Internal Revenue Code Section 709: To Deduct, Amortize, or Capitalize, That Is the Question

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I. INTRODUCTION

This Article is an in-depth examination of section 709 of the Internal Revenue Code. Section 709, which was enacted in 1976, prescribed rules for the treatment of organization expenses and syndication expenses of a partnership.

Cases and commentary from three different time periods, as well as the legislative history and regulations, will be analyzed. The first area of emphasis is the pre-1976 case law on organization expenses and syndication expenses. The cases examined in this section included corporate cases that laid the foundation for the treatment of organization expenses and syndication expenses, the first partnership cases that dealt with the subject, and the Revenue Ruling and Tax Court

* Dedicated to the memory of my mother, Bernadette Piazza Ojile. I would like to thank Prof. William H. Lyons, UNL College of Law, and Mr. Fred T. Witt, Jr., Esq., Haynes and Boone, Dallas, Texas, for their editorial comments, and Barbara Kline for her typing and patience.
decisions that were cited by the authors of section 709 in its legislative history. The next area of emphasis will be cases that were decided after section 709 was enacted, but dealt with transactions originating prior to the section's effective date. The final body of case law that will be examined in this Article are those cases that have applied section 709.

The purpose of this Article is twofold. First, it is meant to be a comprehensive survey of cases and commentary on the treatment of partnership organization expenses and syndication expenses. Second, it is meant to be a practical guide as to what expenses are deductible and what expenses are not deductible. To this end, planning ideas will be highlighted and areas of controversy will be explored. The theory and foundation of section 709 will be fully examined in order to determine the direction that the application of the section may be heading.

II. CASE LAW PRIOR TO SECTION 709

A. Historical Treatment of Organization and Syndication Expenses

The first cases on the treatment of organization expenses dealt with corporations.1 The Board of Tax Appeals, in Holeproof Hosiery Co. v. Commissioner,2 held that expenditures made for the acquisition of capital assets represent the cost of the acquired asset. In Holeproof Hosiery, attorney's fees incurred in connection with an increase in capitalization of the company were deemed to be capital in nature and, therefore, not deductible as an ordinary and necessary expense.3 Citing Holeproof Hosiery, the court in Bush Terminal Building Co. v. Commissioner,4 held that expenses in connection with the reorganization of the petitioner's corporation must be capitalized. The court stated that it has long been held that expenses of organizing or reorganizing a business are capital expenditures that are not deductible as business expenses.5

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1. In a series of cases the courts stressed that costs incurred in the organization of a corporation must be capitalized rather than deducted. See, e.g., Fireman's Ins. Co. v. Commissioner, 30 B.T.A. 1004, 1013-14 (1934); Commercial Inv. Trust Corp. v. Commissioner, 28 B.T.A. 143, 148 (1933); Malta Temple Ass'n v. Commissioner, 16 B.T.A. 409, 411 (1929); Grain King Mfg. Co. v. Commissioner, 14 B.T.A. 793, 796 (1928); Holeproof Hosiery v. Commissioner, 11 B.T.A. 547, 556 (1928).
2. 11 B.T.A. 547 (1928).
3. Id. at 556.
4. 7 T.C. 793 (1946).
5. Id. at 819. See also Mills Estate, Inc. v. Commissioner, 17 T.C. 910 (1951), rev'd on other grounds, 206 F.2d 244 (2d Cir. 1953). In Mills Estate the court recognized that costs incurred in organizing and re-organizing a corporation, altering its capital structure, selling and disposing a stock issue, or acquiring and retiring outstanding stock are treated as capital expenditures, rather than as ordinary and necessary business expenses deductible from current income. Id. at 914.
In two cases, *Wolkowitz v. Commissioner*,\(^6\) and *Meldrum & Fewsmith, Inc. v. Commissioner*,\(^7\) the Tax Court dealt with the issue of organization expenses of a partnership. In *Wolkowitz*, petitioner was a shareholder in a corporation that manufactured leather clothing. The corporation was dissolved, and the shareholders and several others formed a partnership to carry on the same business. On its partnership tax return for its first year of existence, the partnership deducted legal fees incurred as a result of the switch from corporate to partnership form. The Tax Court, citing *Bush Terminal* for the proposition that organization expenses of a corporation are non-deductible capital expenses, held that organization expenses of a partnership are also non-deductible. The court stated that organization expenses are assets of a permanent nature and, therefore, represent property that should be capitalized.\(^8\)

In *Meldrum & Fewsmith*, petitioner was a partnership that had been formed from a pre-existing corporation because of the corporation's inability to maintain adequate working capital. The shareholders became partners, and the corporation leased its equipment to the partnership in order for the partnership to conduct business operations. The partnership retained a Certified Public Accountant (CPA) to determine the advisability of a change in the accounting period of the business, and to analyze and compare the income tax liability of the business under both the corporate and partnership forms of organization. An attorney was retained to determine a solution to the working capital problems of the business, to draft a pension plan, and to draft documents in connection with the organization of the partnership.

The Tax Court held that expenses incurred determining the advisability of a change in organization form and accounting period were deductible,\(^9\) as were expenses relating to the pension plan and credit problems of the business.\(^10\) However, citing *Mills Estate v. Commissioner*,\(^11\) the court held that the remaining portion of the attorney's fee, relating to the organization of the partnership, must be classified as a capital expense.\(^12\)

From these cases it is apparent that organization expenses are to be capitalized and are not currently deductible. Also, no amortization similar to that which is provided for corporations in section 248 would be available to the partnership unless a useful life could be established.

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\(^6\) 8 T.C.M. (CCH) 754 (1949).
\(^7\) 20 T.C. 790 (1952).
\(^8\) *Wolkowitz* v. Commissioner, 8 T.C.M. (CCH) 754, 772 (1949).
\(^9\) *Meldrum & Fewsmith, Inc. v. Commissioner*, 20 T.C. 790, 807 (1952) (citing *Parker v. Commissioner*, 6 T.C. 974 (1946)).
\(^10\) *Id.* at 807.
\(^11\) 17 T.C. 910 (1951), rev'd on other grounds, 206 F.2d 244 (2d Cir. 1953).
\(^12\) *Meldrum & Fewsmith v. Commissioner*, 20 T.C. 790, 807 (1952).
for the intangible asset created by the organization of the partnership. Wolkowitz established that organization expenses are to be considered permanent in nature and would have value to the partnership over the life of the partnership. Since most partnerships are assumed to have an indefinite life unless otherwise provided, amortization of organization expenses would only be available to those partnerships established for a limited purpose and for a certain number of years.

In 1954, section 248 was adopted as part of the Internal Revenue Code. This section provides an election for amortization of the organization expenses of a corporation over a period of not less than sixty months. There was no comparable provision under the 1939 Code.

The legislative history of section 248 shows that Congress recognized that, under the then existing law, organization expenses could only be amortized if the corporation had a limited existence specified in the corporate charter. The Conference Committee noted that since most corporations are perpetual, a vast majority of corporations recovered their organization expenses for tax purposes only in the year of liquidation. The Conference Committee report excluded expenses incurred in connection with stock issues and costs of reorganization from section 248 treatment.

With the advent of section 248 in 1954, corporations received a decided tax advantage over partnerships. A corporation could amortize its capitalized organization expenses, while no similar provision was available to partnerships. The authors of a leading treatise on partnership taxation contend, however, that the case law requirement of capitalization of organization expenses was largely ignored by taxpayers. The authors suggest that the organization expenses were often deducted as legal or accounting fees, and these deductions were never challenged by the Internal Revenue Service (Service).

As has been previously shown, other partnerships avoided the capitalization requirement by reimbursing partners who paid the organization expenses. Those payments were then deducted by the

13. Most real estate limited partnerships will have a limited life. Partnerships formed to carry on a trade or business, and not formed for investment purposes, would more than likely have an unlimited life.
17. Id.
18. Id.
20. Id.
partnership as section 707(c) guarantee payments. Some practitioners contended that under pre-1976 section 707(c), those payments were automatically deductible by virtue of their being guaranteed payments, and that the underlying expense that was reimbursed did not need to be examined.  

