

1995

## A Comparison of Partnership Income Taxation in the United States and Germany: A Study in Differences

Walter D. Schwidetzky

Follow this and additional works at: <http://digitalcommons.wcl.american.edu/auilr>



Part of the [International Law Commons](#)

---

### Recommended Citation

Schwidetzky, Walter D. "A Comparison of Partnership Income Taxation in the United States and Germany: A Study in Differences." American University International Law Review 10, no. 4 (1995): 1331-1364.

This Article is brought to you for free and open access by the Washington College of Law Journals & Law Reviews at Digital Commons @ American University Washington College of Law. It has been accepted for inclusion in American University International Law Review by an authorized administrator of Digital Commons @ American University Washington College of Law. For more information, please contact [fbrown@wcl.american.edu](mailto:fbrown@wcl.american.edu).

# A COMPARISON OF PARTNERSHIP INCOME TAXATION IN THE UNITED STATES AND GERMANY: A STUDY IN DIFFERENCES

Walter D. Schwidetzky\*

## INTRODUCTION

This article compares how partnerships are taxed under the German and United States legal systems. In so doing, the reader is introduced to the virtues and deficits of the two nations' respective partnership tax systems.

The partnership-type entities that exist under German law parallel those that exist under United States law. Germany has the general partnership (*Offene Handelsgesellschaft* or "OHG") and the limited partnership (*Kommanditgesellschaft* or "KG"). As in the United States, a German limited partnership also can have a corporate general partner, commonly a *Gesellschaft mit beschränkter Haftung* (GmbH), in which case the limited partnership is called a GmbH & Co. KG.<sup>1</sup> Neither Germany

---

\* Walter Schwidetzky is a professor of law at the University of Baltimore School of Law and director of the University's Graduate Tax Program. He wishes to thank Dr. Edith Palmer of the Library of Congress, Sabine Zimmzick, Dipl. Finanzwirtin, of the Westfälische Wilhelms-Universität, and Mr. Harvey Morrell of the University of Baltimore Library for their invaluable substantive assistance, Prof. Wendy Gerzog for her helpful editorial comments, Ms. Andrea Gillespie, a law student and former graduate tax student at the University of Baltimore, for her outstanding research efforts, and Ms. Peggie Albiker for her word processing talents. The responsibility for any errors or omissions is, of course, their's.

1. German law does not require a GmbH general partner in a GmbH & Co. KG to have an equity interest in the partnership, i.e., no actual partner may have unlimited liability. Nonetheless, this type of partnership will survive scrutiny, if there is a legitimate business purpose for its formation.

The German GmbH is an entity similar to the United States limited liability company. The latter is a relatively new, but increasingly popular, entity in the United States. As is the case with a corporation, the members of a GmbH or a United States limited liability company do not have liability for the debts of the entity. A

nor the United States generally imposes an entity level income tax on

GmbH, however, is distinguishable from a corporation in certain perspectives. For example, stock certificates are not issued and members of a GmbH have more rights to participate in management than do the shareholders of a corporation. The GmbH and the United States limited liability company, in fact, represent something of a hybrid between a partnership and a corporation.

While the limited liability company is typically taxed as a partnership in the United States, in Germany the GmbH is taxed as a corporation. *Compare* Rev. Proc. 95-10, 1995-3 I.R.B. 20 (describing taxation of a United States limited partnership) with *Körperschaftsteuerreformgesetz* [KStG] § 1, 1967 Bundesgesetzblatt [BGBl] I 2597 (F.R.G.) (describing taxation of a German GmbH). The Internal Revenue Service, however, no longer insists that the GmbH be taxed as a corporation in the United States; therefore, the GmbH can qualify as a partnership for United States income tax purposes. Rev. Rul. 93-4, 1993-1 C.B. 225. *See generally* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, ON LIMITED LIABILITY COMPANIES (1992); MARK SARGENT & WALTER D. SCHWIDETZKY, THE LIMITED LIABILITY HANDBOOK (1995) (discussing the law and practice of limited liability companies and partnerships in the United States); German Tax & Business Law Guide (CCH Europe) ¶ 127-250 (Feb. 22, 1994) [hereinafter CCH] (discussing the taxation and entity classification of German partnerships); Gumpel World Tax Series: Germany (CCH) ¶¶ 5/5.2-5.3 (1982) [hereinafter Gumpel] (discussing the German silent partnership and the GmbH & Co. KG); Mark R. von Steinberg, *The Close Corporation's Counterparts in France, Germany, and the United Kingdom: A Comparative Study*, 5 HASTINGS INT'L & COMP. L. REV. 291 (1981/82) (comparing the German GmbH structure to the United States close corporation).

