ELECTING OUT OF SUBCHAPTER K UNDER IRC § 761(A): CAN CERTAIN LIMITED LIABILITY COMPANIES AND LIMITED PARTNERSHIPS BECOME ELIGIBLE TO MAKE THE ELECTION?

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INTRODUCTION

Benjamin Franklin once famously stated that "in this world[,] nothing can be said to be certain, except death and taxes."[1] Concededly, death may indeed be certain for all; however, section 761(a) of the Internal Revenue Code may provide a potential exclusion from the certainty of taxes for limited liability companies and limited partnerships—at least for their entity-level reporting duties, that is.[2] More specifically, section 761(a) allows certain unincorporated organizations classified as partnerships for tax purposes to elect to be excluded from the application of Subchapter K, resulting in reduced reporting requirements for an electing entity.[3] However, clear guidance regarding this election is lacking, and the resultant ambiguity has given rise to longstanding uncertainty in determining what types of entities can become eligible to make elections under section 761(a).

Limited liability companies and limited partnerships face challenges in gaining section 761(a) election eligibility, largely due to two requisite conditions necessary for achieving such eligibility. First, there is an ambiguous condition requiring the partners of an electing entity to "[o]wn the [entity's] property as [co-owners] . . . ."[4] Second, there is a condition that requires those partners to "[r]eserve the right separately to take or dispose of their shares of

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[1] Letter from Benjamin Franklin to Jean-Baptiste Le Roy (Nov. 13, 1789).
[2] Unless otherwise stated, all section references throughout the text of this Article are to the Internal Revenue Code of 1986, as amended from time to time.
[3] I.R.C. § 761(a); Treas. Reg. § 1.6031(a)-1(c).
[4] Treas. Reg. § 1.761-2(a)(2)(i), -2(a)(3)(i).

any [partnership] property . . . ."[5] The ability of a limited liability company or limited partnership to meet that first condition largely rests upon the applicable meaning of the word "co-owners"[6]; however, these entities generally cannot meet the second condition when operating under the default rules of state statutes governing such entities.[7] Nonetheless, the Tax Court has suggested that limited liability companies and limited partnerships can meet these conditions and achieve section 761(a) election eligibility in certain instances where proper drafting is present within the relevant entity's operating agreement.[8] Alternatively, the Internal Revenue Service (the "*I.R.S.*") has issued guidance stating that such entities are inherently barred from making elections under section 761(a), regardless of any provisional drafting language within their operating agreements.[9]

Notably, the I.R.S. later indicated a willingness to reconsider its stance on this issue in its publication of I.R.S. Notice 2004-53, which requested public comments regarding the application of the conditions for section 761(a) election eligibility.[10] Unfortunately, the discussion and guidance regarding the availability of this election to limited liability companies and limited partnerships

[5] *Id.* at § 1.761-2(a)(2)(ii), -2(a)(3)(ii).

[6] Competing interpretations of this co-ownership are discussed *infra* Part I.F.1.

[7] *Cf.* REVISED UNIF. LTD. LIAB. CO. ACT § 404(c) (UNIF. L. COMM'N 2006) (amended 2013) ("A person does not have a right to demand or receive a distribution from a limited liability company in any form other than money."); REVISED UNIF. LTD. P'SHIP ACT § 503(c) (UNIF. L. COMM'N 2001) (amended 2013) ("A person does not have a right to demand or receive a distribution from a limited partnership in any form other than money.").

[8] *See* Hager v. Comm'r, 76 T.C. 759 (1981); Elkins v. Comm'r, 81 T.C. 669 (1983); Emershaw v. Comm'r, 59 T.C.M. (CCH) 621 (1990). Discussed *infra* Part I.G. Note that the Author recognizes the term "operating agreement" will not be the technical term in all cases and that the name of the governing document of formation and organizational management for limited liability companies and limited partnerships differs between the specific entity and different states. For efficiency, this Article refers to all such documents as "operating agreements."

[9] *See* I.R.S. F.S.A. 1999-23-017, 1999 WL 379166, at *6, *7 (June 11, 1999); I.R.S. F.S.A. 2002-16-005, 2002 WL 599379, at *3, *4 (Apr. 19, 2002). Discussed *infra* Part I.H.

[10] I.R.S. Notice 2004-53, 2004-2 C.B. 209. Discussed *infra* Part I.I. The responses to this notice were adamant that the section 761(a) election should be available to limited liability companies and limited partnerships. Those responses are discussed *infra* Part II.B.

came to a halt after the publication of that notice in 2004, leaving this issue largely unanswered.[11]

Aiming to revive that discussion, Part I of this Article presents an overview of section 761(a), the regulations thereunder, and the relevant Tax Court cases and I.R.S. guidance. These sources together create a large, intricate web of information that must be understood cohesively before scholars may adequately enter the discussion on whether limited liability companies and limited partnerships may achieve section 761(a) election eligibility. Part I of this Article aims to bring all this information together in one place, in an understandable way, so that this discussion may become more readily accessible and lead to greater clarity in the availability of this election to limited liability companies and limited partnerships.

Following Part I's overview, Part II argues that limited liability companies and limited partnerships should be able to achieve section 761(a) election eligibility through proper drafting within the relevant entity's operating agreement. The basis for this argument consists of three factors: (A) the plain language of the relevant statutes and regulations; (B) the public responses to I.R.S. Notice 2004-53; and (C) the resultant benefits to owners of these entities if allowed to make this election. Each factor provides an independent basis for allowing the section 761(a) election to limited liability companies and limited partnerships; however, the argument for allowing the election to such entities is strongest when considering these factors together as a whole.

Parts III and IV are substantially shorter than Parts I and II and provide more foundational ideas intended to spark discussion of their respective topics rather than providing in-depth analyses. Accordingly, Part III provides sample operating agreement drafting language that may be sufficient in rendering limited liability companies and limited partnerships eligible to make elections under section 761(a), and Part IV then discusses the potential limited liability concerns that might result if such an entity were to make this election.

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[11] The reason for this is unknown; however, the Author has seen first-hand that I.R.S. enforcement continues to operate under the interpretation that this election is unavailable to limited liability companies and limited partnerships.

Although this Article presents arguments in favor of allowing limited liability companies and limited partnerships to achieve section 761(a) election eligibility, the Author's primary goal is simply to revive the discussion of this election's availability to those entities. Such availability has been left unanswered for nearly twenty years, and the time has come to achieve more certainty regarding the election under section 761(a). The attainment of that certainty—whether resulting in an allowance of the section 761(a) election to these entities or otherwise—relies upon the continued scholarly discussion of the ideas in this Article.

I. OVERVIEW OF SECTION 761(A)

A. The Enactment of Section 761(a)

Under the partnership tax regime in place within the United States prior to 1954, certain "qualified partnerships"—consisting largely of joint operating agreements that were generally regarded more-so as co-tenancies rather than true partnerships—were "required to file merely a blank partnership return with a schedule of the receipts and expenses of the co-owners."[12] Further, the co-owners of such qualified partnerships were essentially allowed to elect out of the partnership tax provisions, with such co-owners "not [being] required to calculate partnership . . . income and thus [being allowed to] individually [make certain elections]."[13] However, the Tax Court's 1953 decision in *Bentex Oil Corp. v. Commissioner* called this treatment into question, ruling that these "qualified partnerships" were indeed partnerships for tax purposes, rather than mere co-tenancies, and thus were subject to the full reporting requirements of the partnership tax regime and ineligible to make entity elections at the individual level.[14]

Shortly thereafter, with the passing of the 1954 Internal Revenue Code, Congress enacted both the Subchapter K partnership tax rules—which were far more extensive than those under the previous partnership tax regime—and the section 761(a)

[12] Noah S. Baer, *Selling a Partnership Interest After an Election Out of Subchapter K*, 9 J. P'SHIP TAX'N 229, 233 (1992).

[13] Bradley M. Seltzer & J. Randall Buchanan, *The Consequences of Electing out of Subchapter K*, 44 TAX EXEC. 264, 264 (1992).

[14] Bentex Oil Corp. v. Comm'r, 20 T.C. 565 (1953).

election out of those rules. Interestingly, the enactment of the section 761(a) election is widely regarded as Congress's approval of the *Bentex* decision, as well as Congress's attempt to provide relief from the hardships caused by that decision.[15] As one such means of relief, the election under section 761(a) provided for reduced reporting requirements for certain eligible partnerships.

