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In this report, Spiro examines how subchapter K's approach to holding periods, when combined with the many ambiguities surrounding goodwill, can lead to anomalous results in structuring partnership mergers and acquisitions for long-term capital gain.

All mistakes belong to the author.

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"Things can go your way if you hold on just one more day."

— Wilson Phillips[1]

Wilson Phillips must have been talking about the taxation of capital gains. Since 1921, the code has (with some notable exceptions) provided for the taxation of long-term capital gain at preferential rates. Today's iteration of the code applies preferential rates to (1) gain from the sale of capital assets held for more than one year (though this holding period is increased to three years for gain recognized from an "applicable partnership interest"),[2] (2) gain from the sale of depreciable property held for use in a trade or business for more than one year (section 1231 gain),[3] (3) 60 percent of mark-to-market gain on certain futures contracts,[4] and (4) certain dividend income.[5] Several policy reasons underlie the application of a preferential rate to assets with a long-term holding period, and though this policy has been controversial throughout the history of the code, it plays a significant role in modern tax planning.

The preference afforded long-term gain runs through subchapter K's complex scheme of affording flow-through treatment to taxable

[1] Wilson Phillips, "Hold On" (SBK Records 1990).

[2] Sections 1(h)(1) and 1061.

[3] Section 1231.

[4] Section 1256.

[5] Section 1(h)(11).

income and gain, applying entity features for administrative convenience and simplicity, as well as aggregate features intended to ensure that the flow-through taxation of partnerships preserves the economics of co-ownership among partners. For the most part, subchapter K tries to balance entity and aggregate features in a way that minimizes distortions that could create taxpayer arbitrage opportunities. For example, the provisions of subchapter K that work in concert to maintain parity between inside and outside tax basis are among the most complex in the code. On the other hand, little in subchapter K makes even a slight attempt to maintain parity between inside and outside holding periods. The substantial distortions that can arise between (1) a partner's holding period in its partnership interest and (2) the partnership's holding period in its assets can, and often do, result in significant tax planning and structuring opportunities to allow taxpayers to maximize preferential rates and achieve varying tax results in economically identical transactions.

The planning around holding periods in partnership mergers and acquisition transactions raises obvious policy questions — does subchapter K's approach to holding periods serve the policy behind the preferential rate afforded long-term gains? — and more subtle operative questions about holding period itself. These latter questions go to the very nature of holding periods and character when applied to assets like goodwill. In some transactions, it is not entirely clear whether goodwill or partnership interests are being sold. In others, the nature of partnership goodwill is unclear. Is it a section 1231 asset? A capital asset? What is the holding period of goodwill? Can goodwill of a single enterprise have multiple holding periods? These questions further muddy the waters around the proper interpretation of current holding period requirements and the justifications for them. The purpose of this report is to examine those issues in detail, including through the use of practical examples.

Accordingly, Section I provides a short history of the preferential rate given to long-term gains and the policies underlying that rate. Section II examines the incongruities between subchapter K's entity approach to the holding period and aggregate approach to basis, and considers practical examples in which those incongruities can have meaningful economic implications. Section III examines goodwill and, based on the authorities now in place, tries to construct a framework for analyzing goodwill character and holding periods. Section III also includes examples of transactional structures where the unique character and holding period of goodwill can have planning implications. Section IV concludes by arguing that to achieve the goal of taxing transactions based on their economic substance rather than their form, Congress should (1) adopt a hybrid entity-aggregate approach to holding periods, consistent with the treatment of basis under subchapter K; and (2) better define the nature and holding period of goodwill.

I. Long-Term Capital Gains

After the passage of the 16th Amendment, the Revenue Act of 1913, and the Revenue Act of 1918, it was not at all clear that gain from the sale of property outside the ordinary course of business was included in "income" subject to the new income tax.[6] Although the Bureau of Internal Revenue (the precursor to the IRS) took the broad view that capital gain was an element of income (and even promulgated regulations to that effect in 1919), many taxpayers believed that increases in capital did not constitute income (even when recognized).[7] It was only in the Supreme Court's decision in *Merchants' Loan & Trust Co.* (which served as the basis for three other cases involving capital transactions decided in that same year) that the Court established that gain on sale from appreciation in capital constituted income that Congress could tax under the 16th Amendment.[8]

The Court's decision to treat capital gains as income was controversial at the time, and Congress immediately responded by adjusting the rate at which long-term capital gains were

[6] The history and theory behind the preferential rate on long-term capital gains are the subject of many excellent law review articles and book chapters (many of which are cited herein). This section of the report represents a highly abbreviated description of that history, with an eye toward identifying the basic policy goals of the preferential rate.

[7] *See* Marjorie E. Kornhauser, "The Origins of Capital Gains Taxation: What's Law Got to Do With It," 39 *SMU L. Rev.* 869 (Jan. 1985).

[8] *Id.* at 876-877. The other three cases were *Eldorado Coal Co. v. Mager*, 255 U.S. 522 (1921); *Goodrich v. Edwards*, 255 U.S. 527 (1921); and *Walsh v. Brewster*, 255 U.S. 536 (1921).

taxed. Under the Revenue Act of 1921, long-term capital gains were (at the election of the taxpayer) subject to tax at a flat 12.5 percent rate instead of being subject to the marginal rates of taxation (which extended to a maximum rate of 65 percent).[9] Since that time, long-term capital gains have been taxed at a preferential rate relative to the top marginal income tax rate at all times other than a two-year period between 1988 and 1990.[10] During that same period, the holding period required to achieve the long-term capital gains rate has ranged from six months to two years; since the Tax Cuts and Jobs Act of 2018, it is three years for long-term capital gains on carried interests meeting the definition of an applicable partnership interest.[11]

The policy rationales underlying the preferential rates applicable to long-term capital gains have not changed in any meaningful way since the promulgation of the Revenue Act of 1921. These generally include those discussed in the following subsections.

A. Free Flow of Capital/Preventing Lock-In

When long-term capital gains are subject to a high rate of tax, there is an incentive for taxpayers to hold (rather than sell) appreciating assets. This can result in an inefficient allocation of resources and a reduction in government revenue (because sales taxed at a lower rate generate more tax revenue than sales that do not occur). Indeed, this was the argument made by corporate lawyer Frederick R. Kellogg in his testimony before Congress in 1920 and 1921.[12] Some data in recent years supports Kellogg's contention. Both 2012 and 2021 were banner years for private equity transaction volume, spurred largely by the possibility of imminent increases in the long-term capital gains rate (scheduled to occur in 2013 and proposed in 2021 to come into effect in 2022 — though the increase proposed in 2021 never came to fruition).[13]

B. Fairness

There are several fairness-based arguments made for taxing long-term capital gains at a reduced rate (and at least as many arguments for the opposite).[14] In general, these arguments take one (or more) of the following forms.

1. Inflation.

When capital is invested in a capital asset, the only means by which that investment can keep up with inflation is through capital appreciation. Thus, for example, if one makes a $100 investment in a capital asset and two years later sells it at an appreciated value that matches the rate of inflation over that two-year period, that person would not have increased his or her wealth but would still be subject to tax on the increase.[15] This could be remedied by indexing tax basis for inflation instead of changing the rate of capital gains tax (as was briefly considered by the administration in 2018),[16] but simply reducing the rate at which capital gains are taxed is often viewed as a more administrable solution to the issue.

2. Bunching.

The problem of "bunching" has been described as the notion that "it is unfair to tax in one year at progressive rates a gain which has accrued over a number of years."[17] That is, when capital appreciation has occurred over a long period, taxing all the income at progressive rates in the year of sale could push the taxpayer into a higher marginal rate of tax than would have

[9] *See* Ajay K. Mehrotra and Julia C. Ott, "The Curious Beginnings of the Capital Gains Tax Preference" 84 *Fordham L. Rev.* 2517 (May 2016); Greg Essenwein, "Individual Capital Gains Income Legislative History," Congressional Research Service (Apr. 11, 2007) (CRS report).

[10] CRS report, *supra* note 9, at Appendix. The current administration has proposed eliminating the capital gains preference for certain high-income taxpayers in its fiscal 2025 budget proposal. *See* Treasury, "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals," at 79-80 (Mar. 11, 2024).

[11] CRS report, *supra* note 9, at Appendix.

[12] Mehrotra and Ott, *supra* note 9, at 2526. As Mehrotra and Ott note, this argument of lower tax rates being a means to higher government revenue "long predates Arthur Laffer's infamous curve."

[13] Alex Schneider, "Private Equity Firms are Back at the Deal Table. Here's What to Expect," Kellogg Insight (July 1, 2021).

[14] Sue (Suyoung) Moon, "Revising the 100-Year-Old Debate on the Preferential Treatment of Capital Gains," *ABA Tax Times*, Jan. 11, 2022.

[15] *See* Michael J. Waggoner, "Eliminating the Capital Gains Preference Part I: The Problems of Inflation, Bunching and Lock-In," 48 *U. Colo. L. Rev.* 313, 318 (1977).

[16] Robert Donachie "Trump Considers Indexing Capital Gains to Inflation," *Washington Examiner*, Aug. 30, 2018.

[17] Waggoner, *supra* note 15, at 318.

applied if the income had been taxed over the course of the taxpayer's holding period.[18]

3. Double tax.

It has also been argued that the capital gains tax on the sale of stock of corporations subject to corporate income tax unfairly taxes income that has been taxed at the corporate level a second time, resulting in a higher effective tax rate on corporate earnings than wages or other "earned" income.[19] Of course, this argument is fairly specific to corporations.

Reasonable people can quibble about whether (and to what extent) any of the policy justifications for the preferential tax rate on long-term capital gain are convincing. However, whether convincing or not, these basic rationales (along with a fair bit of lobbying[20]) have driven tax policy for upward of 100 years. As discussed below, much of the complex interplay between subchapter K and goodwill can create results that either fail to advance these policies or, in some cases, run counter to them.

II. Basis and Holding Period

The three fundamental elements of property that govern its taxation on a sale or exchange are its basis, its character, and its holding period. Basis and holding period, though separate and distinct concepts, are inextricably related in the sense that they work in concert to determine the tax consequences of a sale or exchange of capital assets and section 1231 assets. In the most basic plain vanilla case, a purchase of an asset on a particular date sets the original cost basis of the asset and commences the asset's holding period, thus fully coupling basis and holding period as a single concept. However, in general (and particularly in the context of subchapter K), there are many transactions that can affect basis without having any effect on the holding period. Moreover, many of the ways in which subchapter K imposes a complex balancing of entity and aggregate concepts apply solely to basis (and not to the holding period), creating significant distortions.

A. Basis

Section 1012(a) sets out the general rule that the tax basis of property is generally the "cost of such property." Section 1016 sets out several adjustments to basis that might increase or decrease it and, as discussed below, subchapter K creates further adjustments to both a partner's basis in its partnership interest (outside basis) and a partnership's basis in its assets (inside basis).

As an economic matter, basis may be best understood as a taxpayer's after-tax investment in property.[21] The purpose of basis is to ensure that income is taxed once (and only once). Basis ensures that invested amounts are not taxed a second time at disposition of the property, and, by the same token, that losses recognized on property are not recognized a second time at disposition (as could occur if basis was not adjusted for depreciation).

Section 1016 sets forth several adjustments that a taxpayer makes to its basis to preserve a running record of the taxpayer's after-tax investment. These adjustments include increases to basis for expenditures (and decreases to basis for deductions and losses) "properly chargeable to capital account, including the cost of improvements and betterments made to the property."[22]

B. Basis Under Subchapter K

The general approach to basis becomes far more complex when applied in the partnership context. As has been discussed extensively by scholars of subchapter K, partnership tax balances both entity and aggregate theories.[23] To maintain an aggregate approach to partnerships, subchapter K mandates a series of adjustments to

[18] Of course, the converse argument could be made that allowing unrealized gain to accrue tax free creates an economic timing benefit that outweighs any negative bunching impact.