Although there were case law prohibitions against deduction of organization expenses, in practice these deductions were seldom challenged. This contention is supported by the fact that relatively few cases addressed the subject of organizational expenses during the period between the Wolkowitz and Meldrum & Fewsmith decisions in the late 1940’s and early 1950’s, and Cagle v. Commissioner, in 1975. This lack of case law can be interpreted in two ways. Either taxpayers were not trying to deduct organization expenses or the Service was not aggressively pursuing the issue. In either case, following the Cagle decision and the enactment of section 709 in the 1970’s, more cases were decided dealing with the subject of the deductibility of organization expenses and syndication expenses.

B. The Historical Foundation of Section 709

In November, 1974, the Tax Court decided Cagle v. Commissioner. This opinion, which was affirmed by the Fifth Circuit Court of Appeals, was one of two authorities cited by the House and Senate when section 709 was adopted. Cagle held that a guaranteed payment made to a general partner was non-deductible by the partnership because the expenses incurred were capital in nature rather than ordinary and necessary business expenses.

In Cagle, the appellants were practicing physicians who entered into a partnership, the purpose of which was to “construct, acquire by purchase, own, hold, deal in, mortgage, operate, manage, equip, lease, sell, exchange, transfer or in any manner dispose of warehouses, office buildings, and other commercial property, and to do and perform all things necessary or incidental or connected with or growing out of such business.” Pursuant to this arrangement, the partnership developed an 80,000 square foot office showroom. The general partner contributed the land and the investor partners contributed $200,000 each. All expenses flowed through to the investor partners pro rata. The partnership also entered into a management contract with the

22. 63 T.C. 86 (1974), aff’d, 539 F.2d 409 (5th Cir. 1976).
23. Id.
24. Id.
25. See infra notes 41-42.
26. Cagle v. Commissioner, 539 F.2d 409, 411 (5th Cir. 1976) (quoting Articles of Partnership, Trial Record at 34).
Work commenced on the building in 1968, and there was no income producing structure until the summer of 1969. The partnership's first tax return listed no income but reported expenses of $105,973.

The sole issue before both the Tax Court and the Fifth Circuit was whether a management fee paid to a general partner was deductible business expense under section 707(c), or a non-deductible section 263(a) capital expenditure. The Fifth Circuit interpreted section 707(c) as intending to permit partnerships to pay partners in the form of guaranteed payments, with such payments being treated as ordinary income to the partner and deductible to the partnership only if the payment fell within section 61(a) or 162(a). The court stated that this interpretation of section 707(c) did not support the partnership's contention that guaranteed payments are automatically deductible when paid by the partnership to a partner. The court further stated that it was improbable that Congress intended to make capital expenditures of a partnership deductible if paid to a partner, but not if paid to a non-partner.

The court held that none of the fees expended by the management company were for the actual management of the finished product. Instead, the fees expended were actually expenses incurred in the development of the project. As such, the court held that these expenditures of the partnership must be capitalized in view of consistent holdings that expenditures for the acquisition of the capital assets of other entities are capital in nature.

Soon after the Tax Court's decision in Cagle, the Service issued Revenue Ruling 75-214. A limited partnership had been formed to

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27. Services provided by the general partner under the management contract included conducting a feasibility study, working with the general contractor and architects on construction of the building, and arrangement of financing. Id. at 512. No part of the fee paid to the general partner in compensation for these services was for management after completion of the building. Id.

28. Id. at 414.

29. The partnership had argued that § 707(c) results in deductibility regardless of the nature of the services performed or capital used if the payment involved was made without regard to partnership income. Id. at 413.

30. The partnership cited Rev. Rul. 69-186, 1969-1 C.B. 185, as being persuasive. The Revenue Ruling stated that "a guarantee payment is includible in the gross income of the recipient as ordinary income and is deductible by the partnership from its ordinary income as a business expense." Id. The court stated that while this language was persuasive standing alone, this interpretation did not seem reasonable in light of congressional action. Cagle v. Commissioner, 539 F.2d 409, 414 (5th Cir. 1976).

31. Cagle v. Commissioner, 539 F.2d 409, 416 (5th Cir. 1976). In support of the main proposition see, e.g., Commissioner v. Idaho Power Co., 418 U.S. 1 (1974); Acer Realty Co. v. Commissioner, 132 F.2d 513 (8th Cir. 1942); Perlmutter v. Commissioner, 44 T.C. 382 (1965).

32. 1975-1 C.B. 185.
acquire, sell, and develop real estate. The general partner was to pay the costs of organization and syndication. Immediately after the last share was sold, the general partner was paid a specified amount. The Service held that even though payments to general partners for services rendered in organizing a partnership are section 707 payments, they are not deductible under section 162(a) because they constitute capital expenditures under section 263(a). The Service stated that the threshold question was whether the expenditure is deductible under section 162(a), and not whether the payment was made to a partner or non-partner.

The Cagle decision and the Revenue Ruling, coupled with the case law examined earlier, cast considerable doubt on the deductibility of organization and syndication expenses of a partnership. In 1976, Congress strengthened these decisions by adopting section 709 and revising section 707(c). Section 709 effectively closed the door on the manipulation of organization and syndication expenses that had been occurring since Meldrum & Fewsmith; however, section 709 was effective only for taxable years beginning after December 31, 1976. In specifically barring current deductions for years beginning after 1976, the Conference Committee stated that no inferences should be drawn as to the deductibility of organization and syndication expenses incurred in years prior to 1976. Therefore, a post-709 “twilight zone” was created in which tax disputes relating to pre-709 law were litigated following the passage of section 709. In the cases decided after the enactment of section 709 that dealt with tax years prior to 1976, the courts could not allow amortization of organization expenses as provided in section 709(b). Based on the Cagle decision, those expenses would be capitalized with no allowable tax recovery.

III. LEGISLATIVE HISTORY OF SECTION 709

Section 709 was added to the Internal Revenue Code by the Tax

33. The § 709(a) non-current deduction provision applies to partnership tax years beginning after December 31, 1975. Treas. Reg. § 1.709-1(a) (1983). The § 709(b) amortization provision applies to organization expenses paid or incurred for partnership tax years after December 31, 1976. Id. at § 1.709-1(b).


35. In Gaines v. Commissioner, 45 T.C.M. (CCH) 363 (1982), the petitioner argued that § 709 should be applied prospectively, closing a loophole that existed prior to its enactment. Since the tax years in question were pre-1976, the petitioner argued that the old rules should govern, and the deduction should be allowed. The Tax Court examined the legislative history and determined that Congress did not view the prior law as permitting the deductions claimed by the petitioner. Id. at 371-73.

36. I.R.C. § 709 (CCH 1985) provides:
(a) GENERAL RULE.- Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any
Reform Act of 1976. Section 709 provides that organization and syndication expenses of a partnership are non-deductible. For organization expenses, section 709(b) provides for an election to amortize the expenses over a period of not less than sixty months. The original text of the Tax Reform Act did not contain the sixty month amortization of organization expenses provision. This provision was added by the Senate and adopted by the House-Senate Conference Committee.

The legislative history of section 709 reflects the examination of the current state of the law conducted by the Ways and Means Committee and the Senate Finance Committee prior to defining their reasons for change. Prior to 1976, partnerships deducted payments made to partners in connection with the organization of a partnership under section 707(c). These “guaranteed payments” are deductible by the partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

(b) AMORTIZATION OF ORGANIZATION FEES.

(1) DEDUCTION. - Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.