B. Section 761(a)

Section 761(a) begins by providing a definition of "partnerships."[16] This definition sets the initial boundaries of eligibility for entities wishing to make elections under section 761(a), requiring that all electing entities must be treated as partnerships for tax purposes.[17] Section 761(a) then allows certain entities meeting that definition to elect to be excluded from the application of Subchapter K, so long as they fall into one of three listed categories of eligible unincorporated organizations.[18] Specifically, the relevant language of section 761(a) provides:

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[15] *See, e.g.*, Baer, *supra* note 12, at 232-33, 234 ("[C]ommentators have generally considered the election as showing congressional approval of *Bentex*, coupled with a recognition of the hardships caused by that decision. . . . Apparently, Congress wanted to relieve qualified partnerships from the new burdens associated with being a partnership, while requiring them to retain their partnership status for the other sections of the Code."); Seltzer & Buchanan, *supra* note 13, at 264-65 ("[T]he generally understood reason for [section 761(a)'s] enactment was the approval of the decision in *Bentex*, coupled with a mechanism to alleviate the hardships caused by the decision.").

[16] I.R.C. § 761(a) ("For purposes of this subtitle, the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.").

[17] *Id.*

[18] *Id.*

> Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of [Subchapter K], if it is availed of—(1) for investment purposes only and not for the active conduct of a business[;] (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted[;] or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities . . . .[19]

Additionally, section 761(a) states yet another condition to making this election—that "the income of the members of the [electing] organization [must] be adequately determin[able] without the computation of partnership taxable income."[20] This condition likely limits the organizations eligible to make elections under section 761(a) to those with relatively simple income calculations; however, where that line lies is beyond the scope of this Article. This leaves three requirements that an entity must satisfy to make an election under section 761(a): (1) the entity must be treated as a partnership for tax purposes;[21] (2) the entity must qualify under one of three categories of eligible unincorporated organizations listed within the statute;[22] and (3) the income of the entity's members must be adequately determinable without the computation of partnership taxable income.[23]

C. The Effect of Making a Section 761(a) Election

For entities meeting the requisite conditions necessary for eligibility, the primary effect of the section 761(a) election is that an electing entity may forego its requirement to file a partnership return. This effect is conveyed in Treasury Regulation section 1.6031(a)-1, which first establishes the general rule that all domestic partnerships must file a partnership return for each tax

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[19] I.R.C. § 761(a)(1)-(3).
[20] *Id.* at § 761(a) (flush language).
[21] *Id.* at § 761(a).
[22] *Id.* at § 761(a)(1)-(3).
[23] *Id.* at § 761(a) (flush language).

year.[24] The regulation then creates an exception for entities making elections under section 761(a), stating that such an electing entity is not required to file a partnership return in subsequent years after making the election.[25] Instead, each "partner" of an electing entity simply reports his or her share of the partnership's income and expenses directly on his or her own individual tax return.[26] For electing entities, this provides a distinct advantage and substantially reduces the administrative costs typically incurred in preparing the partnership return. Owners of electing entities may also experience several additional benefits as a result of this election, which are discussed *infra* Part II.C.

D. Tax Treatment of Limited Liability Companies and Limited Partnerships

The first element towards achieving section 761(a) election eligibility requires that an electing entity must be treated as a partnership for tax purposes.[27] Accordingly, the tax treatment of limited liability companies and limited partnerships is critical to this discussion. First, limited partnerships are inherently

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[24] Treas. Reg. § 1.6031(a)-1(a)(1) ("Except as [otherwise] provided . . . , every domestic partnership must file a return of partnership income . . . for each taxable year on the form prescribed for the partnership return.").

[25] *Id.* at § 1.6031(a)-1(c)(1) ("An eligible partnership . . . that elects [under I.R.C. § 761(a)] to be excluded from all the provisions of [S]ubchapter K of chapter 1 of the Internal Revenue Code . . . must timely file the form prescribed for the partnership return for the taxable year for which the election is made. . . . [In subsequent years after the election is made], an eligible partnership that elects to be wholly excluded from the application of [S]ubchapter K is not required to file a partnership return.").

[26] *See, e.g.*, I.R.S. F.S.A. 2002-16-005, *supra* note 9, at *5 ("The [partners] of the [electing] organization . . . report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from [S]ubchapter K beginning with the first taxable year of the organization." (citing Treas. Reg. § 1.761-2(b)(2)(ii)); Martin J. McMahon, Jr., *The Availability and Effect of Election Out of Partnership Status Under Section 761(a)*, 9 VA. TAX REV. 1, 30 (1989) ("Following a valid election under section 761(a), each partner reports directly on his own tax return his income realized and recognized with respect to the property and the deductible expenses he paid or incurred with respect to the property.").

[27] I.R.C. § 761(a) (defining the term "partnership" as including "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate").

partnerships and are treated as such for tax purposes.[28] Thus, limited partnerships at the very least meet this initial requirement of section 761(a) election eligibility.

Second, a limited liability company may receive tax treatment as either a partnership, corporation, or disregarded entity.[29] However, a limited liability company with more than one member receives default treatment as a partnership.[30] Therefore, unless electing to be treated as a corporation or otherwise, a limited liability company "is subject to the same filing and reporting requirements as partnerships."[31] Thus, like limited partnerships, limited liability companies, at the very least, meet the initial requirement of section 761(a) election eligibility—being treated as a partnership for tax purposes.

Although limited liability companies and limited partnerships both easily meet this definition of "partnerships," satisfying that definition is only the first step towards achieving section 761(a) election eligibility. Unfortunately, the remaining requirements are more ambiguous.

E. Additional Requirements for Section 761(a) Election Eligibility

Next, section 761(a) also requires electing entities to fit within one of three categories of eligible unincorporated organizations.[32] These categories include those unincorporated organizations that are availed of (1) for investment purposes only; (2) for the joint production, extraction, or use of property; or (3) by dealers in securities.[33] More specifically, section 761(a) requires that an electing organization must be availed of:

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[28] WILLIAM K. SJOSTROM, JR., BUSINESS ORGANIZATIONS: A TRANSACTIONAL APPROACH 12 (2d ed. 2016) ("The Internal Revenue Code treats a limited partnership the same as a general partnership for federal income tax purposes.").

[29] I.R.S. Pub. 541, 2019 WL 1318827, at *3 (Feb. 25, 2019) ("An LLC may be classified for federal income tax purposes as either a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the [Check-the-Box] rules in Regulations section 301.7701-3.").

[30] I.R.S. Pub. 3402, 2020 WL 1942435, at *2 (Mar. 8, 2020) ("An LLC with at least two members is classified as a partnership for federal income tax purposes.").

[31] *Id.*

[32] I.R.C. § 761(a).

[33] *Id.* at § 761(a)(1)-(3).

> (1) for investment purposes only and not for the active conduct of a business[;] (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted[;] or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities . . . .[34]

Interestingly, the Treasury Department has issued regulations providing additional requirements for qualifying under the first two of these categories but not for the third.[35] Those first two categories of eligible organizations include: (1) those availed of for investment purposes only (referred to in the regulations and henceforth as "*Investing Partnerships*"),[36] and (2) those availed of for the joint production, extraction, or use of property (referred to in the regulations and henceforth as "*Operating Agreements*").[37]

First, the requirements for qualification as an Investing Partnership require that the "partners" of an unincorporated organization within this category must (1) own the property held by the entity as "co-owners," (2) reserve the right to take or dispose of their respective shares of any property held by the entity, and (3) not actively conduct business.[38] The complete language of those requirements states:

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[34] *Id.*

[35] Susan Kalinka, *Check-the-Box Regulations Raise Questions Concerning the Ability of a Partnership or an LLC to Elect Out of Subchapter K*, 75 TAXES: THE MAG. 411, 413-14 (1997) ("Treasury regulations have been issued providing the requirements that must be met by investment organizations and by organizations involved in joint operating arrangements for the production, extraction, or use of property. . . . Currently, there are no regulations implementing [the third category of organization that may elect out of Subchapter K, organizations availed of by securities dealers].").

