SHOP TALK

How Small Can a Partner's Interest Be: Did "Small" Just Get Smaller?

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors:

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There is no partnership interest too tiny to catch the attention of your Shop Talk editors (and some of our column's readers). How small can a partner's interest be, while still being recognized as a partner's interest for federal and state tax purposes? As discussed in more detail below, a recent appellate court case indicates some tax-driven partnerships involve general partner interests of 0.01% (or less).

Shop Talk has long counted the angels (in the form of tiny ownership interests) on the pinhead of partnerships. See, e.g., Shop Talk, "The 1% Standard: Back from the Dead?," 120 JTAX 317 (June 2014); "Revisiting the 1% Minimum Ownership Interest in Safe Harbors," 132 JTAX 38 (May 2020) (the "May 2020 Shop Talk article"); and "More on the 1% Minimum Ownership Interest Standard in Safe Harbors: A Drafter Responds," 133 JTAX 35 (August 2020) (the "August 2020 Shop Talk article"). This last article was generated by an email we received from Michigan attorney (and former IRS Tax Law Specialist) Jerrold (Jerry) Bigelman, who, as one of the drafters of Rev. Proc. 74-17, provided us with insight as to its creation and scope.[1] Section 3.01 of that revenue procedure established the so-called 1% minimum interest standard (pre-condition)[2] for the general partners of a limited partnership for obtaining a partnership tax status letter ruling. Mr. Bigelman stated he has "been a '74-17 – 1% General Partnership Interest Guy' all my life."

Your editors recently received an interesting commentary from Andrew Gradman, a Los Angeles attorney, which delves further into the 1% standard and the rationale behind Rev. Proc. 74-17, and provides his thoughts about abuses that may arise from the use of de minimis partnership interests. Andrew writes in relevant part:

> "I read your 2020 articles on the 1% minimum interest in partnerships (May 2020, August 2020). I wanted your thoughts on something.
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> In the second half of the article, after quoting Mr. Bigelman (Mr. "1% all my life"), you ask why the IRS would want to impose hurdles to partnership status in the first place. (You ask: "Is the partnership form itself evil?"). You refer to a 1973 comment by Commissioner Alexander: "tax shelter promoters were using the partnership form for mischief by so-called general partners who merely had an interest in set fees; the Commissioner said their interest 'must be something more'". Then you pick this argument apart.
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> Maybe I'm naive, because I grew up when leveraged tax shelters were no longer a thing, but: I assumed you had in mind a different abuse when writing about the 1% question. I assumed the 1% issue was always about a solo taxpayer, who wanted to hide embarrassing activities in a separate partnership return. This worked because (before my time) there was this thing called "TEFRA" which made it hard to audit partnership tax returns. So, to enjoy audit protection, the solo taxpayer would bring on a partner; but it would be a straw partner, with the lowest economic interest that could pass IRS scrutiny.
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> We talk about the 1% rule like it represents a constraint (not-legal-if-lower-than). But to deter the most abuse, a vague facts-and-circumstances test works better. Announcing a number is something you do to accommodate non-abusers (not-illegal-if-higher-than). If so, this suggests we should view the 1% rule as a safe harbor, not a floor.
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> Your Objection 1: "Then why did Mr. Bigelman say that stuff about tax shelters?" Dunno.
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> Your Objection 2: "If so, then why didn't the IRS limit it to two-partner partnerships? Why does the rev proc say 'all of the general partners, taken together'?" Again, dunno. Maybe

[1] Rev. Proc. 74-17, 1974-1 CB 438.

[2] Under Rev. Proc. 74-17, one pre-condition is that the interest of all of the general partners, taken together, in each item of partnership income, gain, loss, deduction, or credit shall be equal to at least 1% of each such item at all times during the existence of the partnership.

someone at the IRS did not think this plan through very carefully.

Your Objection 3: "Then why did the IRS issue this in the form of a no-rule rev proc? That doesn't create a safe harbor." Dunno.

Your Objection 4: "If so, then why does Rev. Proc. 74-17 only consider the possibility of the general partner as straw partner? The same abuse could be perpetuated with the limited partner as straw partner; why not extend the rule across the board?" A very-low-percent sole general partner looks plausible. A very-low-percent sole limited partner does not. If the taxpayer truly did lack any other reason to be a partnership, he'd be a fool to do that.