Germany has several specialized partnerships, one of which is a general partnership organized for non-commercial purposes, the *Gesellschaft bürgerlichen Rechts* (GbR). The GbR is taxed as a partnership. *Amtliches Einkommensteuergesetz* [EstG] § 15, 1990 BGBl I 1898, amended by 1993 BGBl I 2374 (F.R.G.). Another specialized German partnership is the partnership limited by shares, the *Kommanditgesellschaft auf Aktien* (KgaA). The KgaA is actually a corporate form used by larger businesses, particularly family-owned businesses that are going public. The KgaA is taxed as a corporation. KStG § 1. Finally, Germany has the "silent partnership," established under Germany's Commercial Code, which is something of a misnomer by United States standards since the silent partner does not have the rights typically accorded to partners under United States law. *See Handelsgesetzbuch* [HGB] § 230, 1897 BGBl III 4100-1 (F.R.G.) (concerning creation, rights, and duties of the German silent partnership). Commonly, a silent partner has the right of access to information about the partnership not available to ordinary creditors and a right to participate in profits limited to a return of the silent partner's investment, not a liquidation share commonly provided to full partners. In the typical situation, the profits paid to the silent partner are deductible by the partnership. In the atypical situation, the silent partner can be treated, in effect, like a limited partner. This latter situation requires the silent partner to participate in the entrepreneurial risk. *See* Gunther H. W. Stratmann, *Partnerships Versus Corporations*, 8 INT'L BUS. LAWYER 317 (1980) [hereinafter Stratmann] (comparing the tax policies underlying German partnerships and corporations).

partnerships; rather, income and losses flow through to, and are taken into account by, the partners.<sup>2</sup> Germany, however, assesses an assortment of non-income taxes at the partnership level, for which there is no United States analog. Examples include the value added tax (*Umsatzsteuer*) and the trade tax (*Gewerbesteuer*), the latter of which is discussed below. In the United States, under the Internal Revenue Code (I.R.C.) § 7704, publicly-traded partnerships are normally taxed as c-corporations. Germany does not have a comparable statutory provision. While United States legislators enacted I.R.C. § 7704 in response to a significant increase in the number of publicly-traded partnerships, this phenomenon does not seem to have taken hold in Germany. Therefore, there simply may have been no need for a statutory response in Germany. Germany does have an entity roughly translated as a "limited partnership limited by shares" (*Kommanditgesellschaften auf Aktien* or "KGaA"). The term "limited partnership" in this context is misleading because the KGaA is a corporate form of business. It is not commonly employed. When it is, it is usually used by major family-owned businesses which are going public.<sup>3</sup> Accordingly, the KGaA is not an analog to the United States publicly-traded, limited partnership.

Unlike in the United States, financial accounting rules form the foundation of the German tax system.<sup>4</sup> Indeed, German partnerships, as well as other commercial taxpayers in Germany, are required to file a commercial balance sheet along with their tax returns.<sup>5</sup> Many important provisions relating to corporate taxation are contained not in the German Income Tax Code (*Einkommensteuergesetz*), but in the German Commer-

---

Germany is considering adopting a new form of partnership similar to the relatively new, United States limited liability partnership. This new German partnership is designed for professionals and limits a partner's vicarious liability. German law will exclude partners, who are neither rendering, directing, nor supervising the relevant professional activity, from liability. In addition, partners of this new German corporate form can limit the amount of their liability, in absolute terms, if otherwise allowed by the law governing the relevant profession. CCH, *supra* note 1, at Update #21 (Jan. 10, 1994).

2. I.R.C. § 701 (1995); EstG, *supra* note 1, § 15; see Gumpel, *supra* note 1, ¶ 5/5.1 (illustrating taxation of partnerships in Germany); see also I.R.C. § 7704 (treating publicly-traded partnerships as C-corporations).