[36] Treas. Reg. § 1.761-2(a)(2).

[37] *Id.* at § 1.761-2(a)(3).

[38] *Id.* at § 1.761-2(a)(2).

> **Investing partnership.** [For an entity to qualify under this category of eligible unincorporated organizations to make elections under section 761(a),] . . . the participants in the joint purchase, retention, sale, or exchange of investment property [must]:
>
> > **(i)** Own the property as [co-owners],
> >
> > **(ii)** Reserve the right separately to take or dispose of their shares of any property acquired or retained, and
> >
> > **(iii)** . . . not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year . . . .[39]

This regulation is dense and difficult to read, causing ambiguity in deciphering what is actually required for qualification as an Investing Partnership. Additionally, the first two requirements of the "partners" of an Investing Partnership—(1) owning the property held by the entity as "co-owners," and (2) reserving the right to take or dispose of their respective shares of that property—create difficulties for limited liability companies and limited partnerships in achieving section 761(a) election eligibility. The root of those difficulties is discussed in the next section.

Second, the requirements for qualification as an Operating Agreement are almost identical to those of Investing Partnerships. These qualifications require that the "partners" of an electing entity within this category must (1) own the property held by the entity as "co-owners"; (2) reserve the right to take or dispose of their respective shares of any property produced, extracted, or used by the entity; and (3) not jointly sell services or the property produced, extracted, or used by the entity.[40] The complete language of those requirements states:

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[39] *Id.*

[40] *Id.* at § 1.761-2(a)(3).

> **Operating agreements.** [For an entity to qualify under this category of eligible unincorporated organizations to make elections under section 761(a),] . . . the participants in the joint production, extraction, or use of property [must]:
>
> > **(i)** Own the property as [co-owners], either in fee or under lease or other form of contract granting exclusive operating rights, and
> >
> > **(ii)** Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and
> >
> > **(iii)** . . . not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year . . . .[41]

This language is once again dense, ambiguous, and difficult to read. Further, the first two requirements of the "partners" of an Operating Agreement similarly create difficulties for limited liability companies and limited partnerships in achieving section 761(a) election eligibility.

The third category of organizations eligible to make elections under § 761(a) are those availed of "by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities."[42] It is generally accepted that Congress allowed the inclusion of this category because Congress "wanted to allow securities dealers, who often form syndicates to sell, underwrite, or distribute a single issue, to be able to elect out of Subchapter K so that they would not be subject to the penalties under section 6698 for failure to file partnership returns."[43] However, the Treasury Department has not issued regulations regarding further requirements for qualification under this category. Therefore, this Article will instead focus on the first two categories of unincorporated organizations possessing section

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[41] *Id.*
[42] I.R.C. § 761(a)(3).
[43] Kalinka, *supra* note 35, at 414.

761(a) election eligibility: (1) Investing Partnerships and (2) Operating Agreements.

F. Difficulties Faced by Limited Liability Companies and Limited Partnerships in Achieving Section 761(a) Election Eligibility

Limited liability companies and limited partnerships face difficulty in qualifying for section 761(a) election eligibility as either Investing Partnerships or Operating Agreements. These difficulties arise due to requirements that the "partners" of either such category must (1) own the property held by the entity as "co-owners" (the "*Co-Ownership Requirement*") and (2) reserve the right to take in kind or dispose of their respective shares of entity property (the "*Disposal Requirement*").[44] Each of these requirements individually creates challenges for limited liability companies and limited partnerships, so this discussion will address each requirement separately.

1. The Co-Ownership Requirement

To qualify for section 761(a) election eligibility as either an Investing Partnership or an Operating Agreement, the Co-Ownership Requirement requires that the owners of such an entity must "[o]wn the [entity's] property as [co-owners]."[45] This requirement creates difficulty, largely due to the ambiguity in the meaning of the word "co-owners." The I.R.S. has interpreted this word as requiring title to entity property to rest directly in the owners of the entity.[46] Alternatively, legal practitioners have argued that the requisite co-ownership necessary to meet this requirement may instead be satisfied when title to entity property rests within the entity itself, so long as the owners of the entity share ownership of those underlying assets in proportion to their

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[44] Treas. Reg. § 1.761-2.

[45] *Id.* at § 1.761-2(a)(2)(i), -2(a)(3)(i).

[46] *See* I.R.S. F.S.A. 1999-23-017, *supra* note 9, at *7; I.R.S. F.S.A. 2002-16-005, *supra* note 9, at *3, *4. *See also* I.R.S. P.C.L. 2004-53, 2004 WL 5387247, at *1 (Nov. 16, 2004) [hereinafter Hughes] ("The Treasury has indicated that it is the Treasury's position that if the title to property is held by a business entity (classified as a partnership), the partnership does not satisfy the requirement that property be held as co-owners.").

respective ownership interests in the entity.[47] Under this latter interpretation, owners of limited liability companies and limited partnerships could satisfy the Co-Ownership Requirement by simply contributing assets to the entity and dividing their respective ownership interests in the entity in relation to the value of the assets contributed.[48]

However, the I.R.S.'s interpretation of the Co-Ownership Requirement creates difficulty for limited liability companies and limited partnerships due to the various state acts that govern the formation and operation of such entities. Many of these acts are based largely upon the Revised Uniform Limited Liability Company Act ("*RULLCA*") or the Revised Uniform Limited Partnership Act ("*RULPA*"), respectively.[49] The main challenge for these entities in satisfying the I.R.S.'s interpretation of the Co-Ownership Requirement is found in RULLCA section 501 (for limited liability companies) and RULPA section 701 (for limited partnerships). These provisions state that a "[limited liability company/limited partnership] interest is personal property."[50] Many state statutes also add the following clarifying language: "A [member/partner] has no interest in specific [limited liability company/limited partnership] property."[51] Under this language, limited liability companies and limited partnerships are seemingly barred from satisfying the I.R.S.'s interpretation of the Co-Ownership Requirement, which requires that the entity's owners take a direct ownership interest in the entity's property.

However, those sections of RULLCA and RULPA are likely default rules subject to modification within the relevant entity's

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[47] *See* Hughes, *supra* note 46, at *1, *2; I.R.S. P.C.L. 2004-53, 2004 WL 5387248, at *1 (Dec. 1, 2004) [hereinafter Medinets].

[48] A more in-depth discussion of these competing interpretations is provided *infra* Part II.B.

[49] *See* SJOSTROM, *supra* note 28, at 11 ("Each state has its own limited partnership statute based on some version of the [Revised] Uniform Limited Partnership Act, with the exception of the Louisiana statute.").

[50] REVISED UNIF. LTD. LIAB. CO. ACT § 501 (UNIF. L. COMM'N 2006) (amended 2013); REVISED UNIF. LTD. P'SHIP ACT § 701 (UNIF. L. COMM'N 2001) (amended 2013).

[51] *See, e.g.*, DEL. CODE ANN. tit. 6, § 17-701 (1985) ("A partnership interest is personal property. A partner has no interest in specific limited partnership property."); DEL. CODE ANN. tit. 6, § 18-701 (1992) ("A limited liability company interest is personal property. A member has no interest in specific limited liability company property.").

Operating Agreement. Section 105(a) of both RULLCA and RULPA provides:

> (a) Except as otherwise provided in subsections (c) and (d), the [operating/partnership] agreement governs:
>
> > (1) relations among the [members/partners] as [members/partners] and between the [members/partners] and the [limited liability company/limited partnership]; [and]
>
> . . . .
>
> > (3) the activities and affairs of the [company/partnership] and the conduct of those activities and affairs . . . .[52]

The effect of this section is that unless a provision of RULLCA or RULPA is explicitly listed in section 105(c)-(d) of those uniform acts, then that provision is a default rule subject to modification within the relevant entity's Operating Agreement.[53] Of note, the provisions addressing members or partners taking interests in specific limited liability company or limited partnership property are not listed within those exceptions,[54] meaning those provisions are default rules subject to modification within the relevant entity's Operating Agreement. Therefore, limited liability companies and limited partnerships *should* be able to draft around those provisions to meet the I.R.S.'s interpretation of the Co-Ownership Requirement.