[19] Moon, *supra* note 14.

[20] For a highly entertaining description of the process by which the Tax Reform Act of 1986 was passed, see Jeffery H. Birnbaum and Alan S. Murray, *Showdown at Gucchi Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (1988).

[21] "The concept of 'basis' prevents double taxation of income by identifying amounts that have already been taxed or are exempt from tax." *Lessinger v. Commissioner*, 872 F.2d 519, 525 (2d Cir. 1989) (*citing* 3 *Mertens Law of Federal Income Taxation* section 21.01, at 11 (1988)).

[22] Reg. section 1.1016-2(a).

[23] *See, e.g.*, Monte A. Jackel, "Partnership Aggregate Entity Cases, Rulings and Analysis," *Tax Notes Federal*, Mar. 27, 2023, p. 2089.

both outside basis and inside basis so as to cause a partner's outside basis to match its share of inside basis. The way that subchapter K addresses inside-outside basis disparities accounts for much of its complexity (and for those of us who have dedicated inordinate energy to the study of subchapter K, its elegance).

C. Partnership Outside Basis Adjustments

Subchapter K lays out an extensive labyrinth of rules and regulations governing the determination of, and adjustments to, outside basis. The goals of these rules are generally (1) to maintain a distinct record of both inside and outside basis, and (2) to avoid disparities between inside and outside basis that could create timing distortions resulting in temporary doubling of taxable income or loss.

A partner's initial basis in its partnership interest is generally determined under section 722 and is equal to the sum of the amount of money contributed and the adjusted basis of any property contributed (increased by any gain recognized on the contribution of property under section 721(b)).

A partner's basis in its partnership interest is likewise increased by its share of partnership liabilities under section 752. This is generally intended to achieve an aggregate result by, in effect, treating the partners as the borrowers for liabilities of the partnership (such that aggregate outside basis will at all times equal aggregate inside basis).[24]

Section 705, the subchapter K corollary to section 1016, then provides for a series of adjustments to outside basis. These include increasing a partner's tax basis by her capital contributions and distributive share of taxable income and tax-exempt income, and reducing the partner's basis by her distributive share of losses (both deductible and nondeductible) and distributions. The ultimate goal of these adjustments is to track a partner's after-tax investment in her partnership interest.

Under section 752, a partner will be treated as having received a distribution to the extent that her share of any partnership liability is decreased, and this decrease would likewise reduce the partner's outside basis. Further, under section 742, upon the acquisition of a partnership interest by one partner from another, the transferee partner's basis in the acquired interest is to be determined under section 1012.

D. Partnership Inside Basis and Adjustments

As with partnership outside basis, subchapter K attempts to apply an aggregate result to the determination of partnership inside basis. There are several mechanisms by which inside basis (and allocations in respect thereof) are adjusted and manipulated to prevent taxpayers from using the partnership entity construct to shift income, gain, or loss among themselves for tax minimization purposes. A full explanation of all the basis adjustment methods in subchapter K would require hundreds of pages. The following summarizes — at a very high level — the way that subchapter K tries to impose an aggregate result on partnership inside basis determinations.

1. Section 723.

When property is contributed to a partnership in a tax-free exchange under section 721, section 723 provides that the partnership will take a carryover basis in the property.[25]

2. Section 704(c).

Congress understood that the carryover basis rule of section 723 could create opportunities for shifting gain among partners in ways that might be detrimental to the U.S. treasury. This led to the promulgation of section 704(c), which requires that pre-contribution gain or loss be allocated to the contributing partner.[26] Section 704(c) was a

[24]T.D. 8237 ("By equalizing inside and outside basis, section 752 simulates the tax consequences that the partners would realize if they owned undivided interests in the partnership's assets, thereby treating the partnership as an aggregate of its partners. Of course, this goal can only be achieved if the partners that are allocated the deductions attributable to a partnership liability are allocated the basis for that liability.").

[25]Accordingly, under section 1223(2), the partnership will likewise have the same holding period in the contributed property as the contributing partner had. *See also* reg. section 1.723-1.

[26]Reg. section 1.704-3(a)(1) ("The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.").

decided move to an aggregate approach, the prior approach of the code having been to allow for shifting of pre-contribution gain or loss under an entity theory.[27]

3. Section 754.

Understanding that adjustments to inside basis to reflect a variety of external transactions are administratively difficult and may be untenable in some situations, Congress provided for certain elective adjustments to a partnership's tax basis in connection with purchases and sales of partnership interests and certain partnership distributions.[28] If a partnership makes an election under section 754, adjustments are made to the partnership's basis in its property under sections 743(b) and 734(b).

4. Section 743(b).

In connection with a purchase of a partnership interest from an existing partner (a cross-purchase), the purchaser adjusts its share of the partnership's inside basis in its assets so as to cause the partner's share of inside basis to equal its outside basis in its partnership interest. The basis adjustment is allocated among the assets of the business under rules set forth in section 755 and, at least for tax basis, places the partner in an aggregate position.

5. Section 734(b).

In connection with a distribution of cash or property to a partner that either results in the recognition of gain by the recipient partner (in the case of a cash distribution) or in an increase or reduction in the basis of the distributed property, the partnership will adjust its basis in its remaining property to achieve an aggregate result. For example, if a partnership distributes property to a partner in full redemption of the partner's interest, and the distributed property has an inside basis of $10 and a value of $20, and the recipient partner has a $0 basis in its partnership interest, then, under section 732, the partner will receive the distributed property with a basis of $0. If a section 754 election is in place, the partnership will then increase the basis of its remaining property by $10 (the amount of the outside reduction in the property's basis). The section 734(b) adjustment also approximates an aggregate approach to basis determinations, although less obviously than a section 743(b) adjustment.

A cash distribution that causes gain to be recognized outside the partnership could be viewed as an in-kind distribution of the partner's pro rata share of each item of partnership property, followed by a cash purchase by the partnership of the distributed property. This aggregate construct would give rise to an upward basis adjustment in the partnership's remaining assets in much the same way as a section 734(b) adjustment.

A 734(b) adjustment in connection with an in-kind distribution of partnership property that results in a reduction or increase in the property's basis under section 732 also creates an aggregate approach to tax basis (albeit less obviously). To see how a section 734(b) adjustment in connection with in-kind distributions achieves an aggregate result, one must assume a tax-free exchange (even when there is no code provision outside subchapter K that would render the corresponding aggregate transaction tax free). Consider the following example.

Example 1. Distributee Partner (DP) owns a 20 percent interest in partnership ABC. ABC has a section 754 election in effect. DP's interest in ABC has a value of $20, and DP has a tax basis of $10. No property has been contributed to ABC within the last seven years.[29] ABC owns two properties: Blackacre, with a tax basis of $50 and a value of $80; and Whiteacre, with a basis of $15 and a value of $20. ABC redeems DP's interest by distributing Whiteacre to DP. Under section 732, DP will take a basis of $10 in Whiteacre. Under section 734(b), the tax basis of ABC in Blackacre will be increased by the $5 by which Whiteacre's basis was reduced in connection with the distribution.

This distribution can be analogized to a situation in which DP has tenant in common (TIC) interests in each of Blackacre and Whiteacre. DP's TIC interest in Blackacre has a value of $16 and a tax basis of $8. DP has a TIC interest in Whiteacre

[27] H.R. Rep. No. 83-2543, at 58 (1954) (Conf. Rep.).

[28] Section 754; S. Rep. No. 83-1622 (1954).

[29] Accordingly, the "partnership mixing bowl" rules of sections 704(c)(1)(C) and 737 do not apply.

with a value of $4 and a tax basis of $2. The other partners of ABC have a tax basis of $42 in their TIC interest in Blackacre and a tax basis of $13 in their TIC interest in Whiteacre. DP exchanges his $16 TIC interest in Blackacre for a $16 TIC interest in Whiteacre. The other partners of ABC will, in effect, be exchanging a TIC interest in Whiteacre with tax basis of $13 and value of $16 for a $16 interest in Blackacre. If this exchange is tax free, the other partners of ABC will shift their $13 of tax basis in the Whiteacre interest transferred to DP to the Blackacre interest received in exchange.[30] This will leave those partners holding the entire Blackacre parcel with a tax basis of $55 ($42 of basis in the 80 percent interest held before the exchange, plus the $13 carryover basis in the newly acquired 20 percent interest). This is the same result mandated by a section 734(b) adjustment.

E. In-Kind Distributions

Generally, under section 731(a), distributions of property are tax free to the recipient. To maintain an approach to tax basis that reflects both aggregate and entity principles, the statute uses a twofold approach to determining the tax basis of distributed property. First, the general rule is that property distributed to a partner will retain the same basis as its adjusted basis to the partnership.[31] However, the basis of distributed property cannot exceed the distributee partner's basis in its partnership interest.[32] If property is distributed in full liquidation of a partner's interest, the distributed property will generally take a basis equal to the partner's basis in its partnership interest[33] (subject to certain optional inside basis adjustments to partnership property discussed below). The goal of these provisions is to prevent the duplication or elimination of overall basis in the partnership system and thus retain the fundamental principle of a single tier of taxation of partnership income and gain.

F. Holding Period

Section 1222 defines long-term capital gain as gain from the sale or exchange of property held by a taxpayer for more than one year. Section 1223 provides certain rules for the "tacking" or continuation of the holding period of property in certain tax-deferred transactions. However, there is no provision of the code that specifies the date on which the holding period begins. Perhaps not surprisingly, when confronted with this statutory defect (which has been a feature of the code since its 1939 iteration), courts have historically found that outside of the context of section 1223, the holding period of property begins on a taxpayer's date of acquisition.[34] For property acquired by purchase, that date is generally fairly easy to determine — it is the date that the title and beneficial ownership of the acquired property pass to the taxpayer as a matter of state law.[35] Because the initial determination of basis generally occurs at the time of a property's acquisition, the time at which the initial basis of property is determined generally corresponds to the beginning of the property's holding period. Thus, the holding period and basis begin as a coupled item to the extent that, as is generally the case, the initial cost basis of an item is established on its acquisition date.

In section 1223, Congress appears to have tried to keep basis and the holding period coupled in connection with tax-free transactions in which a taxpayer receives a carryover basis. This coupling makes sense as a policy matter. Tax-deferred transactions are generally tax deferred because Congress has determined that notwithstanding the transaction, the taxpayer has continued its investment in the applicable property without a meaningful realization. It thus stands to reason that the taxpayer's holding period also should continue.

For self-constructed property, the "acquisition date" can be difficult to ascertain. As property is

[30] *See, e.g.*, section 1031(d).

[31] Section 732(a)(1).

[32] Section 732(a)(2).

[33] Section 732(b).

[34] *See Paul v. Commissioner*, 206 F.2d 763, 765 (3d Cir. 1953), *rev'g* 18 T.C. 601 (1952). The Third Circuit cites *McFeely v. Commissioner*, 296 U.S. 102, 107 (1935); and *Helvering v. San Joaquin Fruit & Investment Co.*, 297 U.S. 496, 499 (1936) ("In common understanding, to hold property is to own it. In order to own or hold one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding.").

[35] *See* Rev. Rul. 54-607, 1954-2 C.B. 177.

created, a date must be identified on which that property is deemed to exist with sufficient substance to be "acquired." This can apply to all manner of property created by a taxpayer. Though this report focuses primarily on self-created goodwill, there is little to no guidance on the holding period of self-created goodwill. On the other hand, there is guidance concerning the construction of real property (which may or may not be an instructive analogy).