3. CCH, *supra* note 1, ¶ 130-050.

4. EstG, *supra* note 1, § 5(1); see CCH, *supra* note 1, ¶¶ 122-250, 127-700, and 187-400 (describing the connection between Germany's financial accounting and tax rules); see also Gumpel, *supra* note 1, ¶ 6/2.6 (same).

5. EstG, *supra* note 1, § 60(2); see Gumpel, *supra* note 1, ¶ 6/2.6 (noting the requirement that German partnerships file a balance sheet with tax return).

cial Code (*Handelsgesetzbuch*).<sup>6</sup> While the German system does permit, or on occasion require, some variation from the traditional financial accounting rules, Germany's financial accounting rules tend to be the starting point. Because the German tax and accounting systems overlap, the German partnership tax system is often less complex than its United States counterpart and, at times, more generous in ways that are startling to a United States tax specialist.<sup>7</sup> Yet while simpler, the German tax system may have more "loopholes" than that of the United States.

The German Income Tax Code is somewhat unusual from an American perspective, in that it contemplates income, but rarely losses. Losses are deductible, however, both from business operations and from business-related property transactions.<sup>8</sup> Unless otherwise stated, this article assumes that where a gain is recognizable under German law, a loss is recognizable as well.

## I. COMMERCIAL REGISTRY

German partnerships generally are required to register in the Commercial Registry (*Handelsregister*).<sup>9</sup> As this article will discuss, registration in Germany's Commercial Registry can have a tax impact. In the United States, general partnerships normally are under no obligation to make a filing. Most states in the United States, however, have some form of a

---

6. HGB, *supra* note 1, §§ 238 et seq. (containing tax-relevant bookkeeping provisions).

7. The German partnership tax system is designed to avoid, for example, the need to allocate gains and losses inherent in property to the contributing partner as is the case in the United States. I.R.C. § 704(c). Consequently, Germany does not impose complex regulations on the allocation of gains and losses. *See* Treas. Reg. § 1.704-3 (containing the United States regulation on the allocation of gains and losses in partnerships).

8. CCH, *supra* note 1, ¶ 125-850; *see* Gumpel, *supra* note 1, ¶ 7/4 (discussing business losses).

9. HGB, *supra* note 1, § 106 (containing the registration requirement for general partnerships); *id.* at § 162 (containing the registration requirement for limited partnerships); *see* Stratmann, *supra* note 1, at 319 (outlining the general registration and filing requirements for German partnerships); Gumpel, *supra* note 1, ¶ 2/3 (same).

filing requirement for limited partnerships.<sup>10</sup> These state filings usually have no tax relevance.

## II. TAXABLE INCOME AND LOSS

For the normal business partnership, Germany calculates taxable income and loss rather differently than the United States does. Germany determines taxable income and loss by comparing the net worth of the enterprise at the end of the business year with its net worth at the end of the immediately preceding business year, increased by withdrawals from and decreased by contributions to the business.<sup>11</sup> If there is an increase, the partnership has a profit; a decrease shows a loss.<sup>12</sup> In the United States taxable income is calculated by deducting expenses from gross income. Germany has this type of system as well, but it is principally applicable to the computation of taxable income from employment, investments, rents and royalties, and smaller businesses.<sup>13</sup> This use of the net worth comparison method has implications for several partnership tax issues and makes a number of tax rules, which the United States finds important, unnecessary—or at least less necessary—in Germany.

Germany uses a variety of valuation methods in applying the net worth method. These involve, among others, the use of cost, going concern value, or the price that would be paid in an arms-length transaction.<sup>14</sup> A discussion of these methods goes beyond the scope of this article. Throughout this article, the term "fair market value," when used in reference to the German tax system, means that the valuation method that attempts to place a current value on an item of property, as opposed to assigning a carryover basis or similar amount, applies. Signifi-

---

10. See MD. CODE ANN., CORPS. & ASS'NS § 10-201 (1993) (requiring that all limited partnerships file a Certificate of Limited Partnership, listing information such as the partnership's name, its principal location, and the name and address for each general partner); Stratmann, *supra* note 1, at 319 (outlining the general registration and filing requirements for German partnerships).

11. EstG, *supra* note 1, §§ 2(1), 4(1); see *id.* § 5(1) (requiring all businesses keeping books and records, either by law or voluntarily, to apply net worth comparison method); see also Gumpel, *supra* note 1, ¶ 6/1.3 (discussing net worth comparison methods).