Admittedly, the challenges arising out of the Co-Ownership Requirement are much easier to resolve if the interpretation offered by legal practitioners were to be accepted. However, under the plain language of the relevant provisions in RULLCA and RULPA, limited liability companies and limited partnerships *should* be able

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[52] REVISED UNIF. LTD. LIAB. CO. ACT § 105(a); REVISED UNIF. LTD. P'SHIP ACT § 105(a).

[53] Some state statutes further clarify this modification ability. *See, e.g.*, MISS. CODE ANN. § 79-29-123(3) (2015) ("Except as provided in this subsection (3), the provisions of this chapter . . . may be waived, restricted, limited, eliminated or varied by the certificate of formation or operating agreement.").

[54] REVISED UNIF. LTD. LIAB. CO. ACT § 105(c)-(d); REVISED UNIF. LTD. P'SHIP ACT § 105(c)-(d).

to satisfy the Co-Ownership Requirement under either interpretation.

2. The Disposal Requirement

Albeit less troublesome, the Disposal Requirement similarly causes difficulty for limited liability companies and limited partnerships in achieving section 761(a) election eligibility. For an entity to qualify for section 761(a) election eligibility as an Investing Partnership or an Operating Agreement, the Disposal Requirement requires the owners of such an entity to "[r]eserve the right separately to take or dispose of their shares of any [entity] property . . . ."[55] However, the default rules of RULLCA and RULPA once again present challenges for limited liability companies and limited partnerships in meeting this requirement. Specifically, RULLCA section 404(c) and RULPA section 503(c) both state that "[a] person does not have a right to demand or receive a distribution from a [limited liability company/limited partnership] in any form other than money."[56] Although these provisions might otherwise prevent a limited liability company or limited partnership from satisfying the Disposal Requirement, they are similarly absent from the exceptions to the general modification ability found in RULLCA and RULPA.[57] Accordingly, these provisions are default rules, and limited liability companies and limited partnerships *should* be able to draft around them to satisfy the Disposal Requirement.

The ideas discussed in this section give rise to the overall question addressed in this Article: can limited liability companies and limited partnerships achieve section 761(a) election eligibility through appropriate drafting within the relevant entity's Operating Agreement? The Tax Court and the I.R.S. seem to answer this question differently.

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[55] Treas. Reg. § 1.761-2(a)(2)(ii), -2(a)(3)(ii).

[56] REVISED UNIF. LTD. LIAB. CO. ACT § 404(c); REVISED UNIF. LTD. P'SHIP ACT § 503(c).

[57] REVISED UNIF. LTD. LIAB. CO. ACT § 105(a), (c)-(d); REVISED UNIF. LTD. P'SHIP ACT § 105(a), (c)-(d).

G. The Tax Court Cases

The question of whether limited liability companies or limited partnerships may achieve section 761(a) election eligibility does not appear to have ever been specifically addressed by a court; therefore, "[b]y negative inference, a blanket prohibition on the election out by limited partnerships [or limited liability companies] does not exist."[58] However, "[s]everal Tax Court cases involving limited partnerships have focused on whether the entity satisfied the mechanics of making the election, rather than on the entity's ability to do so."[59] These cases are often cited as evidence that the Tax Court would allow limited liability companies and limited partnerships to achieve section 761(a) election eligibility in the presence of proper drafting within the relevant entity's Operating Agreement. The case most frequently cited as such is *Hager v. Commissioner*.[60]

In *Hager*, the relevant entity attempted to amend its original limited partnership agreement to insert specific language that the entity hoped would be sufficient to achieve section 761(a) election eligibility.[61] The entity also filed a Federal partnership return, which included a statement declaring that all members of the limited partnership had elected to be excluded from the application of Subchapter K under section 761(a).[62] However, the I.R.S. disallowed the election, contending that the limited partnership "was not entitled to make the election and that therefore the election was ineffective."[63]

In examining the validity of the purported section 761(a) election, the Tax Court found that while the original partnership agreement "neither consented to the election under section 761(a) nor reserved the right separately to take or dispose of their shares of partnership property," the amendment to the partnership

[58] Sheldon I. Banoff & Richard M. Lipton, *Can Limited Partnerships Elect Out of Subchapter K?*, 91 J. TAX'N 125, 126 (1999) [hereinafter Banoff & Lipton, *Can Limited Partnerships Elect Out of Subchapter K?*].

[59] *Id.* Although these cases specifically involved limited partnerships, the relevant issues apply directly to limited liability companies as well.

[60] 76 T.C. 759 (1981). *See also* Elkins v. Comm'r, 81 T.C. 669 (1983); Emershaw v. Comm'r, 59 T.C.M. (CCH) 621 (1990).

[61] *Hager*, 76 T.C. at 766.

[62] *Id.*

[63] *Id.* at 783.

agreement cured those defects by "reserv[ing] such right and . . . consent[ing] to the election."[64] However, because the entity failed to bring evidence that the amendment was properly executed in accordance with the requirements of the original partnership agreement, the Tax Court held that the amendment failed, thereby rendering the entity's section 761(a) election invalid.[65] It is important to emphasize that the Tax Court struck down the entity's section 761(a) election due to mechanical failures in amending the entity's original Operating Agreement, not because the entity—as a limited partnership—was inherently unable to achieve section 761(a) election eligibility. Rather, "[t]he court's language intimate[d] that had the [s]ection 761(a) election been perfected, it would have been valid."[66]

To be clear, the Tax Court in *Hager* did not explicitly state that the section 761(a) election is available to limited liability companies and limited partnerships. However, the Tax Court's language in *Hager* suggests that the court would allow the election to such entities when properly executed. Unfortunately, the I.R.S. does not appear to agree with this position.

H. The I.R.S. Guidance

Until 1999, "the prevailing view [was] that an entity formed under state law, such as an LLC or a limited partnership, [could] make a Code Sec. 761 election."[67] However, in June of that year, the I.R.S. published Field Service Advisory 1999-23-2017 (the "*First Advisory*"), advising that two limited partnerships formed under

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[64] *Id.* The specific language inserted into the amended Operating Agreement dealt with the Disposal Requirement. Interestingly, the Tax Court never addressed whether the relevant entity had satisfied the Co-Ownership Requirement. This may lead to a presumption that the Tax Court would agree with the interpretation of that requirement as proffered by legal practitioners, which would not require any special drafting to satisfy.

[65] *Id.* ("There is no additional evidence showing that the partners consented to the election under section 761(a) or reserved the right separately to take their shares of partnership property, and accordingly, we conclude that [the relevant entity] did not validly elect not to be subject to [S]ubchapter K.").

[66] Banoff & Lipton, *Can Limited Partnerships Elect Out of Subchapter K?*, *supra* note 58, at 126.

[67] *See* Steven G. Frost, *Electing Out of Subchapter K Under Code Sec. 761*, 2 J. PASSTHROUGH ENTITIES 12, 12 (1999).

RULPA could not elect out of Subchapter K under section 761(a).[68] More specifically, the I.R.S. stated that "[g]enerally, the Service does not allow entities formed under a state's *partnership or limited partnership laws* to elect out of Subchapter K."[69] This statement caused serious concern because it suggested that not only were limited partnerships and limited liability companies barred from making elections under section 761(a), but also that general partnerships were similarly prohibited from making such elections.[70] As stated by Sheldon Banoff and Richard Lipton in *Can Limited Partnerships Elect Out of Subchapter K?*, "[n]o authority [was] given for this blanket statement regarding (general) partnerships, and the conclusion [came] as a surprise to us (and, we assume, to many other tax practitioners)."[71] The I.R.S.'s interpretation meant that all "unincorporated entities formed under state law, i.e., limited partnerships, general partnerships, and LLCs, 'generally' would not be able to elect out of Subchapter K"[72] and that "only entities not formed under a state statute (such as tenancies-in-common) could qualify for election out."[73]

The primary basis for the I.R.S.'s position in the First Advisory was the default rule under RULPA that limits a partner's ability to take or dispose of his or her share of partnership property, which restricts a limited partnership's ability to meet the Disposal Requirement.[74] Specifically, the I.R.S. pointed to the following

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[68] I.R.S. F.S.A. 1999-23-017, *supra* note 9, at *7. Although the advisories published on this issue specifically addressed limited partnerships, their analysis applies directly to limited liability companies as well.