The determination of the holding period of self-constructed real property was the subject of a line of cases in the Tax Court commencing with the decision in *Paul*.[36] In *Paul*, the Tax Court considered whether the sale of constructed property qualified for a lower rate of tax applicable to the sale or exchange of depreciable property used in a trade or business and held for more than six months under section 117(j) of the 1939 IRC (the precursor to current section 1231, which requires a one-year holding period). The taxpayer had acquired a parcel of land and begun construction of a building to be held for rental income. More than six months after the start of construction but less than six months from the completion of construction, the building was sold. At issue was whether the six-month holding period had been met.

The Tax Court initially determined that the building had not been "acquired" until its completion and that the gain on sale thus did not qualify for the lower rate.[37] However, that decision was reversed by the Third Circuit. The Third Circuit, while affirming that the acquisition date was the appropriate basis for determining the holding period, found that the acquisition date should be bifurcated and allocated based on the cost of the part of the building that was erected as of the date that was six months before the date of sale.[38]

The Tax Court was presented with a similar fact pattern in *Draper* (in this case, concerning the proper characterization of loss on self-constructed property).[39] In *Draper*, the Tax Court explicitly adopted the rule set forth by the Third Circuit in *Paul*, and it required allocation of expenditures among the completed portion of the building to determine the holding period of the building.[40] The reasoning used in *Draper* was later adopted by the IRS in Rev. Rul. 75-524, 1975-2 C.B. 342,[41] in which the IRS ruled that "the portion of the building sold by the taxpayer that was actually completed more than 6 months prior to the date of sale is held for more than 6 months for purposes of section 1231 of the Code."

It is not entirely clear whether the brick-by-brick holding period determination set forth in Rev. Rul. 75-524 reaches beyond the context of self-constructed real property.[42] To what extent does this holding period bifurcation apply to ordinary course maintenance and repair of existing property? For example, if a building held for a long time requires a new roof because of regular wear and tear, and the cost of replacing the existing roof is capitalized under section 263(a), does the taxpayer commence a new holding period in the roof? Or is the example of an improvement of an existing structure distinguishable from property that has been so altered as to be deemed acquired only upon the completion of construction?

In the context of improvements to existing owned real property, the general consensus is that improvements that do not give rise to a separate unit of property would generally not create a new or divided holding period in the property.[43] Rather, capitalized improvements to real property

[36] *Paul*, 18 T.C. 601.

[37] *Id. at* 604.

[38] *Paul*, 206 F.2d at 766.

[39] *Draper v. Commissioner*, 32 T.C. 545 (1959).

[40] *Id.* at 549.

[41] *See also* TAM 9639009.

[42] James B. Sowell and Jon G. Finkelstein, "Tax Reform and Investment in U.S. Real Estate," *Tax Notes*, Apr. 16, 2018, p. 285.

[43] This view does not appear to be stated directly in any specific guidance addressing the general holding period of real property. However, there are indications elsewhere in the code that this must be the case. Reg. section 1.263-3(e) goes to great lengths to define a unit of property to which improvements must be capitalized. The notion of an improvement as being an element of a unit of property would be inconsistent with the notion that the improvement was itself a separate asset with a separate holding period. Moreover, the special rules set forth in section 1250(f) for determining applicable holding periods for purposes of computing section 1250 recapture would be superfluous if the generalized holding period of property was based on the same notions. *See also* IRS Publication 544, "Sales and Other Dispositions of Assets" (2023).

would increase tax basis under section 1016 but would not generally change the holding period of the property.[44]

Thus, to the extent that general rules of application can be gleaned from the relevant authorities, one might posit the following: (1) holding period generally commences on the date that property is acquired; (2) for self-constructed real property, the acquisition date will be staged based on the timing of the completion of particular stages of construction; and (3) outside of self-constructed real property, capitalized improvements to property (that do not themselves give rise to separate property) generally do not affect its holding period.

G. Holding Period and Subchapter K

As is the case for basis, subchapter K applies an entity theory to holding period, whereby a partner has a holding period in its partnership interest (outside holding period) and the partnership has a holding period in its assets (inside holding period). However, unlike in the context of basis, subchapter K only provides for very limited adjustments to the holding period, and those adjustments rarely attempt to achieve an aggregate-based parity between the inside and outside holding periods.

1. Distributive share adjustments.

When a partner's basis is increased by his or her distributive share of partnership income or gain, or decreased by the partner's share of loss or deduction, there is no change to the partner's holding period in that partnership interest. This basis adjustment without holding period adjustment is consistent with the treatment of adjustments to basis under section 1016. Just as a capitalized expenditure that increases basis does not necessarily affect the holding period, and a depreciation deduction that reduces basis does not affect the holding period, basis adjustments arising out of a deemed loss of invested capital or deemed increase of invested capital in the partnership context do not have corresponding holding period implications.

2. Adjustments as the result of distributions.

Distributions that reduce tax basis generally do not change the holding period of a partner's partnership interest (though, as discussed below, they can play an indirect role). As is also discussed below, an in-kind distribution can have holding period implications because the distributee partner will generally have a holding period in the distributed property equal to the partnership's inside holding period.[45]

3. Capital contributions.

Unlike a corporation, in which each share of stock held by a taxpayer has its own basis and holding period, the IRS has long taken the view that a partnership interest constitutes a "singular" asset with a single basis.[46] In Rev. Rul. 84-52, 1984-1 C.B. 157, the IRS considered the consequences of a partner's conversion of a general partnership interest to a limited partnership interest. The IRS determined that (1) the conversion would be a nonrecognition transaction in which no gain or loss would be recognized; (2) the partner's basis in its interest would generally remain the same, except that it would be adjusted to account for any change in the partner's share of liabilities occurring as a result of the conversion; and (3) the partner's holding period in its interest would be unaffected by the conversion. This ruling was upheld and expanded to encompass conversions of a partnership from a limited partnership to a limited liability company in Rev. Rul. 95-37, 1995-1 C.B. 130.

In 2000 Treasury adopted final regulations that relied on this "unified basis" theory to require substantial adjustments to a partner's holding period in its partnership interests for contributions to the partnership. Reg. section 1.1223-3(a) provides:

> The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the

[44] *See* reg. section 1.263(a)-3(d).

[45] Section 735.

[46] Rev. Rul. 84-53, 1984-1 C.B. 157.

> denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).

Because a partner is deemed to have a singular interest in a partnership, that interest may have a divided holding period to the extent that a mixture of assets with a long-term holding period and assets with a short-term holding period are contributed to the partnership in exchange for the interests received. This is consistent with the general rule of section 1223(1).

The regulations, however, then expand this general rule to create deemed acquisitions of partnership interests in connection with any contribution to capital. Reg. section 1.1223-3(f)(4) specifies that when partners make pro rata capital contributions to a partnership without altering their ownership of the partnership, the contribution of capital is treated as a contribution in exchange for the increased capital account it creates, and the partners' holding periods in their partnership interests will be divided based on the amount of the contribution relative to the total value of the partnership interest. Although phrased as being part and parcel of the general treatment of a partnership interest as a single asset, this is inconsistent with the general approach to investments in improvements to existing property. For partnership capital contributions, the IRS has taken a form of the brick-by-brick approach ordinarily used only in the real property context. As additional capital contributions are made, a new holding period commences on a portion of the partnership interest. The implications of this outside brick-by-brick approach to holding periods are far-reaching.

The regulations provide three exceptions to the brick-by-brick general rule.

a. Netting of cash contributions.

Cash contributions made within one year can be offset by cash distributions within the same year.[47] Thus, if cash is contributed by a partner, and within the same year, cash is distributed to that partner, only the excess of the cash contributed over the cash distributed would be taken into account in determining the portion of the partnership interest that has a short-term holding period. This rule is necessary to avoid strange and distorted results. For example, if a partnership generates positive taxable income, the portion of the income that is allocated to a partner increases that partner's basis without any impact on the partner's holding period. However, if that cash was distributed to the partner and then re-contributed, in the absence of the special netting exception, the partner would be in the same economic position but with a divided holding period in its partnership interest.

b. Liability shifts.

Consistent with Rev. Rul. 84-52, deemed contributions associated with a change in a partner's share of liabilities do not create a divided holding period.[48] The preamble to the regulations explains the reasoning for that decision as follows:

> A deemed contribution of cash resulting from a shift among partners in their share of liabilities or as a result of a partnership incurring new debt does not expand the net asset base of the partners represented by their interest in the partnership. Accordingly, it is inappropriate to create a new holding period as a result of such deemed contributions.[49]

That is a curious distinction because "expansion of the asset base" is generally not a good proxy for the acquisition of property. When income is earned and allocated by a partnership, the asset base is decidedly expanded without creating a divided holding period in partnership interests. On the other hand, when one partner acquires a partnership interest from another partner for cash, the asset base of the partnership

[47] Reg. section 1.1223-3(b)(2).

[48] Reg. section 1.1223-3(b)(3).

[49] T.D. 8902, 65 F.R. 57092, 57095 (Sept. 21, 2000) (section 2.c of the preamble).

is unaffected, but the acquiring partner begins a new holding period in the acquired interest.[50]

c. Section 751 assets.

Reg. section 1.1223-3(b)(4) provides:

> For purposes of applying paragraph (b)(1) of this section to determine the holding period of a partnership interest (or portion thereof) that is sold or exchanged, if a partner receives a portion of the partnership interest in exchange for property described in section 751(c) or (d) (section 751 assets)[[51]] within the one-year period ending on the date of the sale or exchange of all or a portion of the partner's interest in the partnership, and the partner recognizes ordinary income or loss on account of such a section 751 asset in a fully taxable transaction (either as a result of the sale of all or part of the partner's interest in the partnership or the sale by the partnership of the section 751 asset), the contribution of the section 751 asset during the one-year period shall be disregarded. However, if, in the absence of this paragraph, a partner would not be treated as having held any portion of the interest for more than one year (e.g., because the partner's only contributions to the partnership are contributions of section 751 assets or section 751 assets and cash within the prior one-year period), this adjustment is not available.

As is described in the preamble to the section 1223 regulations, this exception is intended to avoid a situation in which "the rules of Section 751(a) in conjunction with [the regulations] cause the 751 assets to be counted twice . . . once in applying section 751(a) to treat part of the amount received as ordinary income, and again in determining the selling partner's short-term capital gain."[52] The question, however, arises as to whether this exception applies in a situation in which a section 751(a) analysis does not result in the recognition of any ordinary income or loss (because the unrealized receivables or inventory items at issue have value equal to tax basis). If income or loss must be recognized for the exception to apply, should taxpayers ensure that $1 of income or loss is recognized under section 751 to prevent a (potentially substantial) short-term capital gain? In my view, even a recognition of ordinary income or loss of $0 ought to suffice for this exception to apply. This exception essentially follows the overall construct of section 751, which segregates specified assets in the context of a sale of a partnership interest and determines their tax consequences under an aggregate construct. Accordingly, these assets ought not play into the holding period of a partnership interest if the partnership owns other assets not described in section 751.

4. Inside basis adjustments and holding period.

Similar to the treatment of an outside holding period, subchapter K almost exclusively adopts an entity approach to the holding period — even when tax basis is adjusted or specially allocated.

a. Contributed property.

Subchapter K does not include a special rule for determining the holding period of property contributed to a partnership in a tax-free exchange under section 721. Instead, it relies on the general rule of section 1223(2) ("A taxpayer includes its holding period for property, however acquired, the period that that property was held by another person if the taxpayer's tax basis in the property is the same as the tax basis of the other person.") One question that arises in this context is whether a partnership is a "taxpayer" or whether, instead, the language of section 1223(2) mandates an aggregate approach that would require each partner to separately determine its holding period for property contributed to a partnership. While perhaps there is an argument

[50] The difficult issue of rationalizing holding periods in securities when capital contributions are made is not limited to partnerships. Taxpayers and the IRS continue to struggle with how "meaningless gesture" corporate transactions, in which no additional shares are issued, affect the holding period of existing shares. *See, e.g.*, AM 2020-005.