(2) ORGANIZATIONAL EXPENSES DEFINED. - The organizational expenses to which paragraph (1) applies, are expenditures which-

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

(C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

38. I.R.C. § 709(a) (CCH 1985).
39. Id. at § 709(b)(1).
40. H.R. REP. No. 10612, 94th Cong., 2d Sess. (1975). The House Report states that the interpretation given in Revenue Ruling 75-214 and in Cagle v. Commissioner, 63 T.C. 85 (1974), disallowing deductions for organization expenses, was correct. The Report stated that “a contrary conclusion would allow partnerships to obtain current deductions for capital expenditures (including organization expenses and the expense of selling partnership interests), even though all other types of taxpayers would be required to capitalize the same or similar expenses.” H.R. REP. No. 658, 94th Cong., 2d Sess 121 (1976).
43. I.R.C. § 707(c) (1970), provided:

(c) GUARANTEED PAYMENTS. - To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a
partnership to the extent the payments are determined without regard to the income of the partnership. A partner would be paid for services rendered in organizing the partnership, and be reimbursed for organizational expenditures made on behalf of the partnership. Taxpayers cited legislative history\textsuperscript{44} and the regulations for section 707(c)\textsuperscript{45} in support of this practice.\textsuperscript{46}

\begin{itemize}
  \item member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).
  \item For current version of § 707(c), see infra note 51.
\end{itemize}

\textbf{44.} See S. REP. No. 1622, 83rd Cong., 2d Sess. (1954):

\begin{quote}
A partner who renders services to the partnership for a fixed salary, payable without regard to the partnership income, shall be treated to the extent of such amount, as one who is not a partner, and the partnership shall be allowed a deduction for a business expense.
\end{quote}

\textit{Id.} at 387 (emphasis added).

\textbf{45.} See Treas. Regs. § 1.707-1(c) (1956), which provided in part:

\begin{quote}
(c) GUARANTEED PAYMENTS.- Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of § 1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership, only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).
\end{quote}

\textbf{46.} The Tax Court in Cagle v. Commissioner, 63 T.C. 86 (1974), affd., 539 F.2d 409 (5th Cir. 1976), commented on the argument that the § 707(c) legislative history provided for automatic deductibility of guaranteed payments. The court stated that § 707 was enacted to end the contradiction and confusion surrounding the tax treatment of partnerships that existed prior to enactment of the 1954 Code. Congress determined the aggregate approach to be "unrealistic and unnecessarily complicated," S. REP. No. 1622, 83d Cong., 2d Sess. 387 (1954), reprinted in 1954 U.S. CONG. & AD. NEWS 4725, and adopted the entity approach for tax treatment of compensation to partnerships. The court believed that implicit in the code as enacted is the premise that payment to a partner for services will be viewed as being made at the partnership level rather than at the partner level, and that the character of the payment must also be viewed at the partnership level to determine its proper tax treatment. Employing the entity approach, a guaranteed payment is treated as being made to one who is not a member of the partnership, rather than as a payment received in part from profits, other partners, and from the receiving partner. Cagle v. Commissioner, 63 T.C. 86, 94 (1974). For a definition and discussion of the aggregate and entity concepts, see 1 PARTNERSHIP TAXATION, supra note 19, at §§ 2.06 & 2.07.

The Cagle court was faced with a question of first impression. The court stated that § 707(c) clearly did not require automatic deduction of guaranteed payments. The court concluded that such payments may qualify as a § 162(a) expense, since § 707(c) employs the entity theory. The court added that congressional intent requires inclusion of, and testing the deductibility of, partnership guaranteed payments in a manner similar to the treatment of guaranteed payments made by other recognized taxable entities because of the simplicity of that
The Cagle decision and a 1975 Revenue Ruling altered the interpretation of section 707(c), by concluding that guaranteed payments were not automatically deductible. The case and ruling required that an inquiry be made into whether the service performed was ordinary and necessary or whether it was capital in nature. Thus, these decisions closed a loophole that would have allowed current deductions to partnerships for capital expenditures, while denying the same deductions to individuals and corporations for similar expenses.

In the Tax Reform Act of 1976, Congress made a two-pronged attack against the deduction of capital expenditures by partnerships through the use of guaranteed payments. First, section 707(c) was amended to make deductibility of guaranteed payments subject to the section 263 capital expenditures provisions. Second, section 709 was added, specifically denying a current deduction for all partnership organization and syndication expenses. In adding these provisions, both the House and Senate agreed with the interpretation given to section 707(c) by the Tax Court in Cagle and the Internal Revenue Service in Revenue Ruling 75-214. The Senate version of the Tax Act (which was later adopted by the Conference Committee), gave partnerships the same treatment for capitalized organization expenses that corporations have under section 248. Therefore, provisions similar to sec-

48. I.R.C. § 162(a) (CCH 1985) ("There shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.").
49. I.R.C. § 263(a)(1) (CCH 1985) ("No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.").
50. See supra note 40.
51. I.R.C. § 707(c) (CCH 1985) currently provides:
   (c) GUARANTEED PAYMENTS.- To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).
   Compare prior version of I.R.C. § 707(c) (1970), supra note 43.
53. I.R.C. § 248 (CCH 1985) provides in part:
   (a) ELECTION TO AMORTIZE.- The organizational expenditures of a corporation may, at the election of the corporation (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the corporation (beginning with the month in which the corporation begins business).
tion 248 were added to the Senate Bill that provided for amortization of organization expenses over a period not less than sixty months.

IV. SECTION 709 REGULATIONS

Regulations for section 709 were proposed by the Commissioner of the Internal Revenue Service (Commissioner) in January, 1980, and adopted in May, 1983.54 Generally, the regulations provide that the partnership may amortize organization expenses over a period of not less than sixty months, with the period of amortization beginning the month the partnership commences business.55 Commencement of business is a question of fact to be determined by the facts and circumstances of each case.56 For most purposes, business is considered to commence when operations begin. If there is a doubt as to the date of commencement of the business, the regulations provide several guidelines.57 The partner-
ship must elect to amortize and must choose its amortization period. 

must elect to amortize and must choose its amortization period.

Blitzer v. United States, 684 F.2d 874, 879-81 (Ct. Cl. 1982), provided a more liberal test of when business commences. In Blitzer, closing occurred in Oct., 1973, and the buildings were completed and ready for occupancy in 1974. The court held that a trade or business commenced upon closing because land and financing plans for construction were present. The court stated that the Commissioner's position that an entity must be income producing in order to utilize § 162(a) was too rigid. The court noted that the partnership was at all times engaged in endeavors for business or profit-making purposes, rather than for personal reasons. The court also stated that § 162 does not require a precise matching of income and expenses in the same year. The court pointed out that the Commissioner had not supplied an argument justifying why non-start up costs should not be deductible as ordinary business expenses, irrespective of whether the business has yet completed construction or acquisition of its income producing asset.

Recent cases show the current unsettled nature of this area. In Ditunno v. Commissioner, 80 T.C. 362 (1983), the Tax Court adopted a facts-and-circumstances test to determine when a taxpayer was in a trade or business. The facts-and-circumstances test was followed in Hoopengarner v. Commissioner, 80 T.C. 538, 540 (1983). Hoopengarner involved the deduction of ground lease rents prior to the completion and occupancy of a building which was to be built on the land. The court stated that the payments were not for the purpose of a trade or business as required by § 162(a)(3). The acquisition of land and the securing of tenants were not events of a sufficient magnitude to place the petitioner in the office building rental trade or business. However, the court did allow a portion of the rental payments to be deducted under § 212(2) because they were expenses paid for the management, conservation, or maintenance of property held for the production of income. Section 212 does not have a trade or business requirement.

The facts-and-circumstances test was also applied in Gajewski v. Commissioner, 45 T.C.M. (CCH) 967 (1983). In Gajewski, the court held that a gambler's full time gambling activities met the trade or business test. This decision was reversed by the Second Circuit Court of Appeals, Gajewski v. Commissioner, 723 F.2d 1062 (2d Cir. 1983). The circuit court stated that three conditions must exist for trade or business status:

1. The taxpayer must be regularly and actively engaged in the activity;
2. The activity must be undertaken with an expectation of profit; and
3. The taxpayer must hold himself out to others as engaged in the selling of goods and services.

Id. at 1065. The court criticized the Ditunno decision, contending that the facts-and-circumstances test was not a standard, but rather a predicate to the determination of whether the trade or business criteria are present. The facts and circumstances are not the criteria. Instead, it is the marketing of goods and services that is the standard for determining if expenses are incurred in a trade or business.