[69] *Id.* (emphasis added).

[70] Banoff & Lipton, *Can Limited Partnerships Elect Out of Subchapter K?*, *supra* note 58, at 126 ("[The] IRS went even further, indicating in dictum that entities formed as *general* partnerships under a state's Uniform Partnership Act also cannot elect out of Subchapter K.").

[71] *Id.*

[72] *Id. But cf.* Frost, *supra* note 67, at 12 ("Arguably, state law entities may make the election because the Code Sec. 761 regulation refers to *all* unincorporated organizations when it discusses those entities eligible to make the election, and it *only* provides that syndicates, groups, pools or joint ventures classified as [a corporation or a trust or estate] may *not* make the election.").

[73] Banoff & Lipton, *Can Limited Partnerships Elect Out of Subchapter K?*, *supra* note 58, at 126 ("We question whether Congress had this [narrow interpretation] in mind when [s]ection 761(a) was enacted in 1954.").

[74] I.R.S. F.S.A. 1999-23-017, *supra* note 9, at *7; *see also* Treas. Reg. § 1.761-2(a)(2)(ii), -2(a)(3)(ii) (requiring that an electing entity's "partners" must "reserve the right separately to take or dispose of their shares of any property acquired or retained").

language in the applicable state's limited partnership act: "*Except as provided in the partnership agreement*, a partner, regardless of the nature of the partner's contribution, has no right to demand and receive any distribution from a limited partnership in any form other than cash . . . ."[75] The I.R.S. then concluded that under this statutory language, the Disposal Requirement was not satisfied because "the partners in [the limited partnerships under review] d[id] not have the right to take their share of partnership property."[76] The advisory did not address whether the entities under review had attempted to draft around this statute within their Operating Agreements; however, the statutory language directly quoted by the I.R.S. plainly provided those entities with the ability to do so.[77]

In 2002, the I.R.S. published another advisory addressing this issue—Field Service Advisory 2002-16-005 (the "*Second Advisory*"). This advisory similarly directed that a limited partnership formed under RULPA was inherently ineligible to make an election under section 761(a).[78] According to the I.R.S., this ineligibility arose because under RULPA, partners of a limited partnership are not "co-owners" of partnership property (as required by the Co-Ownership Requirement) and cannot take their share of entity property at will (as required by the Disposal Requirement).[79] Specifically, the I.R.S. provided the following analysis:

[75] I.R.S. F.S.A. 1999-23-017, *supra* note 9, at *7 (emphasis added); *cf.* REVISED UNIF. LTD. P'SHIP ACT § 503(c) (UNIF. L. COMM'N 2001) (amended 2013) ("A person does not have a right to demand or receive a distribution from a limited partnership in any form other than money.").

[76] I.R.S. F.S.A. 1999-23-017, *supra* note 9, at *7.

[77] *Id.* ("Except as provided in the partnership agreement"); *cf.* REVISED UNIF. LTD. P'SHIP ACT § 105(a).

[78] I.R.S. F.S.A. 2002-16-005, *supra* note 9, at *5.

[79] *Id.* at *2.

> Under RULPA, partners of a limited partnership own partnership interests in that partnership. Partnership interests are personal property that consist of the right to a share of the profits and surplus of the partnership. Ownership of a partnership interest *generally* does not give a partner the right to take separately or dispose of its share of the partnership property. In short, partners in a partnership under RULPA are not co-owners of partnership property and cannot take their share of the property at will.[80]

The I.R.S.'s analysis in the Second Advisory largely mirrored that of the First Advisory, but with the addition of the "co-owners" language of the Co-Ownership Requirement.[81]

Interestingly, the Second Advisory noted that the relevant entity maintained a limited partnership agreement in which it "explicitly state[d] that the partners intend[ed] that [the limited partnership] be an investing partnership . . . and intend[ed] for [the limited partnership] to elect to be excluded from the application of the [S]ubchapter K provisions pursuant to section 761."[82] However, the I.R.S. disregarded this drafting, stating:

> Nevertheless, because Partnership 1 is a limited partnership formed under RULPA, the partners are not considered to be [co-owners] of the partnership property and thus, Partnership 1 is not an eligible entity for purposes of section 761(a). Accordingly, Partnership 1 may not elect to be excluded from the application of the [S]ubchapter K provisions pursuant to section 761.[83]

In other words, the I.R.S. advised that the entity, "as a limited partnership, was not eligible to make a [s]ection 761 election, notwithstanding the stated intent and terms of the limited

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[80] *Id.* (emphasis added). Note the I.R.S.'s use of the word "generally." Is this a concession that proper drafting within a limited liability company's or limited partnership's Operating Agreement could satisfy the Disposal Requirement?

[81] For more in-depth discussion of Field Service Advisory 2002-16-005 and its comparison to Field Service Advisory 1999-23-017, see Sheldon I. Banoff, *Limited Partnerships Can't Elect Out of Subchapter K*, 96 J. TAX'N 379, 381 (2002) [hereinafter Banoff, *Limited Partnerships Can't Elect Out of Subchapter K*].

[82] I.R.S. F.S.A. 2002-16-005, *supra* note 9, at *5.

[83] *Id.*

partnership agreement to do so."[84] This analysis reflects the I.R.S.'s interpretation of the Co-Ownership Requirement as being satisfied only when title to entity property rests directly in the entity's owners, rather than within the entity itself.[85] At the very least, the Second Advisory "indicate[d] that taxpayers can expect a battle on this issue on audit."[86]

I. *The I.R.S.'s Apparent Willingness to Reconsider*

Following its harsh interpretations of the requirements to achieve section 761(a) election eligibility, the I.R.S. expressed a willingness to reconsider its position on this issue in Notice 2004-53, *Request for Comments Concerning the Application of Section 761*.[87] This notice "request[ed] comments regarding the application of section 761 of the Code and whether section 1.761-2(a)(2) of the regulations should be revised, modified, or clarified[,]" particularly in regards to the Co-Ownership Requirement.[88] In full, the relevant language of this notice stated:

> The Internal Revenue Service and the Treasury Department request comments regarding the application of the conditions set forth in § 1.761-2(a)(2) and whether those conditions should be revised, modified, or clarified. Among other things, comments are requested on the circumstances under which participants in the joint purchase, retention, sale, or exchange of investment property should be treated as owning the property as [co-owners] for purposes of electing out of [S]ubchapter K under section 761.[89]

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[84] Banoff, *Limited Partnerships Can't Elect Out of Subchapter K*, *supra* note 81, at 381.

[85] *See* discussion *supra* Part I.F.1.

[86] Banoff, *Limited Partnerships Can't Elect Out of Subchapter K*, *supra* note 81, at 379.

[87] I.R.S. Notice 2004-53, *supra* note 10; *see also* Sheldon I. Banoff, *Will IRS Reconsider Elections Out of Subchapter K by Partnerships and LLCs?*, 101 J. TAX'N 188, 189 (2004) [hereinafter Banoff, *Will IRS Reconsider Elections Out of Subchapter K by Partnerships and LLCs?*] ("In Notice 2004-53, 2004-33 IRB 209, the IRS signaled its willingness to reconsider whether individuals who own investment property through a state law entity—albeit a limited partnership or LLC—are eligible to elect to be excluded from the application of Subchapter K.").

[88] I.R.S. Notice 2004-53, *supra* note 10, at *1.

[89] *Id.*

This notice arguably showed an acknowledgement by the I.R.S. that its stance toward this issue had been ill-advised and that it would reconsider whether certain limited liability companies and limited partnerships could become eligible to make elections under section 761(a). The public responses strongly supported the allowance of this election to such entities and recommended various methods by which the I.R.S. could achieve that result.[90] However, the I.R.S. never issued any further guidance on this topic.

It was at this point, nearly twenty years ago, that the rulings, guidance, and discussion on this topic came to a halt. Ever since, the question of whether certain limited liability companies and limited partnerships can achieve section 761(a) election eligibility through proper drafting within the relevant entity's Operating Agreement has remained unanswered.