12. EstG, *supra* note 1, § 4(1); Gumpel, *supra* note 1, ¶ 6/1.3b.

13. I.R.C. §§ 61-63; EstG, *supra* note 1, § 2(2); see Gumpel, *supra* note 1, ¶ 7/2.1 (discussing general principles of deductions in Germany).

14. See Gumpel, *supra* note 1, ¶ 6/5 (discussing general principles of valuation of assets and liabilities).

cantly, under German valuation methods, unrealized profits are *not* reflected in the company's books or, therefore, in the company's net worth.<sup>15</sup> An enterprise's books and records, however, must reflect net losses from current assets and liabilities. The books and records need only reflect net losses from fixed assets and liabilities at the option of the taxpayers.<sup>16</sup>

By looking to a significant extent at the actual value of property, the German net worth system often reflects income more accurately than the United States system, which by and large ignores changes in the value of property. Nevertheless, the greater accuracy in income assessment under the German system does come at a price. The regular valuation of property is a burden which businesses often would like to avoid. The extent of this burden, however, is ameliorated due to the permissibility of valuing many properties with the cost-less-depreciation method and, thereby, avoiding the need for appraising a property.<sup>17</sup> Furthermore, the possibility of taking losses currently, while recognizing gains only on the disposition of property, also takes much of the sting out of the burden of regularly valuing property. Then again, the net worth system arguably fails to measure income fully if losses from property are taken currently, while gains must await disposition. If it is not politically feasible to recognize gains currently, the question remains whether the net worth system really offers an advantage over the income-less-expense method and, further, whether it makes sense for Germany to have both systems?

Unlike a United States partnership, a German partnership cannot have non-business income and expenses. By definition, all of its activities are business related.<sup>18</sup>

---

15. EstG, *supra* note 1, § 6; see Gumpel, *supra* note 1, ¶ 6/5.2(d) (explaining the treatment of unrealized profits and losses in Germany).

16. See *supra* note 15. The valuation rules are one area in which German tax law diverges from general German accounting principles. The tax valuation rules override their accounting counterparts in the calculation of income and loss. See Gumbel, *supra* note 1, ¶ 6/2.6.

17. See Gumpel, *supra* note 1, ¶ 6/5.3(b) (noting buildings as an example).

18. See HGB, *supra* note 1, § 6 (stating that all regulations on commercial activities likewise apply to German partnerships); Gumpel, *supra* note 1, ¶ 6/1.4(b) (noting that "all companies formed under the rules of the commercial law are merchants because of their form of organization").

### III. TRADE TAX

While this article focuses on income tax considerations, a brief discussion of Germany's trade tax (*Gewerbesteuer*) is important because of its collateral impact on Germany's income tax. The trade tax is governed by German federal law, but it is assessed and collected by municipalities.<sup>19</sup> It is designed to offset the direct and indirect burdens commercial enterprises place on communities.<sup>20</sup> The trade tax plays an important role in the taxation of partnerships and other commercial enterprises. The trade tax applies to trade profits, which are based on taxable income with certain adjustments.<sup>21</sup> Unlike the income tax, which is assessed on the partners, the trade tax, for most partnerships, is assessed on the partnership itself.<sup>22</sup> If a company incurs a net trade loss, the loss can be carried forward.<sup>23</sup> The German trade tax also imposes a tax on trade capital.<sup>24</sup>

### IV. AGGREGATE VERSUS ENTITY TREATMENT

The United States system of partnership income taxation involves a blending of aggregate and entity concepts.<sup>25</sup> In some instances, a partnership is treated as an aggregation of persons doing business together and matters are analyzed at this "partner level." In other instances, the partnership is treated as an entity apart from the partners. An example of the aggregate concept is the principle that the partnership is not a taxable entity; rather, the income and losses flow through to the partners and are taken into account by them.<sup>26</sup> In contrast, an example of the entity concept lies in the characterization of income at the partnership level.<sup>27</sup> Thus, if a particular type of income is a capital gain to the partnership, the income will normally constitute a capital gain to all of

---

19. *Gewerbesteuer*gesetz, 1991 BGBI § 1 (I.R.G.) [hereinafter *GewStG*].