[51] These include inventory and unrealized receivables. For this purpose, accrual method accounts receivable do not meet the definition of unrealized receivables in section 751(c), but generally meet the definition of inventory in section 751(d), because those items constitute "property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231."

[52] Preamble to T.D. 8902, 65 F.R. at 27095 (section 2.d).

for aggregate treatment of the holding period (and there certainly is a policy argument for that treatment), the weight of authority treats a partnership as a taxpayer for this purpose.

The term "taxpayer" as defined in section 7701(a)(14) includes "any person subject to any internal revenue tax." Because partnerships are subject to certain internal revenue taxes at the entity level (including payroll taxes and, in some cases, income taxes under the centralized partnership audit provisions of subchapter C of chapter 13 of the code), partnerships do appear to fit within this definition.[53]

Moreover, section 703 generally provides that a partnership determines its taxable income and loss in the same manner as an individual except to the extent that items are separately stated and reported in accordance with section 702(a). Paragraphs (1) and (2) of section 702(a) provide:

> In determining his income tax, each partner shall take into account separately his distributive share of the *partnership's* —
>
> > (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,
> >
> > (2) gains and losses from sales or exchanges of capital assets held for more than 1 year. [Emphasis added.]

This language strongly indicates that although these items are separately stated, the relevant holding period is the partnership's holding period — not the individual partner's holding period.

The IRS has expressly adopted the position that a partnership has a separate holding period in property based on entity principles. In Rev. Rul. 68-79, 1968-1 C.B. 310, the IRS ruled that a taxpayer with a short-term holding period in its partnership interest still takes into account as long-term capital gain its distributive share of long-term capital gain (as determined by reference to the partnership's holding period). Likewise in reg. section 1.1061-4(b)(8)(ii), the IRS has specifically noted the following for purposes of determining the holding period of property sold subject to the special three-year holding period rule of section 1061:

> The relevant holding period is the direct owner's holding period in the asset sold. Accordingly, for purposes of determining an API Holder's Taxpayer's API One Year Distributive Share Amount and API Three Year Distributive Share Amount for the taxable year under paragraph (a)(3) of this section, the partnership's holding period in the asset being sold or disposed of (whether a directly held asset or a partnership interest) is the relevant holding period for purposes of section 1061.

b. Section 704(c).

As noted above, section 704(c) mandates an aggregate approach to prevent the shifting of the tax consequences of contributed property. However, even when property has built-in-gain or loss that implicates the rules of section 704(c), the foregoing analysis remains unchanged — the partnership receives a tacked holding period in the contributed property without any adjustment for other partners. Thus, a partner contributing cash to a partnership will commence a new holding period in its partnership interest, and although that partner may obtain the benefits of aggregate treatment for basis purposes (in the form of obtaining allocations of cost recovery deductions that approximate a purchase of a pro rata share of property contributed by other partners), the partnership holding period will be determined based on a strict entity approach.

c. Sections 743(b) and 734(b).

The result is the same in the case of adjustments under sections 743(b) and 734(b). Notwithstanding the mind-bending complexity of statutes and regulations to approximate aggregate results for basis, no adjustment is ever made to a partnership's holding period in its assets, which is determined solely at the entity level.

d. Section 735.

The theme of a strict entity approach to holding periods is further demonstrated in the

[53] *See Gregory v. Commissioner*, 149 T.C. 2 (2017) (finding that in the context of qualifying for election under section 468(a), an S corporation was a taxpayer for income tax purposes based solely on the liability of S corporations to pay employment tax).

contrast between the basis adjustment rules of section 732 for distributed property and the way that section 735 addresses the holding period of distributed property. Under section 735, when property is distributed in kind to a partner, the partner's holding period for the distributed property includes the partnership's holding period for the property. Thus, for example, looking only to sections 732 and 735, a partner could purchase interests in a partnership for $100, be redeemed in kind within one year for a partnership asset with $0 tax basis and a long-term holding period, and then have a long-term holding period and a $100 tax basis in the distributed property.[54]

5. Examples

The following examples show the ways in which the interplay of subchapter K's basis and holding period rules can create distortions.

a. Example 2: The growth equity investment.

On January 1, 2019, founder A formed a wholly owned new LLC X to begin a business. A contributed a capital asset to X with a tax basis of $0 and a holding period of more than three years (Asset 1).[55] On January 1, 2022, X purchased a plot of land for $7 million. On January 2, 2022, venture capital fund V decided to make a growth investment in A based on a valuation of $50 million. As part of this funding round, X was restructured in the following manner:

- A contributed 100 percent of the interests in X to a newly formed LLC (Holdco) in exchange for the common interests in Holdco. V invested $25 million in Holdco for a 50 percent common interest in Holdco.
- X used the cash invested by V to meet the expenses of expansion. The cash was used for new payroll, rent and lease payments, and other immediately deductible expenses.[56] The infusion of capital allowed for rapid expansion, and within 10 months of V's investment, a large public company offered to purchase X from Holdco for $150 million, at a time when the land's market value remained $7 million.

i. Analysis.

Before the investment by V, X was disregarded as an entity separate from its owner. When A contributed the X interests to Holdco, and V contributed $25 million to Holdco, A and V were deemed to have each contributed property to a newly formed partnership.[57]

X is a disregarded subsidiary of Holdco. As such, a purchase of 100 percent of the equity of X is treated as a sale of all the X assets (and assumption of any X liabilities) by Holdco. Under section 1060, the purchase price paid for the X equity will be allocated among the assets of X based on their respective fair market values (using the residual method for allocating value to goodwill and going concern value). The plot of land will have a tax basis equal to $7 million and an FMV of $7 million. Accordingly, $7 million would be allocated to the purchase and sale of the land, giving rise to $0 gain or loss. The remaining $143 million would be allocated to Asset 1, resulting in $143 million of gain.

ii. Allocation of gain on sale.

As Asset 1 had, at the time of V's investment, a tax basis of $0 and a value of $25 million, that asset will be section 704(c) property. Under section 704(c) (assuming that the parties used the traditional method for making section 704(c) allocations for the contributed assets),[58] $25 million of the recognized $150 million of tax gain will be allocated to A. The remaining $125 million of taxable gain will be allocated 50 percent to A and 50 percent to V. Of the $62.5 million of gain recognized by V, $12.5 million will be offset by the $12.5 million loss allocated to V as a result of the payment of $25 million in expenses before the sale. Thus, V will recognize $50 million in net gain. This is the appropriate result because V invested $25 million and received overall proceeds of $75 million.

[54] As a practical matter, the disguised sale rules of section 707(a) and the regulations thereunder would most likely treat this transaction as a disguised sale of the partnership property to the partner, thereby creating a new holding period in the property upon the distribution.

[55] This capital asset is most likely goodwill or a similar intangible. See Part III for a discussion of the determination of the holding period in intangible assets like goodwill.

[56] For purposes of simplicity, we will assume that no operating income or loss (other than the losses associated with the spending of the $25 million) was generated.

[57] Rev. Rul. 99-5, Situation 2.

[58] *See* reg. section 1.704-3(b).

iii. Character of gain.

As discussed above, Holdco has a holding period in the X assets that includes the pre-contribution period. Accordingly, the sale of X constituted (1) a sale of land generating no gain or loss, and (2) the sale of Asset 1 (a capital asset with a partnership-level holding period of over three years). As such, the gain allocated to V would not only be long-term capital gain but, to the extent allocated to a carried interest holder at V, ought to qualify as three-year capital gain eligible for taxation at the preferential long-term capital gains rate.

This example, though not very complicated, is interesting because it represents a rare taxpayer-favorable whipsaw in subchapter K's aggregate-entity dichotomy. In a pure aggregate approach, the holding period would be determined separately for the two partners, and each would be taxed on its share of economic gain, based on its actual holding period in the investment. In a pure entity approach, each of the partners would be taxed on their share of entity-level gain (on a pro rata basis) (so that of the $150 million of taxable gain, $75 million would be allocated to each A and V), and the character of that gain would be based on the entity's holding period. Here, V gets the benefit of an aggregate approach to tax basis (recognizing gain only on its economic profits) and the benefit of an entity approach to holding periods (allowing V to tack onto A's holding period for purposes of characterizing its gain). For a tax planner, this type of "best of both worlds" scenario is rare. However, as shown in Example 3, small changes in the structure could alter the result.

b. Example 3: Cross-purchase.

In Example 2, V's cash was used as a primary investment for use in the X business. Assume, however, that instead of using V's investment for the business, immediately following A's contribution of X to Holdco, V purchased a 50 percent interest in Holdco from A.

i. Analysis.

When the example is modified in this fashion, the transaction's character changes meaningfully. In Example 2, when A contributed the X interests to Holdco, and V contributed $25 million to Holdco, A and V were deemed to have each contributed property to a newly formed partnership in a tax-free transaction under Rev. Rul. 99-5, 1999-1 C.B. 434, Situation 2. In the current example, by contrast, when V purchases the Holdco interests from A for $25 million, under Situation 1 of Rev. Rul. 99-5, V is deemed to have purchased from A a 50 percent interest in each of the assets of X, and A and V are deemed to have each contributed a 50 percent interest in each of the assets to a newly formed partnership.

Upon its deemed purchase, V will obtain an FMV tax basis in its share of each of the assets of X: $3.5 million in the land and $21.5 million in Asset 1. A will retain its basis in the portion of each asset deemed retained by A in the sale. V will commence a new holding period in the capital asset and land deemed purchased from A. The holding period in the portion of each asset deemed retained by A will not change.

When A and V are deemed to contribute the assets of X to Holdco, Holdco will receive (1) for the land deemed contributed by A and by V, a short-term holding period; (2) for the 50 percent of Asset 1 deemed contributed by A, a long-term holding period; and (3) for the 50 percent of Asset 1 deemed contributed by V, a short-term holding period.

The 50 percent of Asset 1 deemed contributed by V will have value equal to its tax basis and will not be a section 704(c) asset. However, the 50 percent of Asset 1 deemed contributed by A will have a $21.5 million value and a $0 basis, making it a section 704(c) asset.

ii. Allocation of gain on sale.

Upon the sale to the third-party purchaser, the purchaser will be deemed to have acquired three assets — the land for $7 million, the 50 percent of Asset 1 with a value of $71.5 million and a basis of $0 contributed by A (the A Asset), and the 50 percent of Asset 1 with a value of $71.5 million and a basis of $21.5 million contributed by V (the V Asset). For the A Asset, the first $21.5 million of gain will be allocated to A (the section 704(c) layer), and the remaining $50 million will be allocated $25 million to A and $25 million to V. For the V Asset, $50 million of gain will be recognized, of which $25 million will be allocated to A and $25 million will be allocated to V. As in the prior example, V ends up receiving a net allocation of $50 million in overall gain.

iii. Character of gain on sale.

Unlike in Example 2, the character of gain recognized by both V and A will include both long-term and short-term capital gain. Because the partnership holding period is determined entirely at the entity level, both A and V will include short-term capital gain from the V Asset and long-term capital gain from the A Asset.

c. Example 4: A slight modification.

One might suggest that the policy justification for the difference in result between examples 2 and 3 is that in Example 3, A received cash (on which gain was recognized), such that, at least for holding period purposes, one might view A's continued investment as a "reinvestment" that should color A's holding period going forward. However, if that was the policy justification, A's result should not be easily altered. But A's result is easily mitigated by some simple planning. If instead of being a disregarded entity, Holdco was a partnership at the time of V's purchase, the result would change. In this example, one day before V's purchase of a 50 percent interest in Holdco from A, A transferred 1 percent of Holdco equity to A's spouse.

i. Analysis.