The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 94, 98 Stat. 615, has affected the trade or business interpretation of § 212 adopted in Hoopengarner. The new law makes it clear that expenses for the production of income incurred prior to business activity must also be capitalized. The 1984 Tax Act amendments to § 195 were directed at Hoopengarner's interpretation of § 212, and its applicability if an entity has not yet commenced its trade or business.
The election is irrevocable, and the period of amortization may not be altered.\textsuperscript{58} A section 709 election is made by attaching a statement to the partnership’s first tax return.\textsuperscript{59}

In the event the partnership should cease conducting business prior to the conclusion of its amortization period, the regulations provide that the partners would be allowed a deduction under section 165 for the unamortized balance.\textsuperscript{60} At dissolution, the regulations provide no deduction for capitalized syndication expenses.\textsuperscript{61}

Organization expenses are defined as expenses that are: (1) incident to the creation of the partnership; (2) chargeable to a capital account; and (3) without value that would survive the termination of the partnership.\textsuperscript{62} The regulations provide that all three requirements must be met in order to qualify as a section 709 organization expense.

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\begin{tabular}{lrrrr}
\textbf{Organization Expenses Listed}\textsuperscript{1} & \textbf{Amount} & \textbf{Date} & \textbf{Incurred} & \textbf{Whether or Not Paid}\textsuperscript{2} \\
\hline
1. Expenses less than $10 need not be separately listed. A total amount and the date on which the first and last expenditure occurred, must be provided. \\
2. If the partnership is on a cash basis, the statement must also note if the payment was made prior to year end. \\
An amended return may be filed to include organizational expenses not included in the original statement. \textit{Id.} \\
\textsuperscript{60} \textit{Id.} at \$ 1.709-1(b)(2). Section 709(b), read literally, provides that if the partnership is liquidated before the end of such 60 month period, such deferred expenses may be deducted under section 165. The \$ 165 deduction is not limited solely to taxpayers electing to amortize over 60 months. \textit{Id.} at \$ 1.709-1(b)(2); \textit{LTR 8217013}. \\
\textsuperscript{61} \textit{See} Treas. Reg. \$ 1.709-1(b)(2) (1983). However, to the extent the partners contributed funds to cover these costs, the contributions are reflected in the partner’s higher basis in their partnership interests. On liquidation, a loss or reduction in gain may result in a tax benefit for the partner because of these syndication costs. One commentator has stated that the tax benefit received by the partners may be a capital loss. \textit{Leder, Guaranteed Payments, Management, and Promoter Fees, 41 INST. ON FED. TAX’N \$ 14.11 n.72 (1983)}. Another commentator has stated that unamortized organization costs should be deductible as an ordinary loss on termination of the partnership (provided the partnership is not reorganized). This would be consistent with corporate law. \textit{Larason, May Partnership Syndication Costs Be Written Off Over a Limited Partnership’s Life?}, 58 J. TAX’N 336, 338 (1983).

In a corporate tax case, \textit{Malta Temple Ass’n v. Commissioner}, 16 B.T.A. 409 (1929), the court held that upon dissolution and surrender of its corporate franchise, the petitioner lost a corporate asset (organizational expenses), “no part of which had been returned to it through exhaustion deductions or as ordinary and necessary expense deductions.” \textit{Id.} at 411. Furthermore, the loss was deductible. The Commissioner has acquiesced in the \textit{Malta Temple} decision. XIII-2 CB 12 (1934).

\textsuperscript{62} Treas. Reg. \$ 1.709-2(a) (1983).
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\end{center}

\textsuperscript{58} Treas. Reg. \$ 1.709-1(b)(1) (1983).

\textsuperscript{59} \textit{Id.} at \$ 1.709-1(c). The form prescribed for the statement of election is as follows:

\textsuperscript{60} \textit{Id.} at \$ 1.709-1(b)(2). Section 709(b), read literally, provides that if the partnership is liquidated before the end of such 60 month period, such deferred expenses may be deducted under section 165. The \$ 165 deduction is not limited solely to taxpayers electing to amortize over 60 months. \textit{Id.} at \$ 1.709-1(b)(2); \textit{LTR 8217013}.

\textsuperscript{61} \textit{See} Treas. Reg. \$ 1.709-1(b)(2) (1983). However, to the extent the partners contributed funds to cover these costs, the contributions are reflected in the partner’s higher basis in their partnership interests. On liquidation, a loss or reduction in gain may result in a tax benefit for the partner because of these syndication costs. One commentator has stated that the tax benefit received by the partners may be a capital loss. \textit{Leder, Guaranteed Payments, Management, and Promoter Fees, 41 INST. ON FED. TAX’N \$ 14.11 n.72 (1983)}. Another commentator has stated that unamortized organization costs should be deductible as an ordinary loss on termination of the partnership (provided the partnership is not reorganized). This would be consistent with corporate law. \textit{Larason, May Partnership Syndication Costs Be Written Off Over a Limited Partnership’s Life?}, 58 J. TAX’N 336, 338 (1983).

In a corporate tax case, \textit{Malta Temple Ass’n v. Commissioner}, 16 B.T.A. 409 (1929), the court held that upon dissolution and surrender of its corporate franchise, the petitioner lost a corporate asset (organizational expenses), “no part of which had been returned to it through exhaustion deductions or as ordinary and necessary expense deductions.” \textit{Id.} at 411. Furthermore, the loss was deductible. The Commissioner has acquiesced in the \textit{Malta Temple} decision. XIII-2 CB 12 (1934).

\textsuperscript{62} Treas. Reg. \$ 1.709-2(a) (1983).
The first requirement would allow for deduction of expenses resulting from the creation of the partnership if the expenses were incurred a reasonable period of time before the partnership begins business, or before the filing of the partnership's first return. To qualify under the third requirement, the expense must be for an item of a nature normally expected to benefit the partnership throughout its entire life.

Expenses that would qualify as organization expenses under section 709 include legal fees, accounting fees, and filing fees incident to the organization of the partnership. Those expenses would include professional fees for negotiation and preparation of the partnership agreement. The regulations also list expenses that would not qualify as organization expenses. Those expenses include:

1. expenses of acquiring or transferring assets;
2. expenses of admission or removal of partners, other than when the partnership is first organized;
3. expenses of negotiating and signing a contract, if the contract relates to the operation of the partnership business (even where the contract is between the partnership and one of its members), and;
4. syndication expenses.

For purposes of section 709, syndication expenses are defined as expenses connected with the issuing or marketing of partnership interest. Examples of syndication expenses would include broker's fees, registration fees, costs associated with the prospectus, and promotional materials. As stated previously, section 709(a) denies current deductibility for syndication expenses. The regulations specifically state that syndication fees are not subject to section 709(b) amortization and must be capitalized by the partnership.

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63. The expenses must be for the creation of the partnership and not for the operation or the starting of the operation of the partnership trade or business. *Id.*
64. See generally Leder, supra note 61, at 14-30. This could pose problems for partnerships formed late in the year when all organization expenses have not yet been incurred by year's end. One example would be legal fees in connection with the filing of a certificate of limited partnership. This expense may not qualify for the § 709(b)(1) amortization if incurred after the end of the first tax year.
66. *Id.*
67. *Id.*
68. *Id.* at § 1.709-2(b).
69. *Id.* One commentator has suggested a test for determining what constitutes a syndication expense for tax advice. Leder advocates a "but for" test. Syndication expenses should include fees for tax advice only to the extent such fees are greater than they would have been had there been no formal syndication. See Leder, supra note 61, at 14-31. See also infra Part VI.
70. Treas. Reg. § 1.709-2(b) (1983). For arguments on potential deductibility, see infra note 98.
PARTNERSHIP EXPENSES

V. SECTION 709 CASE LAW

A. Post-709, Pre-effective Date

The first post-709 case was *Kimmelman v. Commissioner.* In *Kimmelman*, the petitioner was a limited partner in five limited partnerships that invested in real estate improved by unprofitable vineyards. The partnerships held the land for resale, and rented the vineyards. The partnerships were charged a general partner fee equal to 10 percent of the purchase price, and a yearly management fee of 1 percent of the purchase price.