II. CERTAIN LIMITED LIABILITY COMPANIES AND LIMITED PARTNERSHIPS SHOULD BE ABLE TO ACHIEVE SECTION 761(A) ELECTION ELIGIBILITY

Part II of this Article argues that certain limited liability companies and limited partnerships should be able to achieve section 761(a) election eligibility through proper drafting within the relevant entity's Operating Agreement. This argument derives from three key factors: (a) the plain language of the relevant statutes and regulations; (b) the public responses to I.R.S. Notice 2004-53; and (c) the resultant benefits to owners of these entities if allowed to make this election. Each factor provides an independent basis for allowing the section 761(a) election to limited liability companies and limited partnerships; however, the argument for allowing this election to such entities is strongest when considering these factors together as a whole.

A. The Plain Language of the Relevant Statutes and Regulations

Perhaps the most convincing argument for allowing section 761(a) election eligibility to limited liability companies and limited partnerships rests in a simple examination of the plain language of

[90] Discussed *infra* Part II.B.

the relevant statutes and regulations. Nothing within this language implicitly bars such entities from making the election, and the I.R.S. took a strained reading to achieve that result.

First, section 761(a) sets the initial boundaries of organizations eligible to make this election by providing a definition of "partnerships" into which an electing entity must fall. "[T]he term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate."[91] As entities treated as partnerships for tax purposes,[92] limited liability companies and limited partnerships unquestionably meet this definition, thereby satisfying this initial requirement of section 761(a) election eligibility.

Next, section 761(a) requires an electing entity to fit within one of three categories of eligible unincorporated organizations, including those availed of:

> (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities.[93]

As discussed above, the Treasury Department has published regulations containing additional conditions for eligibility under the first two categories, but not for the third. For this reason, this Article primarily addresses eligibility under the first two categories: Investing Partnerships and Operating Agreements.

Under either of those categories, the first regulatory condition for section 761(a) election eligibility is that the owners of the entity must "own the [entity's] property as [co-owners]."[94] This is the toughest requirement for limited liability companies and limited partnerships to satisfy, especially under the I.R.S.'s interpretation

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[91] I.R.C. § 761(a).
[92] Discussed *supra* Part I.D.
[93] I.R.C. § 761(a)(1)-(3).
[94] Treas. Reg. § 1.761-2(a)(2)(i), -(2)(a)(3)(i).

of "co-owners."[95] However, a response to I.R.S. Notice 2004-53 proposed a more appropriate interpretation of the Co-Ownership Requirement, which, if accepted, would minimize the difficulty in meeting this condition.[96] Nonetheless, under the plain language of RULLCA and RULPA, limited liability companies and limited partnerships should still be able to draft around the challenges imposed by the I.R.S.'s interpretation and satisfy the Co-Ownership Requirement.

These entities face difficulty meeting the I.R.S's interpretation of the Co-Ownership Requirement due to a provision found in RULLCA section 501 and RULPA section 701, which states that "[a] [limited liability company/limited partnership] interest is personal property."[97] Many state statutes follow this language with a clarifying clause: "A [member/partner] has no interest in specific [limited liability company/limited partnership] property."[98] Under this language, the members or partners of limited liability companies and limited partnerships generally do not take a direct ownership interest in the entity's property, seemingly prohibiting them from satisfying the I.R.S.'s interpretation of the Co-Ownership Requirement. However, section 105(a) of both RULLCA and RULPA allows a limited liability company or limited partnership to modify certain default rules through proper drafting within the relevant entity's Operating Agreement.[99] Section 105(c)-(d) of those uniform acts then states the specific mandatory rules

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[95] Under the I.R.S.'s interpretation, the Co-Ownership Requirement is satisfied only when title to entity property rests in the hands of the entity's owners, rather than within the entity itself. Discussed *supra* Part I.F.1.

[96] Under this alterative interpretation, the Co-Ownership Requirement could be satisfied even when title to entity property rests within the entity itself, so long as the owners of the entity share ownership of those underlying assets in proportion to their respective ownership interests in the entity itself. Discussed *supra* Part 1.F.1 and *infra* Part II.B.

[97] REVISED UNIF. LTD. LIAB. CO. ACT § 501 (UNIF. L. COMM'N 2006) (amended 2013); REVISED UNIF. LTD. P'SHIP ACT § 701 (UNIF. L. COMM'N 2001) (amended 2013).

[98] *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-701 (1992) ("A limited liability company interest is personal property. A member has no interest in specific limited liability company property."); DEL. CODE ANN. tit. 6, § 17-701 (1985) ("A partnership interest is personal property. A partner has no interest in specific limited partnership property.").

[99] REVISED UNIF. LTD. LIAB. CO. ACT § 105(a); REVISED UNIF. LTD. P'SHIP ACT § 105(a).

that may not be modified;[100] however, the provisions addressing partners or members taking ownership interests in specific limited liability company or limited partnership property are not listed amongst those mandatory rules, meaning they are default rules. Accordingly, under the plain language of RULLCA and RULPA, limited liability companies and limited partnerships should be able to draft around the challenges imposed by the I.R.S.'s interpretation of the Co-Ownership Requirement. Thus, these entities should be able to meet the Co-Ownership Requirement under either interpretation.

The second regulatory condition for section 761(a) election eligibility as an Investing Partnership or Operating Agreement is that the participants in the entity must "reserve the right separately to take or dispose of their shares of any property acquired or retained."[101] This Disposal Requirement similarly creates difficulty for limited liability companies and limited partnerships due to a provision found in RULLCA section 404(c) and RULPA section 503(c), which states that "a person does not have a right to demand or receive a distribution from a [limited liability company/limited partnership] in any form other than money."[102] Under this language, the members or partners of limited liability companies and limited partnerships generally cannot satisfy the Disposal Requirement; however, RULLCA section 404(c) and RULPA section 503(c) are similarly absent from the mandatory rules, meaning they are default rules.[103] Accordingly, under the plain language of RULLCA and RULPA, limited liability companies and limited partnerships should be able to draft around these provisions to satisfy the Disposal Requirement.

The final regulatory condition for section 761(a) election eligibility as an Investing Partnership or Operating Agreement is that the participants in the entity "do not actively conduct business."[104] This requirement is the least difficult to satisfy and is

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[100] *See* REVISED UNIF. LTD. LIAB. CO. ACT § 105(c)-(d); REVISED UNIF. LTD. P'SHIP ACT § 105(c)-(d).

[101] Treas. Reg. § 1.761-2(a)(2)(ii), -(2)(a)(3)(ii).

[102] REVISED UNIF. LTD. LIAB. CO. ACT § 404(c); REVISED UNIF. LTD. P'SHIP ACT § 503(c).

[103] REVISED UNIF. LTD. LIAB. CO. ACT § 105; REVISED UNIF. LTD. P'SHIP ACT § 105.

[104] Treas. Reg. § 1.761-2(a)(2)(iii), -(2)(a)(3)(iii).

based merely upon a facts and circumstances test.[105] Thus, in certain circumstances, limited liability companies and limited partnerships can assuredly pass the test of "not actively conduct[ing] business," thereby satisfying the plain language of this third and final requirement.[106]

Each requirement for section 761(a) election eligibility has now been satisfied. Accordingly, under the plain language of the relevant statutes and regulations, certain limited liability companies and limited partnerships should be able to achieve section 761(a) election eligibility through proper drafting within the relevant entity's Operating Agreement. The I.R.S. in the First and Second Advisories relied heavily upon RULLCA and RULPA as disqualifying such entities from achieving section 761(a) election eligibility; however, those advisories ignored the ability of those entities to modify default rules within their Operating Agreements.[107] Because the relevant provisions are default rules under the plain language of RULLCA and RULPA, certain limited liability companies and limited partnerships should be able to draft around those rules, thereby satisfying each of the necessary requirements to achieve section 761(a) election eligibility.

B. The Public Responses to I.R.S. Notice 2004-53

Although the I.R.S.'s interpretation of the Co-Ownership Requirement can likely be satisfied through proper drafting within the relevant entity's Operating Agreement, the responses to I.R.S. Notice 2004-53 provide a more sensible means of reconciling the language of the Co-Ownership Requirement with the allowance of section 761(a) election eligibility to limited liability companies and limited partnerships.[108] The I.R.S. received two responses to that notice, both of which argued that such entities should be able to achieve section 761(a) election eligibility. The first of these

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[105] *See, e.g.*, Higgins v. Comm'r, 312 U.S. 212, 217 (1941) ("To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case."); Comm'r v. Groetzinger, 480 U.S. 23, 36 (1987) (adhering to the proposition of the *Higgins* court that resolution of whether a taxpayer is carrying on a business "requires an examination of the facts in each case" (quoting *Higgins*, 312 U.S. at 217)).

