partner's successor in interest becomes an assignee of the partnership interest or perhaps even a substituted partner, the decedent's interest will be liquidated pursuant to Civil Code article 2823.<sup>135</sup> If this occurs, adverse tax consequences may be experienced by the successor in interest and adverse economic consequences would be experienced by the partnership.

First, payments to a deceased partner's successor in interest, other than for his share of partnership property, are treated as either (i) a distributive share of partnership income, if they are determined with respect to partnership income,<sup>136</sup> or (ii) guaranteed payments, if they are not determined with regard to partnership income.<sup>137</sup> Guaranteed payments are taxed as ordinary income to the distributee and are deductible as ordinary and necessary business expenses by the partnership. The character of a distributive share of partnership income is determined, of course, by reference to the partnership's total income.<sup>138</sup>

To the extent that payments to a deceased partner's successor in interest are attributable to the deceased partner's interest in partnership property, such payments are treated as being paid in exchange for his partnership interest,<sup>139</sup> generally resulting in a long-term capital gain<sup>140</sup> to the successor in interest. However, payments attributable to the decedent's interest in unrealized receivables are taxed as distributive shares

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133. Treas. Reg. § 1.706-1(c)(iii) (1960).

134. *Id.* § 1.702-1(d) (1960).

135. Compare LA. CIV. CODE art. 2823 with LA. CIV. CODE art. 2833. Comment (a) to article 2823 states that a former partner (or his successor) is not entitled to an interest in partnership assets, but only the right to be paid an amount equal to the value of his partnership interest as of the time he ceases to be a member of the partnership. To the contrary, on the distribution of partnership assets, article 2833 and comment (b) to Civil Code article 2803 state that unless otherwise agreed, partners are entitled to the restoration of their capital contributions even when such restoration might result in an unequal distribution or disproportionate distribution with respect to the profit-sharing ratio.

136. I.R.C. § 736(a)(1) (1976).

137. *Id.* § 736(a)(2).

138. *Id.* § 704(b).

139. *Id.* § 736(b)(1).

140. *Id.* § 1223(11) (Supp. V 1981).



of partnership income or guaranteed payments under section 736(a), thus resulting in ordinary income to the recipient.<sup>141</sup> Also, if the partnership agreement makes no provision for the treatment of goodwill, a payment therefore will be treated as ordinary income to the recipient and as a deductible business expense to the partnership.<sup>142</sup> Finally, payments for a deceased partner's share of substantially appreciated items of inventory also will result in ordinary income to the recipient.<sup>143</sup>

Thus, although the decedent's partnership interest attains a fair market value basis upon his death,<sup>144</sup> his estate could nevertheless suffer ordinary income tax consequences upon a redemption of his interest. If those consequences are planned pursuant to the partnership agreement, the parties will be prepared for them, but unexpected ordinary income tax consequences resulting from a redemption caused by Civil Code article 2823 should certainly be avoided.<sup>145</sup>

#### CONCLUSION

Louisiana's new partnership law is clearly a vast improvement over its predecessor. From the viewpoint of United States income taxation, however, a better approach would have been to adopt a modified form of the Uniform Partnership Act and the revised Uniform Limited Partnership Act, since the partnership provisions of the Internal Revenue Code and Treasury Regulations were drafted with those uniform laws in mind. Nevertheless, because the new partnership law generally allows partners to modify its effects through contractual agreements, practitioners can certainly be comfortable from a federal taxation viewpoint in using Louisiana partnerships if appropriate contractual modifications are made to that law.

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141. *Id.* § 736(b)(2)(A) (1976). The term "unrealized receivables" means the partnership's rights to the payment for goods delivered and to be delivered and services rendered and to be rendered as well as all potential recapture income under all recapture provisions of the Code. *Id.* § 751(c) (1976 & Supp. V 1981).

142. *Id.* § 736(b)(2)(B) (1976).

143. *Id.* § 751(a).

144. *Id.* § 1014 (1976 & Supp. V 1981).

145. For tax consequences caused by section 736(b) payments, see MCKEE, NELSON & WHITMIRE, *supra* note 13, ¶ 22.02[5].