The Tax Court, citing *Cagle*, held that expenses incurred incident to the organization and syndication of a partnership are capital in nature, and therefore not currently deductible. The court then noted that the section 709(b) election to amortize was not available.

In arriving at its decision, the court stated that the entity approach to partnerships adopted by Congress in the 1954 Internal Revenue Code, and the court in *Cagle*, was consistent with the court's current holding that guarantee payments to partners for performing services that were capital in nature are non-deductible. Expenditures relating to the acquisition of an asset that has a useful life greater than one year are capital in nature and are not deductible as business expenses. The court concluded that the management fee must be capitalized because the 10 percent fee included costs of organization and syndication.

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71. 72 T.C. 294 (1979).
72. Services provided by the general partner included negotiating the purchase price, retaining a civil engineer to survey and search title, having a title insurance company insure the title, retaining an accounting firm to set up the books, retaining a bank to set up a deed of trust, and retaining an escrow agent to handle the purchase. Each individual was paid for his/her services. Id. at 297-98.
73. Id. at 303-04.
74. See I.R.C. § 706(a) (CCH 1985).
76. Id. at 306. The petitioners could not substantiate their claim that the management fee was paid for services rendered other than organization or syndication. The court found the petitioners' evidence vague as to the services performed. Petitioners also made an argument that these fees were deductible under § 212. The court stated that § 212 does not enlarge the range of allowable deductions vis-a-vis § 263, but merely enlarges the category of income with reference to which expenses were deductible. Id. at 306 n.4 (citing McDonald v. Commissioner, 323 U.S. 57, 62 (1944)). Capital expenditures were held to be non-deductible under § 212.

In *Huber v. Commissioner*, 49 T.C.M. (CCH) 57 (1984), the Tax Court relied on *Kimmelman* in reaching its decision on the deductibility of an up-front management fee. The partnership in question was formed to buy farms in sub-standard condition, make improvements, and then operate or lease the farms until they could be sold at a profit. A management fee equal to 10 percent of the purchase price was paid on the date the agreement to purchase a farm was executed. Services included in the management fee included evaluation of the prop-
In Wendland v. Commissioner, the Tax Court discussed section 709 extensively, even though the amortization provisions of section 709(b) did not apply because the tax years in question were prior to the effective date of the section. Wendland involved a limited partnership formed to acquire an ongoing coal mine. The partnership incurred extensive legal fees in its formation, which were then passed through to the partners and deducted pro rata.

The issue before the Tax Court was whether the legal fees in question were ordinary and necessary expenses that would be currently deductible, as advanced by the petitioner, or whether the legal fees were organization expenses, and therefore had to be capitalized, as contended by the Commissioner. The court stated that legal fees relating to the organization and sale of partnership interests are not currently deductible. The nature of the services performed must be examined to determine whether the expenditure is ordinary or necessary, or capital.

The court held that Congress intended section 709 to parallel sections 248 and 263, and for that reason, “the portion of the fee attributable to legal advice must be capitalized.” In reaching its decision, the court stated no opinion as to whether tax advice is deductible under section 212(3), or whether section 709 overrides section 212(3) with respect to tax advice. The court did state, however, that it did not have enough evidence before it to determine whether section 212(3) was applicable because petitioner had not distinguished legal advice from tax advice in the services it received.

The courts that examined situations dealing with the organization, appraisal, engineering assessment, negotiation of the sales price, drafting of contracts, and drafting of the partnership agreement.

The court stated that § 162(a) must be satisfied in order for the expense to be deductible by the partnership. Deductibility under § 162(a) depends on the nature of the services performed rather than the designation or treatment of the expense by the partnership. Id. at 60. The court determined that a large portion of the management fee went towards selecting farms to be purchased, contacting limited partners, and setting up the partnerships. As such, these expenses were characterized as organization and syndication expenses, and they were treated as non-deductible capital expenses. Id. The expenses in question were incurred from 1974-76, therefore § 709(b) amortization was unavailable.

77. 79 T.C. 355 (1982).
78. Id. at 367 n.19.
79. The lawyer prepared the confidential offering memo, obtained geological information, rendered a tax opinion, and prepared income and expense projections. Id. at 388.
80. The petitioner has the burden of proving that the fee accrued by the partnership is currently deductible. TAX CT. R. PRAC. & P. 142(a). See generally Welch v. Helvering, 290 U.S. 111 (1933).
83. Id.
of partnerships, as previously noted, followed the proscription of section 709, and declared organization and syndication expenses to be non-deductible capital expenditures.

A major case, which has been seen as retreating from some of the section 709 requirements, was decided by the Court of Claims in 1982. *Blitzer v. United States,*[^84] dealt with a suit for refund of taxes. A partnership was formed to construct and operate a housing project. The land was purchased in 1971, loan commitments and investors were secured by 1973, and construction was completed in 1974. At issue was the deductibility of the petitioner’s share of losses attributable to fees claimed to have been paid to the construction mortgagee and the administrative general partner.

Focusing on the deductibility of organization and syndication expenses, the court examined several transactions of the partnership. The construction mortgagee charged the partnership, by deducting from the loan proceeds, an initial service charge and a federal mortgage commitment fee it had paid. The petitioner claimed that this amount was totally deductible because it was additional interest.[^85] Respondent argued that such a charge was a reimbursement to the mortgagee for services performed, and should be deductible over the life of the loan.

The court determined that there was no correlation between the bank's services and the fee it charged. The court determined the fee to be an additional charge for the use of the money, and therefore deductible under section 163.[^86] However, the court went on to state that a cash basis taxpayer who gives a promissory note for interest does not thereby become entitled to a deduction for interest paid pursuant to section 163.[^87] The court determined the federal loan commitment fee was not interest, but rather a cost involved in obtaining a loan that must be amortized over the life of the note.[^88] The court concluded that the commitment fee benefited both the lender and the borrower, thereby refuting the mortgagee’s contention that it was a

[^84]: 684 F.2d 874 (Ct. Cl. 1982).
[^86]: Blitzer v. United States, 684 F.2d 874, 882 (Ct. Cl. 1982). *See also* Wilkerson v. Commissioner, 70 T.C. 240 (1978), *rev’d*, 655 F.2d 980 (9th Cir. 1981). *But see* Gaines v. Commissioner, 45 T.C.M. (CCH) 363 (1982) (guaranteed payments held not deductible even though included in recipient's income); Goodwin v. Commissioner, 75 T.C. 424 (1980) (bank loan fees held not deductible, requiring fees to be capitalized over the lives of the associated loans); Lane, *supra* note 57, § 21.05 at 21-21 (real property construction-period interest and taxes capitalized under I.R.C. § 169(c)(1)).
[^88]: Blitzer v. United States, 684 F.2d 874, 890 (Ct. Cl. 1982).
"mere conduit." 89

The court disallowed a deduction for the partner's proportionate share of the administrative general partner's fee. 90 The court stated that limited partnerships should be afforded the same treatment as corporations when dealing with issues of organization, issuance of stock, and acquisition of assets. 91 For corporations, these expenses have long been held to be non-deductible, capital expenses. 92 Citing Woodward v. Commissioner, 93 the court stated that capital expenditures are not limited to the actual costs of the assets, but also include legal, brokerage, accounting, and other ancillary expenses incurred in acquiring a capital asset. 94 In its most controversial holding, the court held that services ancillary to forming the partnership 95 and syndicating its shares should be amortized over the fifty year life of the partnership. 96 This holding has been followed in one case, 97 and has prompted a debate among commentators. 98

89. Id. The lender could only assure repayment at face value if it received the Federal National Mortgage Association commitment. Also, the lender had the option of keeping the loan if it was profitable or selling the note at a premium.

90. Id. at 893. The role of the administrative general partner was summarized as "looking out for the interests of the limited partners and doing everything it can do to see that the partnership is managed properly and effectively, remains viable, and does not default. . . ." Id. at 890. Services performed by the general partner included the conducting of a feasibility study, preparation of partnership documents, retaining a Certified Public Accountant, selection of a management company, making progress reports on construction, marketing units and supervising operations. Id.