In conclusion. When you asked, "Is the partnership form itself evil?", I was thinking how under TEFRA (and whatever they had before 1982), partnership audits used to be costly/tedious for the IRS. Then, I was expecting you to conclude: "But those awful days are now behind us, because the BBA has made partnership audits really simple. So now the IRS has no more reason to care about a 1% rule. So IRS, how about you get rid of the 1% rule?"

Your editors enjoyed Mr. Gradman's comments in providing further grist for the "1% partner mill." Even though the IRS has never revoked Rev. Proc. 74-17, it appears to be guidance that is taken into account only in the breach – and apparently few seem to care about it anymore.

For example, there is a recent court case (a non-tax dispute) involving low-income housing, *Sun America Housing Fund 1050 v. Pathway of Pontiac, Inc.*[3] As stated in the district and appellate court opinions, the two general partners in the operating partnership ***collectively*** owned a 0.01% partnership interest. The Sixth Circuit Court of Appeals matter-of-factly mentions that low-income housing tax credit (LIHTC) partnerships usually allocate 99.99% of the credit available under Section 42 and tax benefits (losses) to the limited partner(s), while the general partner retains only 0.01%. The appellate court stated:

> "A typical arrangement under LIHTC proceeds as follows. See generally Off. of the Comptroller of the Currency, Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks 6-9 (Mar. 2014), https://www.occ.gov/publications-and-resources/ publications/community-affairs/community-developments-insights/pub-insights-mar-2014.pdf (providing general overview of the mechanics of LIHTC). A low-income housing developer first applies to a state housing credit agency for an award of federal tax credits. If the state agency grants the application, the developer then enters into a limited partnership as a general partner with a private investor as a limited partner. Often, the investor is a bank or another financial entity that has ample annual tax liability of its own that makes acquiring the nonrefundable tax credits a worthwhile investment. The limited partner investor then provides the capital needed to build and develop the low-income housing development. *In return, the partnership allocates the vast majority (usually 99.99%) of tax credits and other tax benefits to the investor.* These benefits alone provide the investor with a significant return on investment that makes the arrangement attractive and worthwhile to the investor. See, e.g., Ernst & Young, Low-Income Housing Tax Credit Assessment Survey 6 (2009), https://www.nahma.org/wp-content/uploads/files/member/Tax%20Credit/Legislative%20Study_FINAL%20092509.pdf (finding average annual post-tax rate of return on investment to be approximately 10%)."
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> "The Partnership [here] followed the same general structure discussed earlier .... Sun America, a large institutional investor, joined the Partnership as a Limited Partner, owning 99.99% of the Partnership .... [Two others] entered as General Partners, collectively owning 0.01% of the Partnership." (emphasis added.)

The structure of this transaction was not shocking to your editors, who have previously explored whether a 0.1% (or even a 0.01%) general partner interest should be treated as a valid partnership interest for tax purposes. See "How Small Can a Partner's Interest Be: Is 0.1% (or 0.01%) the 'New' 1%?," 114 JTAX 186 (March 2011) and "Taxpayer's 0.02% Partnership Interest Won't be Disregarded (at Least at Another Taxpayer's Request!)," 122 JTAX 282 (June 2015). There does not appear to be any good policy argument to require a floor for the size of a partnership interest (as in Rev. Proc. 74-17) as long as there are two taxpayers who are sharing profits and losses, which satisfies the statutory requirement that a partnership have at least two partners.

Is there a hierarchy of minimum percentage standards, depending upon the facts and circumstances of

3 (CA-6, 5/10/22), rev'g & rem'g 2021 WL 291420 (E.D. Mich. 2021).

the partnership and its partners? For example:

1. Is there a different minimum ownership interest standard for partnerships allocating low-income housing tax credits than for wind tax credits? There apparently is widespread comfort in the low-income housing tax credit community with a 99.99% limited partner / 0.01% general partner ownership structure, given their widespread use, as observed by the Sixth Circuit in *Sun America* and quoted above. However, in the case of tax credits for wind projects, Rev. Proc. 2007-65 tells us a 99.5% limited partner / 0.5% general partner arrangement will be subject to "close scrutiny" for advance ruling purposes.[4]