[106] Treas. Reg. § 1.761-2(a)(iii).

[107] I.R.S. F.S.A. 1999-23-017, *supra* note 9; I.R.S. F.S.A. 2002-16-005, *supra* note 9.

[108] I.R.S. Notice 2004-53, *supra* note 10.

responses was signed by Mr. Timothy M. Hughes, Esq., serving as Chairman of the Federal Taxation Committee of the Chicago Bar Association at the time of the response (the "*Hughes Response*").[109] The second response was written by Mr. Lee David Medinets, Esq., serving as General Counsel at Madison Exchange, LLC, an I.R.C. section 1031 exchange company in Lakewood, New Jersey, at the time of his response (the "*Medinets Response*").[110]

Both responses focused primarily on the Co-Ownership Requirement. Interestingly, the Medinets Response noted that "[t]he word [co-owners] does not appear in the statute, IRC 761"; rather, "[i]t has been grafted onto the statute by regulation."[111] The Medinets Response continued: "The word [co-owners], as it has been used in the context of 26 CFR 1.761-2(a), is not a good choice because its meaning has not been adequately defined and because its common use is contrary to the apparent intent of IRC 761 . . . ."[112] The I.R.S. has taken a technical interpretation of the word "co-owners," essentially requiring the title to entity property to rest in the owners of an electing entity, rather than within the entity itself.[113] Alternatively, the Medinets Response proposed:

> [T]he intention of adding this word to the regulation was to make it clear that the kind of partnership that may make an election under 761(a) to be excluded from [S]ubchapter K must be the kind of partnership in which the partners share ownership of the partnership assets in proportion to their ownership interest in the partnership, itself. Therefore, a 40% owner of the partnership must thereby have a 40% interest in the partnership property. This can be true regardless of whether the partnership property is legally titled in the name of the partnership or in the name of the partners, themselves, or in the name of some other nominee.[114]

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[109] Hughes, *supra* note 46, at *1.

[110] Medinets, *supra* note 47, at *1.

[111] *Id.*

[112] *Id.*

[113] *See* I.R.S. F.S.A. 1999-23-017, *supra* note 9, at *8; I.R.S. F.S.A. 2002-16-005, *supra* note 10, at *4, *5. *See also* Hughes, *supra* note 46, at *1 ("The Treasury has indicated that it is the Treasury's position that if the title to property is held by a business entity (classified as a partnership), the partnership does not satisfy the requirement that property be held as co-owners.").

[114] Medinets, *supra* note 47, at *1.

The Medinets Response continued:

> The use of the word [co-owners] was intended . . . to *exclude* partnerships where to some unequal extent, one partner contributes the use, but not the ownership, of property to the partnership, while another partner contributes services or capital or something else of value. That exclusion follows from the principal that a partnership electing to be excluded from [S]ubchapter K must be the equivalent of ownership by tenants in common. This relationship does not exist when one partner retains an interest in property subject to the partnership that is disproportionate to his or her interest in the partnership.[115]

This interpretation of the Co-Ownership Requirement is much more reasonable than that of the I.R.S. Rather than requiring legal title to entity property to rest directly in the owners of an electing entity, this interpretation would allow legal title to rest within the entity itself. Thus, so long as the members or partners of that entity shared ownership of the entity's underlying assets in proportion to their respective ownership interests in the entity itself (i.e., as occurs when a 40% owner of the entity has a 40% interest in the partnership property), the Co-Ownership Requirement would be met. With the addition of proper drafting language in satisfaction of the Disposal Requirement, a limited liability company or limited partnership could then achieve section 761(a) election eligibility.

The Hughes Response similarly argued that such an interpretation of "co-owners" would be more appropriate, stating that "[i]t has long been a general principal of tax law that legal title alone is not determinative of ownership for federal income tax purposes."[116] The Hughes Response continued: "In fact, in a variety of circumstances[,] title may be held by an entity, but the property is deemed to be owned by one or more of the participants for federal income tax purposes."[117] For these reasons, the Hughes Response argued for the following amendment to the requirements for section

[115] *Id.*

[116] Hughes, *supra* note 46, at *1 (first citing Seattle Brewing & Malting Co. v. Comm'r, 6 T.C. 856 (1946); then citing I.R.S. Tech. Adv. Mem. 97-48-005 (Nov. 28, 1997); and then citing I.R.S. Tech. Adv. Mem. 98-02-002 (Jan. 9, 1998)).

[117] *Id.*

761(a) election eligibility under Treasury Regulation section 1.761-2(a):

> (2) *Investing partnerships*. Where the participants in the joint purchase, retention, sale, or exchange of investment property—production, extraction, use of property or in a business entity (including trusts) treated as partnerships for Federal income tax purposes (an "*unincorporated organization*")—
>
> > (i) Own the property as co-owners, either in title for state-law purposes or as fractional interests (whether stated as percentages or in units) in a business entity (including trusts) treated as partnerships for Federal income tax purposes (an "*unincorporated organization*"); and
> >
> > (ii) Reserve the right separately to take in kind or dispose of their shares of any property acquired or retained or separately dispose of their interests in the venture or entity (subject to reasonable restrictions to prevent the application of section 7704); and
> >
> > (iii) Do not actively conduct business or irrevocably authorize some person or persons . . . .[118]

The primary effect of this amendment is that it would "re-interpret[] the [Co-Ownership] [R]equirement to include interests held as fractional interest in business entities."[119] This amendment would essentially codify the interpretation of the Co-Ownership Requirement offered by the Medinets Response.

Whether the regulatory language of the Co-Ownership Requirement was (a) merely reinterpreted in accordance with the Medinets Response, or (b) amended in accordance with the Hughes Response, either solution would simplify the ability of limited liability companies and limited partnerships to meet that requirement. In either option, these entities could then unquestionably satisfy the necessary requirements for achieving section 761(a) election eligibility.

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[118] *Id.*; *cf.* Treas. Reg. § 1.761-2(a). Note that subsection (2)(ii) of this proposed amendment would also simplify the ability of a limited liability company or limited partnership to satisfy the Disposal Requirement.

[119] Hughes, *supra* note 46, at *3.

C. The Benefits of Making the Section 761(a) Election

If limited liability companies and limited partnerships were allowed to make elections under section 761(a), the benefits to the owners of those entities would be plentiful. The most obvious is that an electing entity could forego its requirement to file a partnership return.[120] Rather than filing a Form 1065 at the entity level, the owners of that entity would report their respective shares of the entity's income, deductions, and credits directly on their individual returns.[121] However, numerous additional benefits would result from the allowance of section 761(a) election eligibility to limited liability companies and limited partnerships. These additional benefits were succinctly summarized by Sheldon I. Banoff in *Will IRS Reconsider Elections Out of Subchapter K by Partnerships and LLCs?*:

[120] Treas. Reg. § 1.6031(a)-1(c).

[121] *See* I.R.S. F.S.A. 2002-16-005, *supra* note 9, at *4-*5; McMahon, Jr., *supra* note 26, at 30.

> [1] Partnership tax returns are avoided, which can reduce both administrative costs and the risk of 'winning' the audit lottery.
>
> [2] Ownership interests may be exchanged tax free, but partnership interests are excluded from like-kind exchange treatment by [s]ection 1031(a)(2)(D).
>
> [3] The [s]ection 183 limitation on the deductibility of losses will apply at the owner (i.e., 'partner') level rather than at the entity ('partnership') level.
>
> [4] Unlike partners, co-owners can make separate depreciation and depletion method elections.
>
> [5] Whereas the sale of a partnership interest would be subject to capital gain and loss treatment under [s]ection 1221, the sale of an ownership interest will be a deemed sale of a proportionate interest in each of the partnership assets subject to [s]ection 1231 gain and loss treatment.
>
> [6] State and local income taxes imposed on entities taxed as partnerships may be avoided (if the state imposes an entity-level tax and respects the federal election out under [s]ection 761).[122]

However, Mr. Banoff also noted that "[a]n election out also may have its disadvantages":

[122] Banoff, *Will IRS Reconsider Elections Out of Subchapter K by Partnerships and LLCs?*, *supra* note 87, at 189.