91. Id. at 893 (citing Kimmelman v. Commissioner, 72 T.C. 294 (1979); Cagle v. Commissioner, 63 T.C. 86 (1974), aff'd, 539 F.2d 409 (5th Cir. 1976); Meldrum & Fewsmith, Inc. v. Commissioner, 20 T.C. 790 (1952)).

92. Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). The Court stated that § 263 took priority over § 151: "The clear import of § 161 is that, with stated exceptions . . . , an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI." Id. at 17.


94. Blitzer v. United States, 684 F.2d 874, 893 (Ct. Cl. 1982). See also Estate of Boyd v. Commissioner, 76 T.C. 646 (1981). Boyd involved expenses incurred in the organization of an oil and gas partnership. The petitioner claimed that expenses involved in the evaluation of oil properties that ultimately were not acquired were deductible. The court held them to be non-deductible, capital expenses because the partnership was in the business of producing oil, not locating and buying properties.

95. See Treas. Reg. § 1.167(a) to 10(b) (1960).

96. Blitzer v. United States, 684 F.2d 874, 893 (Ct. Cl. 1982).

97. Sartin v. United States, 5 Ct. Cl. 172, 179 (1984). The Claims Court stated that it was bound by Blitzer, and had no authority to overrule it. The tax year in question in Sartin was 1975.

98. Larason, supra note 61, advances several theories to support his conclusion that syndication costs should be amortized. He first argues that § 709 has language similar to § 263(a) ("no deduction shall be allowed"), but that § 263(a) has never been interpreted to deny depreciation or amortization. Larason further states
Taxpayer interest in the Blitzer ruling, and its later acceptance by the court in Sartin v. United States,99 must be tempered for two reasons. Both Blitzer and Sartin involved refund claims for years prior to 1976. It is unclear what effect the Claims Court would give section 709 if faced with a post-1976 syndication fee deduction, in light of its Blitzer and Sartin decisions. Also, the partnership involved in Blitzer had a limited life of fifty years. There is no clue given in Blitzer as to how partnerships with unlimited lives are to be treated. A recent Tax Court case and Revenue Ruling have rejected the Blitzer and Sartin approach to the treatment of syndication expenses.100 At present, the Blitzer and Sartin decisions thus seem to be restricted to the Claims Court for the benefit of taxpayers who can afford to pay the tax in question and then sue for a refund.

The period of time between Cagle in 1974, and Blitzer in 1982, saw major developments occur with respect to the deductibility of partnership organization and syndication expenses. Not only was section 709 enacted and regulations thereunder promulgated, but also a number of cases were decided with relation to organization and syndication expenses. Thus, the scarce case law of the 1950's and 1960's was compensated for by a two-pronged attack of legislation and case law in the 1970's and early 1980's.

B. Post-709, Post-effective Date

The final area to be examined is how the Service and courts have dealt with section 709 issues subsequent to the effective date of the legislation. The cases examined in the prior section all recognized the existence of section 709, but were not bound by it because the issues in question related to taxable years prior to the effective date of section 709. This section of the Article will analyze the post-effective date section 709 decisions and lay the foundation for planning considerations in section 709 situations.

Revenue Rule 81-153101 was the first post-section 709 ruling directed at organization and syndication expenses. The Ruling involved a tax advisor who entered into an agreement with a promoter to sell

100. See infra notes 112-19 and accompanying text.

that since Blitzer is based on § 263 and Cagle, and since § 709 was stated to codify those principles, the Blitzer decision would support the proposition that § 709 does not preclude amortization of syndication expenses.

A subsequent article, McGuire, Can the Syndication Costs of a Partnership be Amortized? An Analysis of Authorities, 59 J. TAX'n 208 (1983), refutes Larason's theory. McGuire states that it is clear based on treatment of corporations and prior partnership cases that amortization of syndication costs is prohibited by § 709. He states that even without § 709, case law has provided that the cost of acquiring capital is non-amortizable.
partnership interests to his clients. The promoter offered to pay an 8 percent "rebate" to the tax advisor's clients if any of his clients invested. In return the tax advisor agreed not to bill any clients who did not invest. The rebate was not offered to non-clients. The partnership's prospectus represented that such a payment would be deductible under section 212.

The Service ruled that the payments were, in fact, payments made by the promoter to the tax advisor, with the client merely acting as a conduit. As such, the payment made in compensation for tax services is considered to be made by the promoter, and it is not deductible by the client/investor. The Service considered the expenses involved to be obligations of the partnership, and not of the investor.

The payments were held to be non-deductible by the partnership under section 709 because the payment was in substance a commission for the sale of a partnership interest. The tax advisor's services related solely to the sale of the interests and not to the organization of the partnership. A similar result would occur if the partnership had deducted the rebate from the purchase price and paid the tax advisor itself.

In Cornutt v. Commissioner, a CPA incurred transportation and other expenses while soliciting clients of the firm he worked for in order to determine whether or not they would retain him if he opened his own firm. The Commissioner disallowed the deductions, arguing that because they were incurred in the establishment of a new trade or business, they should be capitalized. The court disagreed with the Commissioner's argument that section 709 should apply. It held that the expenses were not incident to the creation of a partnership, but instead were incurred to determine potential client base without regard to the form of entity used. Since no assets were acquired, the expenses were not of a nature requiring capitalization.

In Marine Contractors & Supply, Inc. v. Commissioner, peti-

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102. In a typical situation, a client would invest and receive a bill from the tax advisor for tax advice. The client would then receive the "rebate" from the promoter. This rebate would then be used by the client to pay the bill from the tax advisor.
103. 45 T.C.M. (CCH) 515 (1983).
104. Id at 517.
105. Id. The fact that the petitioner ultimately formed a partnership was held by the court to be of no consequence. The court, however, should have found that these expenses were incident to the creation of a partnership because the petitioner chose to operate his new business as a partnership based on the information his survey collected. This type of expense should be classified as a § 195 start-up cost. Start-up expenses are defined as amounts paid or incurred in creating or investigating the creation or acquisition of an active trade or business. This definition would seem to characterize the expenses incurred in Cornutt.
106. 43 T.C.M. (CCH) 305 (1982).
tioner was a corporation engaged in contract drilling of oil and gas wells and related services. The president of petitioner was also the chief executive of the general partner in a number of oil and gas limited partnerships. To procure financing, selling agents corresponded with the general partner concerning the sale of partnership interests. After securing an investor, the selling agent remitted the investment to the general partner. The petitioner was then to pay the selling agent a commission of not greater than 10 percent of the amount invested from its corporate account. There were no express agreements between the petitioner and the general partner as to commissions, but there was an agreement between the president of petitioner and the selling agents whereby petitioner would pay the commissions.

The petitioner contended that the commissions were an ordinary and necessary expense because securing investors was necessary in order to insure that petitioner would receive drilling contracts. The court stated that the commissions were in essence syndication fees of the partnership and as such were non-deductible capital expenses. The court was unwilling to convert an otherwise non-deductible expense into a deductible expense by virtue of an individual's dominance over other related entities such that he is able to cause another entity to make the expenditure.107

In Surloff v. Commissioner,108 the petitioners were partners in a limited partnership formed to mine coal in Kentucky and Tennessee. The partnership agreement provided that cash contributions of the partners would apply primarily to the general partner commencement fee, attorney's fees, offeree-representative fees, and advance royalties. The Tax Court determined that the partnership was not engaged in a trade or business. Payments to the general partners were therefore non-deductible under section 162(a).109 Because the payments were non-deductible under section 162(a), the court stated that there was no need to determine their status under section 709.110

The offeree-representative was required to assist each partner in the evaluation of the relative risk of investing in the partnership. If there was a decision to invest, the offeree-representative received 10 percent of the amount invested. The court held that this expenditure must be capitalized because the services were rendered to the partners rather than to the partnership. For that reason, they were not ordinary and necessary expenses of the partnership.