2. Is there a different minimum ownership interest standard for partnerships allocating LIHTC and wind tax credits (discussed in the preceding paragraph) than for partnerships allocating other types of tax credits? We previously observed that in Rev. Proc. 2014-42, 2014-3 IRB 415, section 4.02(1), "Partners' partnership interests – principal's minimum partnership interests," the IRS reasserted the 1% "gold standard" minimum requirement for purpose of partnerships and partners meeting a safe harbor for rehabilitation tax credit partnerships under Section 47.[5] In Rev. Proc. 2020-12, 2020-11 IRB 511, dealing with allocations of the tax credit for carbon capture projects under Section 45Q, the IRS again imposed the 1% minimum interest as a pre-condition to the safe harbor. We observed in our May 2020 Shop Talk article that only the 2007 wind tax credit revenue procedure, Rev. Proc. 2007-65, indicates a 0.5% interest may be acceptable (i.e., is not 'dead in the water'), albeit subject to the IRS's close scrutiny. In contrast, neither the 2014 rehab credit rev proc nor the 2020 carbon tax project tax credit discuss or so provide as to a 0.5% interest.

3. Finally, is there a different standard for a minimum partnership interest in partnerships that have no tax credits to allocate from those that do? It would appear not. As partnership tax status letter rulings for non-tax credit partnerships are no longer available,[6] and correspondingly no 1% (or other) preconditions exist with respect to the size of the minimum interest in a non-tax credit partnership, we have no basis to conclude whether an IRS field agent would attack a small or de minimis interest in a partnership.

Of course, there is no substantive tax law (statutes, cases, regulations, or rulings) that distinguishes between minimum interests of partnerships designed to qualify for certain types of tax credits among other tax credit partnerships. Nor is there substantive tax law that distinguishes between minimum interests of partnerships that qualify for tax credits and those that don't. In a case of first impression, however, facts and circumstances before a trier of fact sometimes make a difference. A court considering whether a 0.1% (or 0.01% or 0.000001%) interest is a valid ownership interest by a purported partner for tax purposes might be influenced by a situation viewed as overly aggressive or abusive. As Mr. Gradman correctly concludes, if the goal is to deter the most abuse, the minimum ownership interest standard should remain a facts-and-circumstances test.

The simplest argument to the contrary is the corporate analogue. Ownership of a single share of stock (common or preferred) with the attendant benefits and burdens of that one share is sufficient for the owner to be deemed a "shareholder" for tax purposes. Shouldn't the same be true of an owner of one partnership unit in a partnership where that owner has the attendant benefits and burdens of ownership of that single unit?[7] If so, then arguably the line should be drawn at having any (i.e., more than zero) ownership interest in the partnership (or corporation) to be recognized for tax purposes as an "owner" (partner / shareholder) of a partnership / corporation.

There are tax cases where mere fractions of 1% partnership interests have gone uncriticized, uncommented upon, or unnoticed, and implicitly approved, and some others where the outcome of the case is premised on the member with the decimal ownership interest being recognized as a partner for tax purposes. But the cases are not so definitive as to put the questions to rest.[8]

This leads, of course, to the question whether tax advisors should require a "minimum" ownership interest of a partner in a two-person

4 Rev. Proc. 2007-65, 2007-45 IRB 967. The IRS subsequently announced that the "close scrutiny" caveat is "*not* intended to provide a substantive rule [and is] *not* to be used as [an] audit guideline." Ann. 2007-112, 2007-50 IRB 1175 (emphasis added.)

5 See Shop Talk, "How Small Can a Partner's Interest Be? The Answer is Blowin' in the Wind," 108 JTAX 57 (January 2008).

6 See Rev. Proc. 2022-3, 2022-1 IRB 144, section 3.01(95).

7 Is it possible that the controversial partnership anti-abuse rules of Reg. 1.701-2 may act as a backstop in a truly 'abusive' situation, whatever that might mean?

8 See the May 2020 Shop Talk article, discussing *Historic Boardwalk Hall, LLC*, 136 TC 1 (2011), 2011 WL 9078, rev'd and rem'd on other grounds, 694 F.3d 425, 110 AFTR 2d 2012-5710 (CA-3, 2012) (cert. denied); Jordan 863 F. Supp. 270, 74 AFTR 2d 94-6275 (DC N.C. 1994); Brumbaugh, TCM 2015-65.

partnership. Even though there is no "legal" basis for requiring a minimum ownership percentage, your editors still get a little queasy when, in a two-person partnership, one of the partners has a truly de minimis interest, such as 0.01%. The facts in the *Sun America* case are even queasier: the partnership at hand involves a sole 99.99% limited partner and two general partners, each presumably having less than a 0.01% interest, as the two general partners "collectively" own 0.01%. Thus, if the two general partners in Sun America own equal interests in the partnership, each partner owns a meager 0.005% of the partnership. That apparently did not cause the court or anyone else to blink, at least for non-tax purposes.