When A transferred 1 percent of the Holdco equity to A's spouse, Holdco became a partnership. Although Rev. Rul. 99-5 speaks only to taxable transfers, the most likely characterization of the transfer was that A transferred a 1 percent interest in each of the X assets to A's spouse (with a carryover basis),[59] and A and A's spouse each contributed their respective portion of the X assets to the new Holdco partnership.[60] Holdco will accordingly have a carryover holding period in each of the contributed assets.

When V purchases a 50 percent interest in Holdco from A,[61] instead of being treated as a purchase of the underlying X assets, the purchase is treated as the purchase of partnership interests from A. If Holdco makes an election under section 754, V will obtain a $21.5 million adjustment to its share of the Holdco basis in Asset 1 under section 743(b). No adjustment will be made to Holdco's holding period in Asset 1.

ii. Allocation of gain on sale.

Because the acquisition of Holdco interests occurred by way of a cross-purchase, V succeeded to A's capital account (including any book-tax disparity therein).[62] Accordingly, the $143 million of gain recognized on the sale of the assets of Holdco will be allocated 50 percent to V, 49 percent to A, and 1 percent to A's spouse. V will receive an initial gain allocation of $71.5 million. This initial allocation will be offset by V's $21.5 million section 743(b) adjustment, resulting in a net allocation of $50 million of gain (as in the prior two examples).

iii. Character of gain on sale.

As in Example 2, the holding period of X is based entirely on A's historic holding period (notwithstanding V's later investment). Accordingly, all the gain allocated to V will once again be long-term capital gain.

These varying results defy logic and policy and arise solely based on subchapter K's pure entity approach to holding periods.

d. Example 5: Private equity buyer with rollover by A; short-term asset with value equal to basis.

Many transactions are not as simple as the base example of a sale for cash. A financial buyer of X (PE) might wish for A to continue its equity investment through a rollover of a portion of its proceeds. In this example, A decides to reinvest half of its proceeds of the transaction ($37.5

[59] Section 1015.

[60] As discussed above, Rev. Rul. 99-5 generally provides for the deemed transactions that occur when a disregarded entity becomes a partnership by virtue of a second member joining the partnership. In Situation 1 of Rev. Rul. 99-5, an LLC is initially a disregarded entity wholly owned by A. B (who was not related to A) purchases a 50 percent interest in the disregarded LLC from A for $5,000. B is deemed to have purchased a 50 percent undivided interest in each of the assets of the LLC from A, and A and B are deemed to have each contributed a 50 percent interest in each of the assets to a newly formed partnership. Although not addressed, it would seem that this same construct ought to apply to a nontaxable transfer of an interest in a disregarded LLC to a second partner.

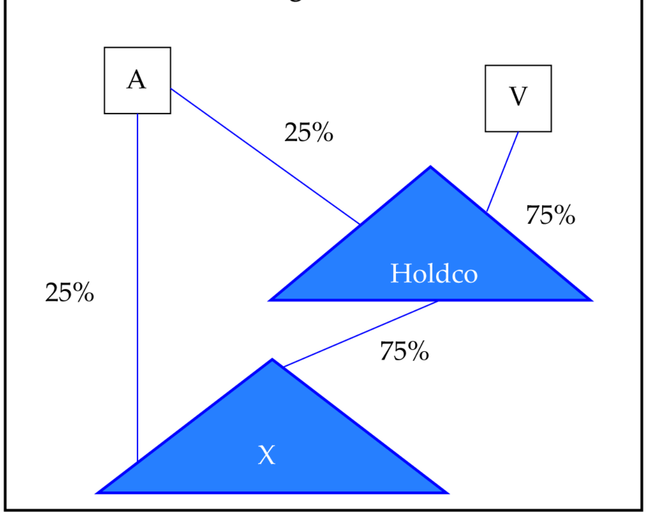
[61] As a practical matter, V may prefer to buy the 1 percent interest transferred to A's spouse. This is generally not recommended, because if that were to occur, the transitory nature of the partnership interest held by A's spouse may not survive a challenge based on the step transaction doctrine. Instead, A's spouse should retain the 1 percent interest. Any resulting governance concerns can be resolved in the LLC agreement of Holdco.

[62] Reg. section 1.704-1(b)(2)(iv)(l).

million). The following structure is used to carry out the acquisition.

Step 1. Holdco distributes 25 percent of X to A in partial redemption of A's interest in Holdco.[63] Immediately after the in-kind distribution, Holdco and X are held as shown in Figure 1.

Figure 1



Step 2. A contributes the 25 percent of X owned directly by A to a newly formed corporation to which the private equity buyer contributes cash that is used to acquire the remaining interests in X from Holdco. Immediately after the transaction, Buyer owns 100 percent of X and is owned by A and PE. A and V continue to own Holdco, but Holdco has ceased conducting any business activities and will wind down and dissolve within the next one to two years. (See Figure 2.)

i. Analysis.

Two high-level characterizations might apply to the distribution of the X interests followed by a contribution and sale transaction. The first possible characterization is (1) a distribution of a pro rata portion of the assets of X to A by Holdco, followed by (2) a deemed contribution of those assets to a newly formed "partnership,"[64] followed by (3) an acquisition of 100 percent of the interests in that partnership by a newly formed corporation. The second possible characterization of the transaction would ignore the interim partnership and simply treat the transaction as a distribution of a pro rata portion of the assets of X followed by an acquisition of those assets by the corporation.[65] The distinction can have meaningful implications.

Whether to give effect to a transitory partnership is a gray area. Under the check-the-box regulations of reg. section 301.7701-3, the default classification of an LLC with two members is as a partnership. Thus, at first glance, immediately upon the distribution, X would become a new partnership. Although not entirely clear, the most likely characterization of this partnership formation would be that, consistent with Rev. Rul. 99-5, Situation 1, first Holdco distributed a pro rata portion of each of the assets of X to A and immediately thereafter, Holdco and A collectively contributed their respectively owned portions of the assets of X to a newly formed X partnership.

However, the fact that a business entity exists under the check-the-box regulations is generally insufficient to cause that entity to be given independent tax significance if it is a transitory entity that exists only to facilitate a larger transaction.[66] For example, under reg. section

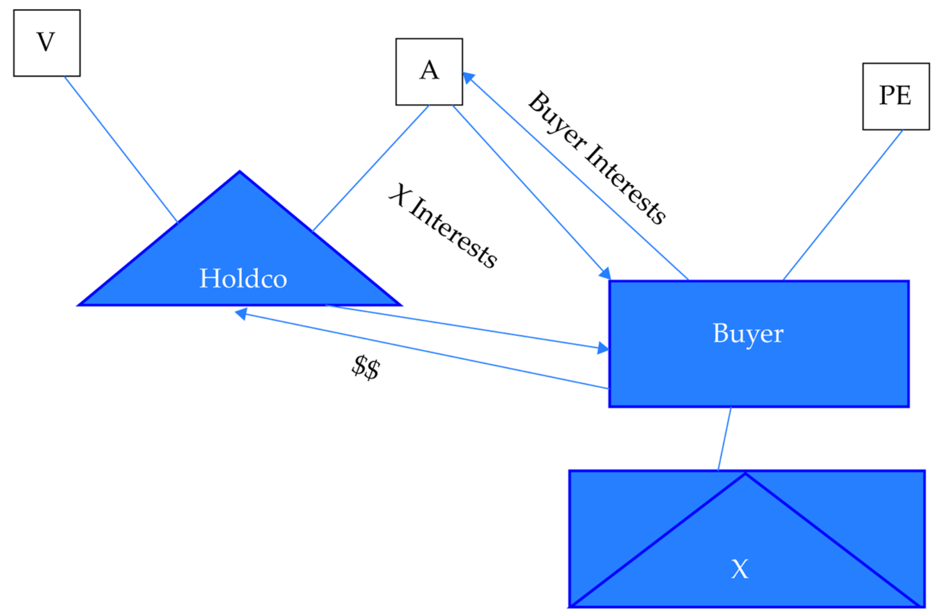
[63] The in-kind redemption is intended to prevent a situation in which the partnership receives both taxable and tax-deferred consideration (for the rollover) because it is not clear that a special allocation of tax-deferred consideration to A would pass muster as a valid allocation under section 704. *See, e.g.*, Andrew W. Needham, 736-2nd T.M. *Hedge Funds* at Para. VI.B; *cf.* American Bar Association Section of Taxation, "Joint Report on Section 1031 Open Issues Involving Partnerships," at 7-12 (Feb. 21, 2001) (Q&A 3). While some commentators have questioned whether a partial in-kind redemption solves the potential issue, many practitioners are comfortable with the practice and believe that it can avoid the allocation problems of a special allocation of realized gain upon sale. For a general discussion of these issues, *see* Jennifer Ray, "Dividing the Indivisible: Identifying the 'Property' in Partnership Transactions," 100 *Taxes* 85 (2022).

[64] Alternatively, the distribution could be a partnership "division" under reg. section 1.708-1(d) using an assets-over form in which the assets of X are deemed contributed to a newly formed partnership, and interests in the newly formed X partnership are distributed to A. It is highly unclear whether the distribution of some (but not all) of the interests of a new partnership by an existing partnership would constitute a division within the meaning of these regulations. The analysis above considers both possibilities.

[65] As is discussed *infra*, a third characterization that reorders the steps of the transaction to ignore the interim distribution is also possible.

[66] Reg. section 301.7701-2(a) defines a business entity as "any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under Section 301.7701-3) that is not properly classified as a trust under Section 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code." X is therefore a business entity for purposes of the check-the-box regulations (which make it subject to the general entity classification rules). However, the carveout for entities "subject to special treatment" under the code could viewed as creating an exception when an entity fails to meet a statutory (or common-law) definition, as discussed above.

Figure 2



301.7701-2(b)(1), a business entity organized as a corporation is to be treated as a regarded corporation. However, a substantial body of authority disregards the separate existence of a transitory corporation formed for the purpose of consummating a reverse triangular merger.[67] Those authorities look to the principles of the step transaction doctrine to disregard the formation of transitory entities whose existence does not survive a series of interrelated steps. By the same token, one might posit that a transitory partnership that springs into existence for purposes of facilitating an acquisition but is terminated immediately as part of a series of interrelated steps should also be disregarded as a separate entity.

Indeed, this position is likely even more compelling in the context of a partnership than in the context of a corporation. Under section 7701(a)(3), a corporation is defined for tax purposes solely by reference to the existence of a state law entity. As such, absent the step transaction guidance discussed above, any state law corporation is presumed to exist as a separate entity for purposes of the federal income tax. By contrast, section 7701(a)(2) defines a partnership as "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." This added requirement that some activity be "carried on" by an entity for it to constitute a partnership lends an independent statutory basis to the position that a transitory entity lacks sufficient time to establish the operations necessary to constitute a partnership as a federal income tax matter.

If no partnership springs to life, there are two ways that the interim distribution of X interests could be viewed. On the one hand, it could be ignored as transitory, and the contribution of X interests by A to Buyer in exchange for stock could likewise be ignored and treated instead as a contribution of X interests by Holdco to Buyer in exchange for stock and cash, followed by a distribution of the stock received in the exchange to A. This characterization has the allure of ignoring an interim step. However, it also requires the invention of a post-closing step (the distribution of the Buyer stock by Holdco to A). If the IRS were to take the position that the steps should be reordered in this fashion, the taxpayer

[67] *See* Rev. Rul. 67-448, 1967-2 C.B. 144 (separate existence of transitory merger subsidiary disregarded under step transaction principles); *See also* Rev. Rul. 90-95, 1990-2 C.B. 67; and Rev. Rul. 2001-46, 2001-2 C.B. 321. If the buyer in this example was a newly formed partnership, one would have to consider whether it is a continuation of the X partnership under section 708(a). If so, there might not be any basis for treating X as transitory.

could reasonably argue that the order selected by the taxpayer should be respected so long as the substance of the transaction follows its form.[68]

Of course, the question might arise as to whether, instead of distributing interests in X, X could simply distribute a pro rata share of each of its assets to Holdco, and Holdco could distribute those assets to A, thus removing the business entity and the risk of an interim partnership. The tax implications of this question will be addressed in Section III. In many cases there are nontax reasons that a buyer may seek to purchase the X entity instead of its assets.[69]

ii. Basis.