In addition, the court held that tax advice is non-deductible when used solely as an aid in selling partnership interests. The attorneys had prepared tax opinion letters and met with the potential investors.

107. Id. at 308.
109. Id. at 240 n.63.
110. Id. at 243-44.
and the offeree-representatives to explain the financial and tax implications of the investment. The court held that these expenses facilitated the sale of partnership interests, and therefore, they must be capitalized.\textsuperscript{111}

A recent Tax Court case and Revenue Ruling have cast considerable doubt on the viability of the \textit{Blitzer} decision on the subject of amortization of syndication expenses. In \textit{Estate of Thomas v. Commissioner},\textsuperscript{112} the petitioner amortized the general partner's commission over the nine year life of the partnership. The partnership in question was formed to acquire computer central processing units and related equipment, to lease or sell the equipment to others, and to perform any acts necessary to accomplish those purposes.

The Tax Court recognized that the question of the proper treatment of the capitalized costs was a case of first impression before the court. The petitioner contended that the partnership should be permitted to deduct the capitalized costs annually over the partnership's life. The respondent, on the other hand, contended that amortization was inappropriate and that recovery should only be allowed upon liquidation of the partnership.\textsuperscript{113}

The court looked to the treatment of corporations in determining that partnership syndication costs may not be amortized.\textsuperscript{114} In reaching its decision, the court noted that fees paid by corporations in connection with stock issues (such as broker's commissions) have historically been treated as a reduction of capital, and accordingly have been held to be non-amortizable.\textsuperscript{115} The court also examined the legislative history of section 248 and section 709 regarding syndication expenses. The court noted that Congress recognized when drafting

\begin{footnotes}
\footnotetext[111]{Id. at 245-46. In \textit{Flowers v. Commissioner}, 80 T.C. 914 (1983), the petitioners claimed a deduction for tax advice. The court noted that a large portion, if not the entire amount of the expense, was incurred for purposes of obtaining the tax opinion letter which accompanied the prospectus. Quoting § 709, the court held that since the petitioners failed to prove that the tax advice was incurred for a purpose other than to promote the sale of an interest in the partnership, it was not deductible. \textit{Id.} at 943.}

\footnotetext[112]{84 T.C. 412 (1985).}

\footnotetext[113]{\textit{Id.} at 441.}

\footnotetext[114]{The court stated: "'[A] commission is a capital expenditure to be charged against the proceeds of the stock, not recovered from operating earnings. It merely reduces the net returns from the sale of the stock and reduces the available capital. It has no relation to operating expenses.'" \textit{Id.} at 441-42 (quoting \textit{Barbour Coal Co. v. Commissioner}, 74 F.2d 163, 164 (10th Cir. 1934), \textit{cert. denied}, 295 U.S. 731 (1935)). The court also stated that "[a]n argument might be made that these expenses are similar to loan costs, which are capitalized and deducted pro-rata over the life of the loan . . . While this theory might be persuasive if we were writing on a clean slate, we cannot overlook the fact that the law in the corporate context—which clearly provides a closer analogy—is to the contrary." \textit{Id.} at 442 n.53.}

\footnotetext[115]{\textit{Id.} at 442.}
\end{footnotes}
both sections that the amortization that was provided for organization expenses was not available for syndication expenses.\textsuperscript{116}

Addressing the Court of Claims decision in Blitzer, the court in Estate of Thomas stated that it "[did] not feel compelled to follow [the] ruling...\textsuperscript{117}" The court stated that in Blitzer, the Commissioner conceded that amortization over the fifty year life of the partnership was called for in that case. Thus, the Court of Claims did not address the issue of the amortization of syndication expenses in an adversarial manner. The court instead reached a conclusion argued for by the Commissioner in the alternative.\textsuperscript{118}

The Service has also recently promulgated a Revenue Ruling on the issue of whether a partnership can amortize syndication expenses incurred in connection with the sale of limited partnership interests. Revenue Ruling 85-32\textsuperscript{119} involved a promoter who amortized the cost of printing the prospectus for his hotel limited partnership. After briefly reciting the applicable code and regulation sections, the Service stated that the cost of printing a prospectus is a syndication expense that is not eligible for amortization under section 709(b). Section 709(b) was held to supersede any other section with respect to the deductibility of the cost of a prospectus. Therefore, the Service held that syndication costs are expenses chargeable by the partnership against the capital account, and are thus non-amortizable.

The decisions dealing with section 709 have not addressed all the relevant issues. Several areas have been addressed, as evidenced by the cases cited in this section, but some still remain open for discussion. These areas of current controversy will be the next topic of discussion.

\section*{VI. PLANNING CONSIDERATIONS}

When faced with the organization of a partnership, a tax planner must address several key issues. The first of these is how attorneys or CPAs should keep records of their time. In any action concerning the deductibility or non-deductibility of an expense, the petitioner carries the burden of proving current deductibility.\textsuperscript{120} A number of attorneys or CPAs will work on both partnership formation and the selling of partnership interests. Because the treatment of these expenses is different under section 709, care should be exercised in properly documenting the time spent for both functions. The authors of one treatise even advocate the submission of separate billing statements for work.

\textsuperscript{116} Id. at 442-43.
\textsuperscript{117} Id. at 444.
\textsuperscript{118} Id.
\textsuperscript{119} 1985-12 I.R.B. 6.
\textsuperscript{120} Supra note 80.
related to organization and work related to syndication.\textsuperscript{121}

Several recent cases have shown the danger of a lump sum statement for professional services.\textsuperscript{122} One of these cases, \textit{Wildman v. Commissioner},\textsuperscript{123} illustrates the necessity of proper documentation of time. Petitioner was a limited partner in a partnership formed to acquire and distribute a movie. A lump sum statement for legal fees was given to the partnership by its attorneys. The statement listed the services performed,\textsuperscript{124} but gave no breakdown as to time allocated for each. The Tax Court concluded that since no substantiated basis for the value of the services performed was provided, it could not allocate between deductible and non-deductible services. As a result, the entire amount of the legal fees was required to be capitalized.\textsuperscript{125}

\begin{footnotesize}
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\item \textsuperscript{121} \begin{itemize}
\item PARTNERSHIP TAXATION, supra note 19, § 21.01 at 21-5 to 6.
\item \textsuperscript{122} Johnsen v. Commissioner, 83 T.C. 103 (1984); Huber v. Commissioner, 49 T.C.M. (CCH) 57 (1984); Flowers v. Commissioner, 80 T.C. 914 (1983); Wildman v. Commissioner, 78 T.C. 943 (1982).
\item \textsuperscript{123} 78 T.C. 943 (1982).
\item \textsuperscript{124} The services performed included tax planning for the structuring of the partnership, drafting the partnership agreement, acquiring the movie, reviewing the distribution agreement, and soliciting and screening limited partners. \textit{id.} at 960.
\item \textsuperscript{125} \textit{id.} at 961. The petitioners relied on the testimony of one of the law firm's partners. The court stated that the testimony provided little more than a description of the work done, and it did not provide a clue as to the time spent on each service.
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In Johnsen v. Commissioner, 83 T.C. 103, 126-29 (1984), one item of controversy was a limited partnership that incurred legal fees and consulting and advisory fees prior to construction of the apartment complex that the partnership was formed to construct. The court held that the partners could not deduct any of the fees because of their failure to prove that any portion of the fees were deductible. The partnership incurred the expenses at issue in 1976; therefore, § 709(a) applied, but § 709(b) amortization was unavailable.

The partnership paid $10,000 for legal advice, $7,500 of which was deducted as tax advice. The law firm submitted an unitemized bill for its services. No member of the firm testified at the trial. The petitioner requested that the court apply the rule of Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930) (where portion of deductible expenses undocumented, still "unfair, wrong, and inconsistent" to disallow entire amount), in order to determine the deductible portion of the legal fees.