20. CCH, *supra* note 1, ¶ 170-000.

21. *GewStG*, *supra* note 20, §§ 7-10.

22. *Id.* § 5(1) (making an exception for European Economic Interest Groupings (EEIG), which are treated as partnerships under German law, by applying the trade tax at the partner level).

23. *Id.* § 10(a).

24. *Id.* § 12.

25. See WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.02 (2d ed. 1990) (discussing the aggregate and entity concept, and the nature of partnerships).

26. I.R.C. § 701.

27. *Id.* § 702(b).



the partners, including the partner in whose hands the gain might be ordinary income if he or she had incurred the gain directly.<sup>28</sup> Germany also blends aggregate and entity concepts, albeit, as will be discussed in greater detail below, in a very different way than the United States. Germany shares the rule concerning the characterization of income with the United States.<sup>29</sup> In the United States and Germany, the partners are taxed on their respective shares of partnership income, whether or not the income is distributed.<sup>30</sup>

## V. FORMATION

The American and German rules on partnership formation contain some dramatic differences. In the United States, no gain or loss is recognized on the contribution of property in exchange for a partnership interest.<sup>31</sup> The partners normally take the same basis in the partnership interest as they had in the property contributed.<sup>32</sup> The partnership takes a carryover basis in the contributed property.<sup>33</sup>

German law, on the other hand, draws a distinction between assets that were used in a trade or business immediately prior to their contribution to the partnership and those that were held for personal purposes and converted to trade or business use on contribution to the partnership. In the case of the former, the parties have a choice. The partnership may take a carryover basis in the property, in which case no gain or loss is recognized.<sup>34</sup> Alternatively, the parties may elect to have the partnership take a higher, fair market value basis in the contributed property or some amount in between basis and fair market value. In either event, the contributing partner will recognize gain to the extent the amount chosen exceeds basis.<sup>35</sup> The gain recognized may be subject

---

28. Occasionally, courts, in order to avoid circumstances or particular abuse, will ignore the form of the partnership and tax the putative partners as if there were no partnership. See *Allison v. Commissioner*, 35 T.C.M. (CCH) 1069 (1976); see also *Hale v. Commissioner*, 24 T.C.M. (CCH) 1497 (1965).

29. *EstG*, *supra* note 1, § 15(2).

30. *Gumpel*, *supra* note 1, ¶ 2/3; I.R.C. § 702.

31. I.R.C. § 721.

32. *Id.* § 722.

33. *Id.* § 723.

34. *Umwandlungssteuergesetz* [UmwStg], §§ 24(2)-(3), 1976 BGBl I 2641 (F.R.G.).

35. *Id.* § 24(2); see *Gumpel*, *supra* note 1, ¶ 9/10.2(b) (discussing the treatment of gain and noting that a partner may increase a capital account up to the fair market value of the contributed property, but avoid recognizing gain by having the part-

to favorable rates of taxation.<sup>36</sup> Whether a full or partial basis step-up or a carryover basis makes the most sense depends on the overall tax picture of the participants. Favorable gains tax rates coupled with healthy depreciation rates may justify recognition of the gain. Absent favorable gains or depreciation rates, a taxpayer may prefer a carryover basis. Losses are normally recognized on an ongoing basis under the net worth system of income taxation and, therefore, there would typically not be a loss inherent in business property on contribution.<sup>37</sup> In the event a loss has not been fully recognized, however, the taxpayer does not have the option of recognizing the loss as a contribution to the partnership. The partnership cannot take less than a carryover basis. It is not immediately apparent why German law permits a gain and an accompanying basis step-up and not a loss and an accompanying basis step-down since the taxpayer may currently recognize losses under the net worth system.

If non-business property is contributed to the partnership, what Germany calls the "speculative transaction" rules may apply. Under these rules, one need not in fact have a speculative intent, because the statute conclusively assumes such an intent is present. Gain is recognized if the taxpayer has held the property for two years or less in the case of real estate, and six months or less in the case of other property.<sup>38</sup> In contrast, losses recognized on speculative transactions are only deductible to

---

nership maintain "supplementary balance sheets," which appear as a "reduction in capital" and as a "reduction of asset value" the gain that increased the partner's capital account).