The X assets consist of (1) Asset 1 with a tax basis of $0 and (2) land with a tax basis of $7 million. Under section 731(a), the distribution of a pro rata ownership interest in each of the assets to A would generally be a tax-free transaction, and under section 732, A would take a carryover basis of $0 in the distributed Asset 1. Because A has no basis in its Holdco interest, under section 732, it would also take a $0 basis in the distributed land. If Holdco makes an election under section 754, it would receive an increase in its asset basis equal to the $1.75 million basis reduction suffered by A under section 734(b). This basis will be allocated among Asset 1 and the land based (initially) on their respective unrealized appreciation. Because only Asset 1 has unrealized appreciation, this $1.75 million basis increase will be allocated to Asset 1.[70]

If the assets are later deemed to be transferred to a new partnership, then under section 722, A and Holdco would each receive basis in their X interest equal to their bases in the deemed-contributed assets — Holdco would receive a basis of $1.75 million in connection with the deemed contribution of Asset 1, and a basis of $5.25 million in connection with the deemed contribution of the land. A would receive a basis of $0 in connection with its deemed contribution of the land and Asset 1.

If the distribution of the X interests is treated as a partnership division, the order of operations would change, but the result would be essentially the same as if the distributed assets were treated as being contributed to a new partnership after distribution. The assets of X would first be deemed contributed to a newly formed partnership. Holdco would have a basis in its partnership interests of X of $7 million (reflecting the existing basis in the land). Upon the distribution of partnership interests to A, A would receive a basis of $0 in the X partnership interest received, creating a $1.75 million section 734(b) adjustment to Holdco in its X interest.

iii. Holding period.

Under section 735, A will have a holding period in the land and in Asset 1 that includes the holding period that Holdco had in the distributed assets. Accordingly, A will have a long-term holding period in the portion of Asset 1 deemed distributed, and a short-term holding period in the land deemed distributed.

If the assets are later deemed to be contributed to a new partnership, each of A and Holdco will have a divided holding period in the partnership based on the relative values of Asset 1 and the land. Because Asset 1 constitutes 95.3 percent of the total value, the interest in the deemed partnership held by each of A and Holdco will have a holding period that is 95.3 percent long-term and 4.7 percent short-term. If the distribution of X interests is treated as a partnership division, then upon the initial deemed contribution of the X assets to the X partnership, Holdco would have the same divided holding period as described above. When the X interest is distributed to A, A would have a carryover divided holding period under section 735.[71] This divided holding period can make a meaningful difference in the tax outcome of the transaction.

[68] *See Turner Broadcasting System Inc. v. Commissioner*, 111 T.C. 315 (1998); *See also* Rev. Rul. 84-111, 1984-2 C.B. 88 (allowing the taxpayer to select different forms of partnership incorporation despite differences in the tax treatment).

[69] These include avoiding third-party consents that may be required for the assignments of certain contracts or licenses.

[70] Reg. section 1.755-1(c).

[71] Because the land in this example is not held as inventory but as a capital asset, it will not constitute either inventory or unrealized receivables within the meaning of section 751, such that neither exception to the general rule for determining the holding period of a partnership interest would apply.

iv. Rollover and sale.

When A exchanges its interests in X for stock of Buyer, the transaction will generally qualify as a tax-free exchange under section 351(a). Buyer will then acquire the remaining 75 percent interest in X from Holdco for $112.5 million, of which $5.25 million is attributable to the value of the land and $107.25 million is attributable to the value of Asset 1.

Holdco has an aggregate basis of $7 million in Asset 1 and the land, of which $5.25 million is allocated to the land and $1.75 million is allocated to Asset 1. If X is disregarded as an entity and treated as being comprised of its underlying assets, the $105.5 million of gain attributable to Asset 1 will be long-term capital gain, and no gain or loss will be recognized on the sale of the land for its tax basis.

On the other hand, if X is treated as a partnership, the $105.5 million of gain recognized on the sale of the partnership interest will be 95.3 percent long-term capital gain and 4.7 percent short-term capital gain. If the difference in rate between long-term capital gain and short-term capital gain is 20 percent, that will create an incremental tax on the transaction of approximately $991,700.

v. A cherry-picking solution?

This additional tax can potentially be avoided through a rather simple trick. Before the distribution of X interests to A, X could distribute the land to Holdco. Instead of distributing a 25 percent interest in X (with a value of $37.5 million) to A, A would receive a distribution of 26.22 percent of X (after reduction for the value of the land) with a value of $37.5 million. The assets deemed contributed to the new partnership would consist only of the long-term assets. Buyer would then acquire from Holdco not only its interest in X but also its interest in the land held separately as a distinct asset with value equal to tax basis. This general construct can be used in any number of contexts when specified long-term assets can be segregated to cause any interim partnerships to consist solely of assets with a long-term holding period, and the ultimate partnership can choose to sell short-term assets with lower disparities between basis and value (or, in some cases, section 1231 assets with less-than-three-year holding periods) directly. Would such a specific allocation be able to withstand an IRS challenge?

In Rev. Rul. 85-164, 1985-2 C.B. 117, the IRS considered the effect of a single shareholder contributing certain assets to a new corporation in exchange for stock and contributing others in exchange for securities that constituted boot for purposes of section 351. The IRS determined that the special allocation was not permitted and that basis (and the holding period) of the contributed assets would be allocated to the stock and boot received pro rata based on their respective FMVs. Thus, in our Example 5, the IRS could try to argue (based on an aggregate theory of partnership) that A should be treated as having received stock (directly) and cash (indirectly through the partnership) in exchange for its pro rata share of both Asset 1 and the land. This look-through approach has some simplicity to suggest it but would seem to rely on ignoring the partnerships in the structure (making it difficult to simultaneously take an entity approach to the X holding period).

Even if the principles of Rev. Rul. 85-164 are applied to the X or Holdco partnership (despite there being considerable controversy surrounding the application of this ruling to fact patterns involving partnership contributions),[72] the ruling does not require that corporate distributions be revised to include assets that are not actually distributed (even when a distribution of the asset would not alter the ultimate result). Even in the broader context of applying the step transaction doctrine to prevent taxpayers from achieving through a series of interrelated steps

[72]In 1991 the IRS proposed regulations (PS-163-84) under section 707(a) that would have required that the taxable consideration paid in connection with a disguised sale be allocated among all the transferred assets on a pro rata basis — similar to the result in Rev. Rul. 85-164. After receiving letters from industry groups (including the ABA tax section) arguing that such a regulation would be inconsistent with existing case law, the IRS declined to include it in the final disguised sale regulations (T.D. 8439). Likewise, in Rev. Rul. 68-13, 1968-1 C.B. 195, in the installment sale context, the IRS found that taxpayers could, for installment sale purposes, allocate current and deferred consideration in a purchase of an overall business separately among the assets of the business so that the cash consideration is separately allocated to inventory ineligible for installment reporting.

that which they could achieve directly, the IRS is generally barred from inventing steps that did not occur.[73] A deemed distribution of the land followed by a deemed contribution to an X partnership could thus be difficult for the IRS to mandate when no such distribution or contribution occurred.

Accordingly, at least on the facts posited by this example, removing the land from the distribution and rollover transaction would likely avoid the holding period trap that a transitory partnership could create. Of course, this type of structuring does little to advance the overall policy goal of the capital gains preference and adds expense and inefficiency to a transaction. The complexity (and uncertainty) that is endemic to these transactions is further expanded when the ambiguities surrounding partnership goodwill are added to the mix.

III. Goodwill

A. Defining Goodwill

Before the basis and holding period of goodwill can be properly analyzed (let alone goodwill held by a partnership) goodwill must first be defined. This is no easy task, and one which legal scholars have struggled with for well over a century.[74] In *St. Louis Dispatch*,[75] one of the Supreme Court's earliest decisions addressing the nature of goodwill, the Court (relying on Justice Joseph Story's partnership treatise) defined goodwill as follows:

> The advantage or benefit which is acquired by an establishment, beyond the mere value of the capital, stock, funds or property employed therein, as a consequence of the general public patronage which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill or affluence or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.[76]

At issue was whether, after a consolidation of two newspapers (the *St. Louis Dispatch* and the *Evening Post*) which led to the creation of a new newspaper (the *Post-Dispatch*), a mortgage interest in goodwill of one of the two parties to the consolidation could foreclose on goodwill of the combined entity. The Court began its analysis by acknowledging that goodwill, in the form of the "probability of . . . continuing to attract customers . . . gives a value which may be protected and disposed of, and constitutes property."[77]

Of course, goodwill is a strange type of property. Tangible property (or even intangibles like intellectual property) can be fairly easily identified and transferred. Tangible property can be moved physically. Its ownership can be represented by legal title, and possession can be established by the exercise of physical possession and control. Intellectual property, though not movable or tangible, is subject to specific legal protections, and ownership of, and title to, IP can be established through the legal protections of trademarks or patents. Goodwill, on the other hand, is nebulous. A simple instrument of transfer conveying "title" to business goodwill is worth virtually nothing since goodwill, by its terms, depends on the future actions of others (customers, subscribers, patrons, and so on) to have value. Indeed, even though the mortgage at issue extended to "goodwill," the Court ultimately decided that in the newspaper context, goodwill was entirely a function of the name of the newspaper, and that any goodwill associated with the name of the *St. Louis Dispatch* (the original mortgagor) ceased to exist when there was no longer a newspaper operating by that name.

The issue of separately identifying specific goodwill — and ascribing value to it as a property right — has continued to be contentious. This, at a

[73] *See Esmark Inc. v. Commissioner*, 90 T.C. 171, 196 (1988) (rejecting the IRS's attempt to characterize a tender offer followed by a redemption as a sale of shares followed by a self-tender, court said: "This recharacterization does not simply combine steps; it invents new ones.").

[74] *See generally* "An Inquiry Into the Nature of Goodwill," 53 *Colum. L. Rev.* 660 (1953) ("Goodwill").

[75] *Metropolitan Bank of New York v. St. Louis Dispatch Co.*, 149 U.S. 436 (1893).

[76] *Id.* at 446 (*citing* Story, *Partnerships*, at section 99 (1841)).