When it comes to issuing opinions, your editors may not always require a full 1% ownership interest for the second partner, but they usually will not go below 0.5%, although there is no authority that provides direct comfort in this regard. Some hang their hats on a minimum of 0.5%, in reference to Rev. Proc. 2007-65, 2007-45 IRB 967, which provides a safe harbor applicable to partners in partnerships with Section 45 credits from wind. Rev. Proc. 2007-65 may or may not be interpreted by tax practitioners and field agents as providing an indication that the IRS National Office was/is not comfortable with partners' interests being in the range of 0.5% or less. That revenue procedure has the rare admonition that the Service generally will "closely scrutinize" a project company as a partnership or investors as partners if the developer has only a 0.5% interest in gross income or loss and credits. See Shop Talk, "How Small Can a Partner's Interest Be? IRS Whispers in the Wind," 107 JTAX 380 (December 2007). The flip side of a 0.5% interest being subject to IRS's close scrutiny is that 0.5% interests in appropriate situations that pass scrutiny will not preclude an entity's classification as a valid partnership for tax purposes.

However, to meet the IRS's requirements for a safe harbor that does not need to run the "close scrutiny" gauntlet to obtain tax credits, the three revenue procedures we previously referenced require the general partner to own no less than a 1% interest (the so-called 1% gold standard).[9] We refer our readers to the May 2020 Shop Talk article for a more detailed discussion, including arguments for supporting the proper threshold as being less than 1%, and our ongoing concerns that the 1% threshold will become an audit standard (and not merely a safe harbor).

So how do your editors respond to Mr. Gradman's questions?

Your Objection 1: "Then why did Mr. Bigelman say that stuff about tax shelters?" Your editors agree, but also put things into historical context. In the 1970s, tax shelters tried to limit the interest of the general partner to maximize the tax benefits to the investors, as in current LIHTC partnerships. The 1% floor was intended to make sure that the general partner had some stake, albeit not large, in the investments. Indeed, one could argue that the 1% floor was generous and from a tax policy perspective, in light of the tax shelter transactions that were being addressed, a larger minimum (say, 10%)[10] would have made more sense. Though, comparatively, that would make little sense in current LIHTC partnerships, especially given the policy goals behind the LIHTC program (i.e., to get capital into low-income housing). On the other hand, the 1% "floor" and this guidance related to a period of time when there were no limited liability companies, so a partnership had to have a general partner who bore the risk of loss arising from all partnership activities.

The risk point is important – if a partnership had only two partners, one of whom was a 0.001% general partner and the other was a 99.999% limited partner, it was clear that the general partner bore all the legal risks attendant to being a general partner in a partnership, so why shouldn't that general partner be treated as a partner for tax purposes? If the measure of a partner is whether the taxpayer bears the risk of loss, then the general partner in this example clearly should be treated as partner.

The risk of loss analysis admittedly falters when we introduce other unincorporated entities (e.g., LLCs) whose manager-members are statutorily shielded from risk of liability and risk of personal loss. Yet the validity of the LLC for tax purposes as a partnership was expressly recognized by the IRS under the Kintner Regulations[11] and thereafter the Check-the-Box Regulations (the "CTB Regs").

Your Objection 2: "If so, then why didn't the IRS limit it to two-partner partnerships? Why does the rev proc say 'all of the general part-

9 See Rev. Procs. 2007-65, 2014-12, and 2020-12.

10 As described in more detail in our May 2020 Shop Talk article, in the early 1970s it was rumored that for purposes of obtaining partnership tax status letter rulings, the interests of all the general partners, taken together, of a limited partnership were required to be at least 5% of each item of partnership income and loss. This column reported this rumored rule of thumb. *See* Shop Talk, "IRS's New Unofficial Partnership Rulings Guidelines," 40 JTAX 256 (April 1974). Two months later, in conjunction with the issuance of Rev. Proc. 74-17, this column helped put that rumor to bed. *See* Shop Talk, "Discrepancy in Limited Partnership Ruling Guidelines," 40 JTAX 384 (June 1974).

