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Issue Contents

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A Step in the Right Direction

-by Neil E. Harl*

The *Tax Cuts and Jobs Act of 2017,*[1] in an obscure section of the Act,[2] seemingly took the first step to address the issue of whether the Congress, perhaps innocently, and the Internal Revenue Service, perhaps less innocently, created the opportunity to give "partnerships" a black eye many years ago by basically denigrating the partnership as a recognized form of organization. That led to more than two decades of unrest and disagreement as to what is a partnership.[3]

Hopefully, this amendment, passed in December 2017, brief as it was, will send a message that will resonate, loud and clear, that partnerships play a useful role as one of the oldest forms of business organization in existence. Many years ago, Congress wittingly or unwittingly, decreed that "interests in a partnership" were not to be listed in definitions that essentially otherwise included partnerships. In a series of rulings and regulations, the twisted logic was used to outlaw the partnership form of business organization.

Real world examples

As one example of the effects of outlawing the partnership as an accepted form of business organization, the most recent litigated case in this general area, *Methvin v. Commissioner*,[4] involved a two to three percent interest in various oil and gas ventures. The Tax Court, in an unusually brief opinion, and the Tenth Circuit Court of Appeals, also in a brief opinion, based entirely on the briefs, relied upon the definition of "partnership" in Treas. Reg. §301.7701-1(a)(2) and held that the facts were within the definition in the regulations for a "partnership" even though partnership status was specifically excluded by Article 14 of the operating agreement of the taxpayer. There was no mention, in either opinion, of the 15-item checklist in *Rev. Proc. 2002-22*[5] which was issued to calm the criticism after the 1997 private letter ruling discussed below.

The second example of the distortion in legal reasoning for someone to achieve the desired outcome whatever that might have been, was the 1997 private letter ruling issued on July 10, 1997, cited above. In the facts of that ruling, two brothers owned equal ownership interests in an arrangement, which itself owned 10 rental properties, all of which involved ownership of land.[6] The brothers represented that they had never executed a partnership agreement and did not consider the arrangement as involving anything other than the co-ownership of properties. For five consecutive years, the brothers had

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duly reported all net income and losses on a Form 1065, as a matter of convenience. Management of the properties had been performed by a property management corporation of which the brothers were equal shareholders but were no longer employees. Because of "irreconcilable differences" between the brothers, the two proposed a like-kind exchange, between themselves, involving nine of the properties. After the exchange, six properties would be owned by one brother and three by the other. The tenth property would owned by the brothers as co-owners. The IRS concluded that the filing of partnership returns for five years indicated an intention to form a partnership. Therefore, the exchange was not eligible for like kind exchange treatment because the interests in the rental properties *were partnership interests rather than mere co-ownership of property and partnership interests under federal law violated I.R.C. § 1031* as then worded.

That conclusion was worrisome for many, including many farm and ranch exchangers involving co-ownership of property. The ruling identified four key factors: (1) there was co-ownership of property; (2) management services exceeded "customary" services for maintenance and repair; (3) the additional services were by the co-owners or an agent; and (4) the co-owners filed a partnership income tax return, essentially as a convenience.

After several years of criticism of the letter ruling, in *Rev. Proc. 2002-22,*[7] the Internal Revenue Service issued a revenue procedure addressing the circumstances under which advance rulings would be issued in situations involving co-ownership of rental real property in an arrangement classified as a tenancy in common. The revenue procedure specifies conditions to be met for an advance ruling.

The 2017 amendment

The 2017 amendment, cited above, merely struck the words ". . . this subsection shall not apply to any exchange of -. . . (D) interests in a partnership," which essentially nullifies the objectionable language.[8] It should be noted that the language varies somewhat from the language appearing in the earliest versions of the Act. However, it appears to retain the basic message.

Is there a clear enough message to withstand pressure?

Those who have pushed the idea of eliminating, effectively, the "partnership" as a form of organization, may well take up the cudgel in support of nullifying the 2017 amendment. Time will tell whether such a move would be effective. Hopefully, the attention given the IRS effort in recent years and the enactment of a bar to prevent nullification would be a sufficient barrier to prevent a replay (which was never really understood except for those who encountered it).

ENDNOTES

[1] Pub. L. No. 115-97, § 13303(a), ___ Stat. ___ (2017).

[2] Pub. L. No. 115-97, § 13303(b), ___ Stat. ___ (2017).

[3] *See, e.g*., Ltr. Rul. 9741017, July 10, 1997.

[4] T.C. Memo. 2015-81, *aff'd*, 2016-1 U.S. Tax Cas. (CCH) ¶ 50,328 (10th Cir. 2016).

[5] 2002-1 C.B. 733.

[6] See 4 Harl, *Agricultural Law* § 27.04[1][b].

[7] 2002-1 C.B. 733.

[8] See Pub. L. No. 115-97, § 13303(b)(1)(A), *amending* I.R.C. § 1031(a)(2).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

LIEN AVOIDANCE. The debtor filed for Chapter 12 in November 2016. In 2011, the debtor had granted a bank a security interest in crops, farm equipment, and general intangibles, including payments under the Agricultural Risk Coverage Program (ARC). The debtor agreed that the bank's lien was valid as to 2015 and 2016 ARC payments, received in October 2016 and October 2017 respectively. The debtor sought to avoid the lien as to the 2015 and 2016 ARC payments because the payments were received within 90 days prior to the petition and after the petition. The bank argued that the lien attached to the payments when the debtor enrolled in the ARC, well before the Chapter 12 petition. Section 547 governs avoidable preferential transfer. Under Section 547(e)(3), a transfer is not made until the debtors acquired rights in the property transferred. The debtor argued that the debtor did not have any rights to the ARC payments until all ARC program requirements had been met. The court found that, although the debtor did have to meet several requirements to receive payments, the ARC agreement with the debtor indicated that the debtor had some right to payment upon execution of the agreement and that failure to meet all requirements resulted in loss of the right to receive payments. The court noted the holding in *In re Lesmeister, 242 B.R. 920 (Bankr. D. N. D. 1999)* where the court held that a security interest in disaster assistance program payments was not avoidable even though the payments were not received until after the Chapter 12 petition. The *Lesmeister* court held that the debtor gained rights to the program payments when the program was enacted and the debtor suffered a loss covered by the program. Thus, the court in this case held that the debtor