[77] *Id. See also Washburn v. National Wall-Paper Co.*, 81 F. 17 (2d Cir. 1897) (Goodwill deemed contributed to corporation in exchange for stock can constitute full payment for capital stock. "Since good will is property, and since in some cases it is valuable property, it would follow that in some way or other it must be practically possible to determine what that value is.").

high level, was the issue before the Supreme Court in *Newark Morning Ledger*.[78] Before the enactment of section 197 on August 10, 1993, purchased goodwill and going concern value were not amortizable assets because they were viewed as lacking a limited useful life. In *Newark Morning Ledger*, the Supreme Court considered a situation in which a taxpayer tried to separately value certain customer subscriptions with a fixed value and useful life. The IRS contended that the customer subscriptions at issue were inseparable from goodwill and thus could not be separately valued and depreciated. In its analysis, the Court focused on how best to define goodwill as a separate and distinct asset. After tracing various attempts to define goodwill through the relevant case law, the Court ultimately appeared to endorse the "mass asset" concept of goodwill.[79] The ultimate value of goodwill "lies in the expectancy of continued patronage through public acceptance," the Court explained, adding:

> It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. . . . The whole is equal to the sum of the fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole.[80]

The Court ruled that although a taxpayer could (and did, in the situation in *Newark Morning Ledger*) establish that a particular asset was distinct from goodwill and had a separate ascertainable value and useful life, "that burden often will prove too great to bear."[81] While the determination of useful life (the issue in *Newark Morning Ledger*) is no longer relevant given the promulgation of section 197 (establishing a deemed 15-year useful life for all purchased goodwill), *Newark Morning Ledger* is still binding on its more general ruling — that in determining whether particular intangibles can be identified as separate from "mass asset" goodwill, the taxpayer will bear the burden of establishing the separateness of a particular intangible.[82]

In addition to the difficulty of defining a specific "item" of goodwill, in the sale context it is very difficult to establish how, exactly, a property right in goodwill is effectively owned or transferred. That is the subject of the *Martin Ice Cream* line of cases. In *Martin Ice Cream*,[83] the Tax Court considered the ownership of goodwill when an individual corporate shareholder, acting as agent for that corporation, had certain customer relationships and expertise. The court held that the shareholder's personal goodwill was not a corporate asset because he "never entered into a covenant not to compete . . . or any other agreement — not even an employment agreement" by which any of his distribution agreements, relationships, and expertise became the property of the corporation.[84]

Later, as part of a transfer of the business, the shareholder sold his personal goodwill. The transfer of the goodwill to the buyer took the form of two agreements. The first was an assignment of rights, transferring all rights to and title in the personal goodwill to the purchaser. The second was a consulting and non-competition agreement. That second instrument has been generally understood as a necessary component of the transfer of goodwill[85] because without the continued efforts of the shareholder, the buyer of the "relationships" could easily find that despite the transfer of title, the value of the intangible would be lost. This seems to indicate that goodwill — unlike a tangible asset, which can be transferred by simply moving title — requires some qualitative mode of transfer that creates in the transferee some ability to use the goodwill. As the Tax Court noted in *Bross Trucking*:

> An employee transfers the benefit of his or her relationships to an employer when the employee cannot benefit from the relationships without the employer. . . . An

[78] *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993).

[79] *Accord* Eric J. Skytte, "Changing the Rules, but Not the Goodwill Game: *Newark Morning Ledger* in the Wake of Section 197," 21 *Wm. Mitchell L. Rev.* 485 (1995).

[80] *Newark Morning Ledger*, 507 U.S. at 558 (*citing Golden State Towel & Linen Service Ltd. v. United States*, 373 F.2d 938, 944 (Ct. Cl. 1968)).

[81] *Id.* at 566.

[82] *See* Skytte, *supra* note 79.

[83] *Martin Ice Cream v. Commissioner*, 110 T.C. 189 (1998).

[84] *Id.* at 207.

[85] *See, e.g., H&M Inc. v. Commissioner*, T.C. Memo. 2012-290.

> employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee.[86]

If (as is clearly the case) the transfer of goodwill requires some action beyond the simple assignment of title, determining transfers of goodwill can be difficult when, as part of a series of interrelated steps, the goodwill of one entity is transferred to a second entity. While the overall movement of the goodwill can often be identified and is generally noncontroversial, intermediate steps in which goodwill is deemed to be owned by persons other than either the historic or ultimate owner may be suspect.[87] This raises the question posed in Example 3: Can a transitory partnership be avoided by distributing assets in kind without a state law entity? Assume that Asset 1 consists of X's business goodwill. Would a bill of sale transferring title to a TIC interest in the X land and the X goodwill succeed in effectively transferring title to business goodwill to A with sufficient substance to support the structure adopted by the parties?

When X exists as a contracting entity and the employer of the employees, then as a matter of state law (whether X is regarded as a tax entity or not), it includes in its assets all contractual rights to services (and any restrictive covenants) necessary to establish the ownership of business intangibles. Thus, it seems rather clear that a transfer of X equity can include the X goodwill. On the other hand, if assets are simply distributed to A without also including A as an interim employer of the X employees and signatory to all contracts of employment, restrictive covenants, or other contractual rights of X, there is at least a concern that the business goodwill would not have been fully transferred and that the distribution would be ignored in determining the tax consequences of the transaction. In most cases, it would not be feasible to take the necessary steps to include A as a contractual party to facilitate its interim ownership of goodwill. Moreover, if A was to become a contractual party to all the X contracts, there would be little difference between an interim distribution of the assets and contract rights, and a distribution of X equity. Unless the argument is made (as in the case of a distribution of X equity) that co-ownership and operation of the business require more than a transitory period in order to qualify as a partnership for tax purposes, nothing will have been accomplished. That is, in the absence of that argument, the steps to make A a contractual party to the X contracts would likely create a partnership under section 761 (which does not, by its terms, require a state law business entity).

B. Basis and Character of Goodwill

1. Purchased goodwill.

When goodwill is purchased, the purchaser will generally obtain a cost basis in the goodwill. Because purchased goodwill is generally eligible for amortization under section 197, purchased goodwill used in a trade or business will generally constitute "depreciable property used in a trade or business." As such, it will not be a capital asset,[88] but if held for more than one year, it will be a section 1231 asset.[89]

2. Taxpayer-created goodwill.

Self-created goodwill is generally a capital asset.[90] In the case of self-created intangibles, outside specified intangible assets for which expenditures are capitalized into tax basis,[91] intangible assets like goodwill, going concern value, workforce in place and other drivers of enterprise value will generally have tax basis of $0 because the ordinary and necessary expenses of operating a business are generally deducted under section 162. This is a significant departure from the treatment of other self-created property, in which amounts spent to develop the long-term construction and appreciation of the property are

[86] *Bross Trucking Inc. v. Commissioner*, T.C. Memo. 2014-107.

[87] Indeed, to add even more complexity, goodwill of a single enterprise may have multiple owners because some of the goodwill might be attributable to the entity's provision of goods and services (and thus owned by the entity), and other goodwill might be attributable to customer relationships owned by an individual. *See Huffman v. Commissioner*, T.C. Memo. 2024-12.

[88] Section 1221(a)(2).

[89] Reg. section 1.197-2(g)(8).

[90] *Horton v. Commissioner*, 13 T.C. 143, 149 (1949) ("Goodwill is a capital asset and any gains resulting from the sale thereof are capital gains.").

[91] *See* reg. section 1.263(a)-4(d).

generally capitalized and added to tax basis. Scholars of goodwill have noted this discrepancy (particularly in the realm of advertising that is purchased specifically to improve the expectancy of future patronage).[92]

Nonetheless, the general deductibility of expenses that increase the value of goodwill is not in question. In Rev. Rul. 92-80, 1992-2 C.B. 57, the IRS ruled that advertising costs of a business are "generally deductible . . . even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising."[93] Accordingly, unless and until an event occurs that requires an adjustment to the basis of partnership goodwill (for example, a purchase and sale of goodwill or an adjustment to basis under section 734(b) or section 743(b)), self-created goodwill will generally be a capital asset with a tax basis of $0.

3. Character of goodwill contributed to, and purchased by, a partnership.

When goodwill is acquired by a partnership in part by contribution in a tax-free transaction and in part by purchase, the question arises as to whether the goodwill is a capital asset or a section 1231 asset. The regulations in this case effectively bifurcate the goodwill. The goodwill, to the extent it is contributed to the partnership in a tax-free transaction under section 721, is not treated as an "amortizable section 197 intangible" (and thus presumably retains its character as a capital asset). The portion of the goodwill deemed purchased (in which the partnership obtains a cost basis) is treated as a separate amortizable section 197 intangible that is a section 1231 asset.[94] When a partnership adjusts its tax basis in an existing intangible that was created by the partnership (and is a capital asset) — whether under section 734(b) or section 743(b) — the basis adjustment is treated as giving rise to a separate amortizable section 197 intangible that, solely for purposes of determining amortization deductions,[95] is deemed to have been acquired by the partnership on the date of the basis adjustment.

Whether this renders the property for which the adjustment is made a section 1231 asset is not entirely clear. One could argue that there are two intangibles: the amortizable basis adjustment, which is a section 1231 asset; and a capital asset with a basis of $0. If that construct were carried to its logical conclusion, upon a purchase of the goodwill, value exceeding basis could be allocated to the "separate" capital asset (rather than the basis adjustment, which is by its very nature a wasting asset), thereby avoiding any ordinary income under section 1245.[96] This argument seems a bit too clever. Though little about goodwill is intuitive, it seems ludicrous to argue that value allocated to the very property that gives rise to the basis adjustment ought to avoid recapture of amortization deductions. As such it would appear that, at least for the goodwill subject to step-up, the goodwill should be treated as a section 1231 asset.

C. Holding Period of Goodwill

Because there is little guidance on the holding period of taxpayer-created goodwill, rules governing the holding period of goodwill must be determined, at least in part, by analogy.

If one tries to analogize self-created goodwill to the construction of a building, applying Rev. Rul. 75-524 would require that the taxpayer identify the "completion date" of varying components of goodwill. Indeed, given the brick-by-brick approach taken for a partnership interest holding period, this would create a rather elegant outside-inside tracking for capital contributions to a partnership used for operations. Each dollar invested in the business would create a new holding period in both the partnership interest and the underlying goodwill. The fact that new investments in a partnership can give rise to a revaluation of goodwill for capital accounting

[92] *See* "Goodwill," *supra* note 74, at 719 ("It is admitted that sums expended to promote favorable customer relation over an indefinite period of time result in the creation of goodwill, that in theory at least these expenditures are directed toward the acquisition of a capital asset. But attempts to achieve a capital classification for these outlays usually meet with failure.").

[93] Although the uniform capitalization rules of section 263A require capitalization of certain general expenses of a business allocable to property of the taxpayer, "UNICAP" adjustments are made exclusively to tangible and real property of the taxpayer, not to goodwill.

[94] Reg. section 1.197-2(g)(2)(ii)(B) and (g)(8).

[95] And not for determining the holding period of the intangible by the partnership.

[96] *See* reg. section 1.197-2(g)(8).

purposes[97] could create the milestones establishing degrees of goodwill "completion."

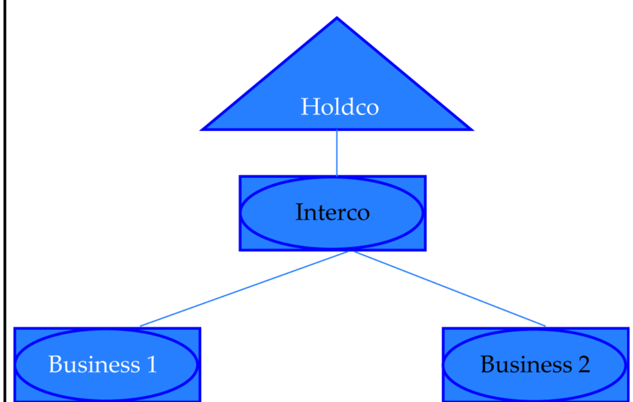
However, this type of segregation of distinct segments of goodwill would seem to violate the standard for mass asset treatment in *Newark Morning Ledger*, which posited that, at least for purposes of ascertaining basis and amortization, most changes to goodwill (customer turnover, changes in workforce, etc.) do not cause a segregation of the asset because they are part and parcel of its existence as a mass asset. If the pre-investment goodwill and post-investment goodwill cannot be separately valued and described as distinct assets, *Newark Morning Ledger* requires that they be amalgamated as a singular asset.