11 Rev. Proc. 95-10, 1995-1 CB 501, section 4.03.

ners, taken together'?" Another good question. Your editors believe the IRS could have limited the policy to two-partner partnerships, but then a partnership could have had (say) two 0.001% partners and a single 99.998% partner, which would have made no sense. So perhaps the broader requirement is logical. Likewise, it probably satisfied the IRS' policy goals if all of the general partners totaled 1%, especially since every partnership back then had to have at least one general partner, and there should have been no difference if there was one or multiple general partners.

Your Objection 3: "Then why did the IRS issue this in the form of a no-rule rev proc? That doesn't create a safe harbor." Your editors' best guess is that the IRS did not want to create a safe harbor, because if it did want to do so, it could have issued regulations to that effect. The Rev Proc was essentially saying that the IRS would not "bless" partnership status for tax purposes if the general partner had less than a 1% interest, but nothing in the Rev Proc prevents a tax practitioner from getting comfortable with a smaller percentage interest.[12]

Your Objection 4: "If so, then why does Rev. Proc. 74-17 only consider the possibility of the general partner as straw partner? The same abuse could be perpetuated with the limited partner as straw partner; why not extend the rule across the board?" Perhaps this requirement should be looked at the other way. If the limited partner in a two-person partnership owned only 1% of the partnership, and the limited partnership was being used for tax avoidance purposes, then Rev. Proc 74-17 would not bless the treatment of the limited partnership as a partnership for tax purposes. In other words, the IRS was essentially saying that a general partner could not be disregarded if the general partner owned only 1% of the partnership, but guidance does not address a limited partner with a small percentage ownership.

It is now almost 50 years since the issuance of Rev. Proc. 74-17, and today most passthrough entities are formed as LLCs, not limited partnerships. If there is no state law general partner, what is the "impact" of the requirement that a general partner own at least 1% of the (limited) partnership? Should practitioners be completely comfortable if one member of an LLC owns more than 99.00% and the other member(s) (collectively) own less than 1.00%? Early on it was recognized that Rev. Proc. 95-10, the LLC tax status revenue procedure applicable prior to the CTB Regs, fails to clearly define the membership interest necessary to qualify as a member, opting instead to examine the facts and circumstances.[13] And the CTB Regs are of no further help; their Preamble also states that the determination of whether an organization has more than one owner must be based on all the facts and circumstances,[14] and to this day, your Shop Talk editors remain unaware of any substantive guidance on point since the issuance of the CTB Regs.

As stated in the 2020 carbon capture tax credit revenue procedure,[15] "A partnership exists when two or more 'parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise,'" quoting from the U.S. Supreme Court's opinion in *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949). Perhaps the idea of a greater than zero partnership interest being required for there to be a bona fide partnership has led to the struggles within the Service (in the tax credit revenue procedures) and outside (among practitioners and clients) to identify the magical dividing line (if one exists) where a de minimis interest does not preclude one from being or becoming a partner.

As we have previously indicated in our discussions of this issue, your editors believe that the Code provides that a partnership exists whenever two or more persons come together to engage in an activity for profit. If that requirement is met – and the non-statutory requirement in *Culbertson* that there be an express intent for two or more persons to share in the profits of a business enterprise – then a partnership should exist for tax purposes without regard to the size of the partnership interests. Thus, your editors believe that Rev. Proc. 74-17 can be largely ignored and treated as "deadwood," and it would be beneficial, if the IRS ever took that step, for the IRS to eliminate one more piece of complexity that clutters up tax planning and compliance.

We thank Mr. Gradman for his observations and as always, we welcome the views and comments of our readers.

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12 Compare Rev. Proc. 2007-65, Example 2, note 4 supra, which states the validity of the partnership will be "closely scrutinized" for purposes of the tax credit for wind if the general partner's interest was 5% or less of the partnership.

13 Rev. Proc. 95-10, section 4.01. *See, e.g.,* Hamill and Oldshue, Jr., "Applying Revenue Procedure 95-10 to the Classification of Limited Liability Companies," 20 ALI-ABA Course Materials 49 (1995).

14 *See* TD 8697, 12/17/96, Part B, "Discussion of Comments on the General Approach to the Classification and Scope of the Regulations."

15 Rev. Proc. 2020-12, section 2.05.