The court stated that in order to make a Cohan estimate, the court must be convinced from the record that the limited partnership incurred expenses for deductible tax advice in at least the amount allowed in such estimate; absent that assurance, "relief to the taxpayer would be unguided largesse." Johnsen v. Commissioner, 83 T.C. 103, 127 (1984). The court was unsure what portion of the fee went to tax advice and which portion went to organization advice. In addition, evidence was received that indicated that the tax advice may have primarily been for preparation of a tax opinion letter that was non-deductible under Surloff v. Commissioner, 81 T.C. 210 (1983). The court, therefore, applied the rule in Wendland v. Commissioner, 76 T.C. 355 (1982), and held that none of the fees were deductible.

Fees were paid to an investment consulting firm for selling and organization expenses as well as tax advice. The firm was made up of several of the general partners of the partnership. The partnership allocated 60 percent of the fee, or
A similar type of holding was reached in *Wildman* with relation to up-front management fees. Because payments to general partners are subject to section 709, whether coming under section 707(a) or section 707(b), it is important to ensure that portions of this payment are allocated to services performed in a reasonable manner. In *Wildman*, the partnership paid the general partner a lump sum amount prior to release of the movie. The court held that since no details were provided as to the specifics of the services that the taxpayer contended had been performed, the payment would be treated as a fee for putting together a syndication. The court held this expense to be a non-deductible, capital expense. Deductibility, stated the court, depended on the nature of the services performed, rather than the designation given those expenses by the partnership.

The issue of the treatment of expenses for tax advice is one of continuing controversy. The court in *Surloff* stated that tax advice used solely as an aid in selling partnership interests is non-deductible. However, section 212(3) states that a current deduction is available for expenses paid or incurred in connection with the determination, collection, or refund of any tax. Finally, the regulations under section 709 treat as syndication expenses the legal fees for advice relating to the adequacy of tax disclosures in the prospectus and the placement memorandum for securities law purposes. The language of the cur-

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126. Services performed by the general partner included retaining of consultants, marketing, negotiating the distribution agreement, liaison with attorneys, and retaining tax advisors.


128. I.R.C. § 212 (CCH 1985). Section 212 provides:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

1. for the production or collection of income;
2. for the management, conservation, or maintenance of property held for the production of income; or
3. in connection with the determination, collection, or refund of any tax.

rent regulations is narrower in scope than that of the original regulations proposed for section 709.130

It is within the above parameters that various commentators have given planning ideas with relation to expenses for tax advice. Under facts similar to Revenue Ruling 81-153, it is apparent that a section 212 deduction would have been available had the investor directly retained the tax advisor to advise him on the tax implications of an investment in the partnership. One commentator has theorized that if the tax advisor in Revenue Ruling 81-153 had refused a commission from the promoter and then negotiated a decrease in cost for the investor, a subsequent arrangement with the investor for compensation would appear to be for tax advice and not for marketing of the interest.131 The key to avoiding Revenue Ruling 81-153 is for the investor to avoid the appearance of being a mere “conduit” between the promoter and the tax advisor. One way to assure this is to have the tax advisor bill all potential investors for any tax advice rendered. Under the facts of Revenue Ruling 81-153, the tax advisor received compensation only if the potential investor was a client, and then only when the potential investor actually invested. When the tax advisor is compensated only when the potential investor invests, a strong argument can be raised that the amount paid is really a sales commission.

A similar situation to that in Revenue Ruling 81-153 received a negative ruling by the Service in a Private Letter Ruling.132 The law firm in question had a policy of evaluating real estate partnerships, and putting clients in touch with syndications if they found them to be sound. The firm did not bill clients until they invested. The Private Letter Ruling stated that section 212 must defer to section 263 in determining deductibility.133 In its rationale, the Service stated that the law firm went beyond tax advice by actually seeking out and negotiating investment opportunities. The key issue, as seen by the Service, was that the taxpayer did not receive personal tax advice on property already identified, but in fact paid the law firm to pick out the asset for them. Since the expenses originated within the process of acquisition, they were not deductible under section 212(3), and had to be

131. See Leder, supra note 61, at 14-31 to 32.
132. LTR. 8108008.
133. The law firm policy was to modify the partnership agreement, if necessary, to benefit the client. A set price was charged to the clients (total cost divided by the number of investors) and a minimum fee was charged to clients who did not invest. The law firm did not represent the client at the closing and no money was funneled through the law firm. The law firm also monitored the clients after investment. Occasionally, the law firm would represent the syndicators. Id.
134. Id. See also Treas. Reg. § 1.212-1(e) (1975).
An argument exists that tax advice, such as advice regarding the tax aspects of how the partnership will operate, projections or forecasts to help plan the operation, and overall tax considerations in structuring a transaction, are not syndication expenses and are either currently deductible or amortizable. One commentator argues that only tax advice that relates to securities law tax disclosures should be capitalized as a syndication expense. Another commentator points to the language of the regulations defining syndication expenses as possibly providing a loophole for deductibility of tax advice. The regulations state that syndication expenses include: "legal fees . . . for advice pertaining to the adequacy of tax disclosures . . . ; [and] accounting fees for preparation of representations to be included in the offering materials . . . ." This distinction may suggest that legal fees that relate to preparation of tax services do not constitute syndication fees. This conclusion, however, is highly suspect in light of the Surloff decision.

The authors of a partnership taxation treatise have listed a number of areas of tax advice that they believe could be deductible, even though rendered in connection with the formation of a partnership. Those areas include:

1. whether it is desirable to retain property and rent to the partnership;
2. tax advice relating to partner contributions;
3. tax advice relating to the transfer of partner property to the partnership;
4. application of section 465 at risk rules;

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135. In Collins v. Commissioner, 54 T.C. 1656 (1970), the petitioner hired an attorney to structure the purchase of an apartment. After the purchase was arranged, the petitioner hired a CPA to secure the best possible tax treatment of the purchase. The Court differentiated between the work done by the CPA and the work done by the attorney. The test was said to be the intent of the person rendering the services. The CPA's services were deductible because they were intended to secure tax advantages. The lawyer's services were non-deductible because they related to the acquisition of property.

137. See id. at § 195 or id. at § 709(b).
138. Podlin and Mitrano, supra note 127.
141. Partnership Taxation, supra note 19, at § 21.03. The authors state that simply because an expense is for tax advice does not keep it from being capitalized. See also Honodel v. Commissioner, 722 F.2d 1462, 1468 (9th Cir. 1984) ("Tax advice directly related to a capital acquisition or disposition is an expense which must be capitalized, just as are legal, brokerage, and other ancillary expenses.").
The type of partnership will also influence planning in the area of organization and syndication expenses. In a large publicly traded limited partnership, a vast majority of first year expenses will go towards syndication. This result is to be expected because there is no doubt as to what the initial expenses of a publicly traded syndication will consist of. Private syndications may provide more opportunity for planning.

VII. CONCLUSION

Although it has been law almost ten years, very few cases have been specifically decided under section 709. Even the most recent cases in the area involved tax years prior to 1977. In the future, the area to watch will be syndication expenses. The regulations relating to syndication expenses are meager in comparison to the organization expense provisions under section 709.

One major question to be addressed is the treatment of capitalized syndication costs upon liquidation of the partnership. The regulations provide no deductibility, but this is inconsistent with corporate treatment and the views of several commentators. Another area to watch will be the continued discussion concerning what constitutes tax advice for purposes of the regulations. The final area to be watched will be the Court of Claims' response to Estate of Thomas. An affirmance of the Blitzer ruling by the Court of Claims could set the stage for a showdown on one of the most critical elements of section 709.

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142. PARTNERSHIP TAXATION, supra note 19, at § 21.03.
143. Telephone interview with Gallen Hull, Vice-President of JMB Realty, Inc., Chicago, Ill. (Apr. 3, 1985). Mr. Hull stated that JMB was not at all aggressive in how its organization and syndication expenses were treated. He stated that the expenses are examined for a partnership, and depending on the size and materiality of the expenses involved, a scope is set. Any expense above that scope amount is capitalized. Any expense below that amount is either amortized or deducted. Expenses that are deducted are usually ancillary, overhead type expenses which could not easily be segregated (i.e., secretarial expenses, telephone, copying).
144. See supra notes 76 & 125 and accompanying text.
146. See supra note 61.