If one applies this mass asset definition of goodwill to the holding period in this manner, the better view of the acquisition date of goodwill and similar taxpayer-created intangible assets would be the date that the relevant business first had operations that could give rise to any "expectancy of future patronage." This is the premise underlying the general approach that the IRS and most tax practitioners have taken to the application of the anti-churning rules of section 197(f)(9). Under those rules, goodwill that predates the promulgation of section 197 on August 10, 1993, cannot be amortized by the taxpayer who held the goodwill before that date, or by any related taxpayer. The general understanding of this rule is that if there was even $1 of business goodwill before August 10, 1993, any appreciation in value of that goodwill is still subject to the anti-churning rules.[98]

In some cases, however, the holding period of goodwill can be difficult to ascertain — particularly when different business lines grow out of a single enterprise or when different businesses are amalgamated. Amalgamation might occur in a private equity roll-up in which several businesses in a particular industry are acquired in a manner that results in synergistic efficiencies and growth, making the "whole" of the business more valuable than the sum of its parts.

Example 6: *The roll-up*. In a roll-up, a private equity fund will generally acquire a company in a platform acquisition. The platform company will then proceed to acquire other companies in the same industry in a variety of add-on transactions. Each of these smaller add-ons might be operated in a separate subsidiary, and if a noncorporate structure is used, the overall entity will often consist of a holding partnership that owns several operating entities that are wholly owned disregarded LLCs. Over the course of the private equity fund's holding period, it might make several investments in partnership interests of the holding partnership, creating a divided holding period in the partnership. At the time of exit, a highly simplified version of the structure might appear as shown in Figure 3.

Figure 3



In this example, assume that Business 1 was acquired in the platform acquisition (which took place four years before exit) and that Business 2 was acquired in an add-on acquisition that occurred two years before exit. Assume further that all the assets of Business 1 and Business 2 consist of intangibles acquired in fully taxable transactions. Rather than being capital assets, these intangibles are section 1231 assets.[99] Accordingly, if Holdco was to sell Interco at gain for cash, the purchase and sale would (at least at first glance) be treated as a purchase and sale of assets. Gain would be recognized as section 1231

[97] Reg. section 1.704-1(b)(2)(iv)(f).

[98] *See* Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 10.33[3]; and Martin D. Ginsburg, Jack S. Levin, and Donald E. Rocap, *Mergers, Acquisitions, and Buyouts*, para. 403.4.1.4.

[99] Reg. section 1.197-2(g)(8).

gain and as such would not be subject to the requirement of a three-year holding period to achieve long-term capital gain treatment for fund-carried interest under section 1061.[100]

Of course, because goodwill is implicated, this result (even in the base case of an all-cash sale) is not necessarily clear-cut. Initially, there are two goodwill assets in the Holdco partnership: the goodwill acquired with Business 1, and the goodwill acquired with Business 2. Each goodwill asset is being separately amortized under section 197 and is a section 1231 asset. However, there might also be a third, hidden goodwill asset. That third asset would be the goodwill that is created through the synergy of Business 1 and Business 2. Indeed, the whole premise underlying roll-up is that the Interco business is worth more as a consolidated whole than the sum of Business 1 and Business 2 as separate unrelated enterprises. If there is such a third goodwill asset, the question arises as to what happens when a third business is acquired. Does yet another synergy goodwill asset arise, or is the new synergy part and parcel of the first synergy goodwill? Although the IRS has provided no guidance on these questions, it appears to me that the better analysis is that the synergy goodwill is actually the self-created goodwill that arises from the roll-up strategy itself. As such, its holding period commences as soon as the initial platform business begins seeking its first add-on, and it grows in value as a mass asset with each add-on. This construct would treat this goodwill (whose value is not realized until the sale of the combined enterprise) as a separate capital asset with no basis, and a holding period roughly equal to the holder period of the overall investment. Of course, this construct does leave open a few legal questions that will be of some consequence, as discussed below.

1. How is value to be allocated between the purchased goodwill and the self-created goodwill?

As discussed above, under *Newark Morning Ledger*, the taxpayer would bear the burden of separating the synergy goodwill as a separate asset. One could engage a valuation firm or investment banker to determine the amount that would be paid for the sale of Business 1 and Business 2 to separate buyers (so that no synergistic value is transferred). Presumably, these amounts could then be allocated to the purchased goodwill, and any value exceeding the sum of those two values would be attributable to the synergistic goodwill.

2. Which of the legal entities in the structure 'owns' the synergy goodwill?

On this second question, it appears to me that the owner of the synergy goodwill must be Interco, because if either Business 1 or Business 2 is sold independently, the synergy would not be transferred. Accordingly, Interco must own the synergy asset since that asset's value depends on the ownership of both Business 1 and Business 2.

Accordingly, even in the base case, some portion of the gain may not be section 1231 gain and may instead be capital gain. Of course, in the current example, if the self-created goodwill theory is adopted, that capital gain ought to have a holding period of more than three years.

3. Rollover structure.

As discussed earlier, a buyer will often require that certain management equity holders of Holdco "roll over" a portion of their investment. Ordinarily, this would be accomplished by making an in-kind distribution of interests in Interco to the rollover sellers,[101] followed by a sale of the remaining interests in Interco to the purchaser. If this in-kind distribution creates a new tax partnership, the character of the gain recognized by Holdco on the sale will change. Instead of being section 1231 gain, the gain will be capital gain recognized under section 741 from the sale of a partnership interest. Holdco will have a holding period in its partnership interest that is divided between more-than-three-year gain — attributable to the Business 1 goodwill (and possibly the synergy goodwill) — and the less-than-three-year gain attributable to the Business 2 goodwill.

The first question that will arise is the proper determination of this divided holding period. That is, should the synergy goodwill be treated as

[100] Reg. section 1.1061-4(b)(7)(i).

[101] Generally tax free under section 731(a), subject to potential gain recognition for underlying cash balances, or under the partnership mixing bowl rules of sections 704(c)(1)(C) and 737.

a more-than-three-year asset that will increase the more-than-three-year holding period of the resulting partnership interest? Or should the synergy goodwill simply be treated as appreciation in the Business 1 goodwill and the Business 2 goodwill that is allocated between them? If this latter construct is adopted, how should that allocation be done? One method might be to allocate the "appreciation" between Business 1 and Business 2 based on their relative performance. However, since both operate within the same overall platform, the performance of one business or the other might be a function of the way the larger business is administered than of the actual value of the two businesses. Another method of allocation might be based on the respective costs of Business 1 and Business 2 when acquired. But, of course, original cost may have little relation to value at the time of the partnership formation.

One possible way to avoid this issue might be to fund the rollover with interests in Business 1 rather than Interco interests.[102] When the Business 1 assets are deemed contributed to a new partnership, the goodwill of Business 1 will most likely have a more-than-three-year holding period. As such, even despite the change in character of the assets from section 1231 assets to capital assets (in the form of partnership interests), the partnership at issue will have a more-than-three-year holding period (subject to appropriate control for cash balances and section 751 assets). If Business 1 holds assets described in section 751, those assets might be distributed to Interco before the distribution of Business 1 interests to the rollover seller, so that upon the formation of the Business 1 partnership, only assets with a more-than-three-year holding period are deemed contributed, and the partnership interest holding period is accordingly more than three years.

IV. Recommendations

It goes without saying that the structures described above do little to advance the policy goals and objectives of the preferential rates applicable to long-term capital gains. Moreover, although potentially fun and profitable for tax planners, there is little overall systemic benefit to the costs of implementing (and inventing!) the structural machinations described above. How might the tax system be improved to achieve results that advance the policy at issue?[103]

Suggestion 1: Make adjustments to inside holding period that reflect adjustments to inside basis.

Most of the distortions that arise out of subchapter K's approach to holding periods are a direct result of a mismatch between the aggregate principles applied to basis and the entity principles applied to holding periods. In many cases, commentators have defended distortions arising from an entity approach to partnership tax as advancing the "congressional goal of simplicity,"[104] which might make some degree of distortion acceptable. However, adding an aggregate element to the determination of a holding period usually would not materially increase complexity, because it would simply be applying a separate holding period to assets whose basis is already being separately tracked on a partner-by-partner basis. Accordingly, I believe that the following two new rules could aid in advancing the policy behind the long-term capital gains preference:

- Apply the carryover holding period in contributed property only to the contributing partner. The holding period of noncontributing partners would be based solely on their outside holding period. Because contributed assets with a built-in gain or loss are already subject to the special tracking regime of section 704(c), this change would not necessarily add meaningfully to administrative complexity and would prevent the windfall enjoyed by V in Example 2.
- In connection with any transaction giving rise to an inside basis adjustment as a result of a section 754 election (whether under

[102] This strategy can also have benefits when used to avoid inclusion of gain under the partnership mixing bowl rules of sections 704(c)(1)(C) and 737.

[103] This, of course, assumes that the policy behind taxing long-term gains at a lower rate is worth preserving. The system could be meaningfully simplified if the differential tax rates were simply eliminated.

[104] Ray, *supra* note 63.

section 734(b) or section 743(b)), treat the basis adjustment as creating a new acquisition date for the assets being adjusted so that the aggregate result achieved for basis and gain calculations extends to the holding period.

Suggestion 2: Rationalize inside and outside holding periods.

Under current law, there is no relationship between changes in the outside holding period and changes in the inside holding period. In particular, the divided outside holding period that can arise from partnership contributions creates meaningful differences between sales of partnership interests and partnership sales of underlying assets that serve no discernible policy goal. Accordingly, it would better serve the policy goals of the long-term capital gains preference to eliminate the brick-by-brick approach to partnership interest holding periods and instead do the following:

- Allow certain capital contributions for existing equity to not affect the holding period. To avoid abuse, these capital contributions should be limited to (1) pro rata capital contributions that do not increase any partner's relative share of partnership property, and (2) non-pro-rata capital contributions that do not increase a partner's share of profits. A non-pro-rata capital contribution that does not increase a partner's share of profit does not increase the investment return on a partnership interest and instead represents a "rescue" capital injection that is much more akin to maintenance and improvement costs for existing property than to the acquisition of new property.
- In connection with a transfer of property to a partnership that does affect the holding period, allow for the segregation of partnership interests into separate lots with different holding periods. Achieving the goals of the long-term capital gains preference requires that long-term appreciation be eligible for taxation at the preferential rate without noneconomic tax engineering.

Suggestion 3: Establish goodwill holding period conventions.

The current hodgepodge of guidance on goodwill leaves open the question of how a taxpayer's holding period in goodwill should be determined. To be sure, the approach of *Newark Morning Ledger* — treating goodwill as a mass asset except as otherwise proven — offers a fairly reasonable basis for many simple businesses. However, it offers us little in the context of businesses that include separate business lines that interrelate with one another (and might have been acquired at different times). To the extent that it is important to be able to determine a precise holding period for an intangible like goodwill, additional definition and clarification of the precise rules for determining the acquisition date of goodwill will be required. The following principles may be helpful in establishing that guidance:

- The acquisition date for any business goodwill ought to be the date on which the business begins — even if the business has little to no value on that date.
- When a business plan includes the integration of other businesses to create synergistic growth, the holding period of the goodwill related to the synergistic growth (as an asset separate from the goodwill of the original business or the goodwill acquired in connection with the purchase of any other business) should be separately tracked as a separate capital asset (distinct from the goodwill acquired in any secondary transaction) and should be based on either (1) the date on which the business formally adopts a plan of synergistic growth through acquisition or (2) the date of the first acquisition of a complementary business.
- Specific means of transferring goodwill should be established by statute or regulation so that taxpayers have certainty as to the ability to structure transactions by transferring goodwill in one or more intermediate steps to facilitate a larger acquisition.

The foregoing suggestions would do much to create certainty in planning partnership acquisitions involving long-term assets, and to prevent planning windfalls and pitfalls that do little to advance a cogent policy objective. Until these (or other) advancements are made to the current system, tax planners would do well to consider the holding period in structuring acquisitions so that their clients can benefit to the maximum extent possible from the preferential long-term capital gains tax rate. ■