> For example, [s]ection 721 will no longer apply and contributions to capital of anything other than cash apparently may trigger gain to the extent of any disproportion in contributions or in the value of the interests received in exchange. Moreover, a purported election out that is not respected by the IRS may have adverse consequences when the entity fails to act as a partnership. Tax elections that a partnership or LLC otherwise might have availed itself of (e.g., [s]ection 754 elections and methods of accounting) will be forgone, and there may be penalties under [s]ection 6698 for failure to file partnership tax returns.[123]

Accordingly, even if section 761(a) election eligibility is granted to limited liability companies and limited partnerships, such an entity must carefully weigh these advantages and disadvantages before making the election. However, the benefits are likely to outweigh the disadvantages whenever the election is properly made and respected.

III. SAMPLE OPERATING AGREEMENT DRAFTING LANGUAGE

Part III of this Article presents sample Operating Agreement drafting language that may be sufficient in rendering a limited liability company or limited partnership eligible to make a section 761(a) election. This proposed language derives largely from that of the partnership agreement analyzed in *Hager v. Commissioner*.[124] In *Hager*, a limited partnership attempted to achieve section 761(a) election eligibility by amending its Operating Agreement to insert specific drafting language.[125] The Tax Court disallowed the attempted election due to mechanical failures in amending the Operating Agreement; however, the Tax Court suggested that the language used would have met the requirements of section 761(a) had the attempted amendment been properly effectuated.[126] Therefore, any discussion of drafting language potentially sufficient to render a limited liability company or limited partnership eligible to make a section 761(a) election must begin with the language analyzed in *Hager*:

[123] *Id.* at 189.
[124] Hager v. Comm'r, 76 T.C. 759 (1981). Discussed in more depth *supra* Part I.G.
[125] *Id.*
[126] *Id.*

> 11. *Election*. Each of the Partners hereby elects, pursuant to [s]ection 761(a) of the Internal Revenue Code of [1986] . . . that the Partnership shall be excluded from the provisions of Subchapter K of the Code.
>
> . . . .
>
> 19. *Withdrawal of Partners; Partition.* Notwithstanding anything in this Agreement to the contrary, each Partner hereby expressly reserves the right (a) to withdraw from the Partnership and receive in exchange for his interest in the Partnership his pro rata . . . undivided interest in all assets owned by the partnership at the time of such withdrawal, and (b) to maintain an action for partition of any property owned by the Partnership in which he owns an [undivided] interest.[127]

This language—particularly section 19—modifies RULPA section 503(c), which states that "[a] person does not have a right to demand or receive a distribution from a limited partnership in any form other than money."[128] In doing so, thereby giving the partners the right to either take their undivided interest in all assets held by the partnership or to maintain an action for partition, this language would likely allow a limited liability company or limited partnership to satisfy the Disposal Requirement.[129] Further, if the alternative interpretation of the Co-Ownership Requirement were to be accepted as proposed by the Medinets Response and satisfied by the ownership structure of an electing entity,[130] then the presence of this language within the entity's Operating Agreement would likely be sufficient to render such a limited liability company or limited partnership eligible to make an election under section 761(a).

[127] *Id.* at 766 (third, fourth, and fifth alterations in original). Although this language specifically addresses limited partnerships, the same language could be used for a limited liability company by substituting "Members" for "Partners" and "Limited Liability Company" for "Partnership."

[128] REVISED UNIF. LTD. P'SHIP ACT § 503(c) (UNIF. L. COMM'N 2001) (amended 2013).

[129] Treas. Reg. § 1.761-2(a)(2)(ii), -2(a)(3)(ii).

[130] Discussed *supra* Part II.B.

IV. LIMITED LIABILITY CONCERNS

Part IV of this Article briefly addresses the limited liability concerns that might arise if a limited liability company or limited partnership were to make an election under section 761(a). As a result of the Operating Agreement drafting language that would be necessary to render these entities eligible to make such an election, there is legitimate concern as to whether the limited liability protection typically enjoyed by the owners of such entities would survive, or if this drafting would instead leave those owners unprotected from a potential piercing of the veil. The Author admits the answer to this question is a relative unknown.[131]

These limited liability concerns primarily arise from the Co-Ownership Requirement, which requires the owners of an electing entity to own the property held by the electing entity as "co-owners."[132] Depending upon the applicable interpretation of "co-owners," this Co-Ownership Requirement could potentially cause a court to find there was a commingling of assets, which is one of the most common factors leading to veil piercings.[133] Especially if the I.R.S.'s interpretation of "co-owners"—requiring title to entity property to rest directly in the entity's owners—was to be accepted, then such piercing concerns would be inevitably worrisome. Alternatively, if the interpretation of "co-owners" as proposed by the Medinets Response—allowing title to entity property to rest within the entity itself—was to be accepted, then the limited liability concerns would likely be mitigated. Under this latter interpretation, the property of the entity would be legally owned by the entity for all non-tax purposes, minimizing the piercing risk.

The Operating Agreement drafting language necessary to satisfy the Disposal Requirement would similarly result in concern for limited liability protection. This language would likely need to give each of the electing entity's owners the right to either take

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[131] *See* SJOSTROM, *supra* note 28, at 92 (noting that the law regarding piercing the limited liability veil "is murky, because no bright line test exists for when a court will pierce").

[132] Treas. Reg. § 1.761-2(a)(2)(i), -2(a)(3)(i).

[133] *See* Minton v. Cavaney, 364 P.2d 473, 475 (Cal. 1961) (Piercing the veil may be appropriate when "[t]he equitable owners of a corporation . . . treat the assets of the corporation [or limited liability entity] as their own and add or withdraw capital from the corporation at will." (citations omitted)).

their respective undivided interests in all assets held by the entity or to maintain an action for partition.[134] Frequently using those rights could similarly give rise to a finding of commingled assets, leading to potential veil piercings. However, so long as those rights were not abused, it is unlikely that their mere granting would destroy an entity's limited liability status.

It is difficult to answer with certainty whether the limited liability protection enjoyed by owners of limited liability companies and limited partnerships would survive the requisite Operating Agreement drafting language necessary to render such entities eligible to make elections under section 761(a). However, so long as the rights granted within the Operating Agreement to satisfy the Disposal Requirement were not abused, it is unlikely that the veil of such an electing entity would be pierced. This argument would be further strengthened if the Medinets Response's interpretation of the Co-Ownership Requirement was accepted, allowing title to entity property to rest within the entity itself.

CONCLUSION

The question of whether limited liability companies and limited partnerships can achieve section 761(a) election eligibility has been left unanswered for far too long. This uncertainty largely derives from the inherent ambiguity within the Co-Ownership Requirement, with competing interpretations having been offered by the I.R.S. and legal practitioners. The I.R.S.'s interpretation is much more difficult for limited liability companies and limited partnerships to satisfy; however, under the plain language of the relevant statutes and regulations, such entities should still be able to meet this interpretation through proper drafting within their Operating Agreements. Regardless, the alternative interpretation of the Co-Ownership Requirement as offered by the Medinets Response is likely a more appropriate reading. Under this interpretation, the Co-Ownership Requirement could be satisfied when title to entity property rests within the entity itself, so long as the owners of the entity share ownership of those underlying assets in proportion to their respective ownership interests in the entity itself. With the addition of proper drafting language in

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[134] Discussed *supra* Part III.

satisfaction of the Disposal Requirement, certain limited liability companies and limited partnerships could then achieve section 761(a) election eligibility, and the resultant benefits to owners of such electing entities would be plentiful.

Even if this argument is rejected, the Author's primary goal in writing this Article was merely to revive the discussion regarding the availability of the section 761(a) election to limited liability companies and limited partnerships. Such availability has been left unanswered for nearly twenty years, and the time has come to achieve more certainty regarding this election. The attainment of such further clarity is dependent upon the continued scholarly discussion of the ideas presented within this Article, and the Author hopes such an on-going discussion will follow.