36. While Germany does not uniformly tax capital-type gains at favorable rates, Germany does tax gains on the disposition of a trade or business at a favorable rate. EstG, *supra* note 1, § 16. On gains not exceeding DM 30,000,000, the preferential rate of taxation is half of the regular rate for such gains. Moreover, the first DM 30,000 of gains—proportionately less for an "independent division" versus an entire business—is entirely free from tax, though this benefit is phased out for sales in excess of DM 100,000. *Id.* §§ 34(1)-(2), 16(2).

37. See *infra* notes 63-64 and accompanying text (comparing United States and German partnership contribution).

38. See EstG, *supra* note 1, § 23(4) (stating that gain need only be recognized to the extent it exceeds DM 1000 in a calendar year); see, e.g., Judgment of Nov. 5, 1974, Entscheidungen des Bundesfinanzhofs [BFH], 1975 Bundessteuerblatt [BStBl] II 411; Judgment of July 23, 1980, Entscheidungen des Bundesfinanzhofs [BFH], 1981 BStBl II 19 (stating that property received by inheritance is not considered a gain); HUGO VON WALLIS & GERHARD BRANDMÜLLER, BESTEUERUNG DER PERSONEN- UND KAPITALGESELLSCHAFTEN 46 (Verlag Recht und Wirtschaft GmbH Heidelberg eds., 1991) [hereinafter BRANDMÜLLER] (discussing the realization of gain in the transfer of property from a partner to the partnership).

the extent of gains from speculative transactions taken in the same calendar year as the losses.<sup>39</sup> If the property is held longer than the specified holding period, no gain or loss is recognized. Whether or not gain or loss is recognized, the partnership takes a fair market value basis in the contributed non-business property.<sup>40</sup>

Capital accounts play an important role in a number of different contexts in both the United States and in Germany, but the calculation of these accounts differs in each country. In Germany, there are no applicable statutory or regulatory definitions or explanations of the capital accounting rules. Accordingly, German taxpayers must rely solely on custom and case law in calculating capital accounts.

In the United States, the amount of money contributed, the fair market value of contributed property, and income serve to increase capital accounts. The amount of money distributed and the fair market value of distributed property and losses reduce capital accounts.<sup>41</sup> The rules for property transactions are different in Germany since contributions and distributions are not necessarily nontaxable events. In Germany, capital accounts are increased by the amount of money contributed, and the partner's basis in the contributed property, increased by any gain recognized.<sup>42</sup> The capital account is decreased by money distributed, the partnership's basis in the distributed property, plus any gain recognized or less any loss recognized.<sup>43</sup> As in the United States, capital accounts are increased by income and decreased by losses.

Other major differences exist between United States and German capital accounts. In the United States, a partner's basis in a partnership interest is increased by the basis of contributed property.<sup>44</sup> The capital account is increased by the fair market value of contributed property.<sup>45</sup>

---

39. EstG, *supra* note 1, § 23(4).

40. EstG, *supra* note 1, § 6(5); see BRIGITTE KNOBBE-KEUK, *BILANZ- UND UNTERNEHMENSSTEUERRECHT* 412 (Verlag Dr. Otto Schmidt KG ed., 1991) [hereinafter KNOBBE-KEUK] (discussing the determination of a partnership's basis when a partner contributes personal, non-business property to the partnership).

41. Treas. Reg. § 1.704-1(b)(2)(iv)(b).

42. Judgment of May 14, 1991, Entscheidung des Bundesfinanzhofs, 1992 Bstbl. II 516; see BRANDMÜLLER, *supra* note 38, at 48-49 (discussing the effect of contributions on capital accounts); see also *infra* note 49 and accompanying text (discussing capital account increases in contributed property).

43. See BRANDMÜLLER, *supra* note 38, at 48-49 (noting tax consequences of non-business contributions to partnerships); see also *infra* notes 110-11 and accompanying text (discussing the tax status of distribution of gains and losses).

44. Treas. Reg. § 1.704-1(b)(2)(iv)(a).

45. *Id.* § 1.704-1(b)(2)(iv)(b).

Therefore, the amount of a partner's tax basis in the partnership interest can be a very different number than the balance in a partner's capital account. Germany does not have separate ways of calculating tax basis and capital account balances. While commentators sometimes refer to a German tax basis, in Germany the concept of a tax basis has largely been merged into the capital account.

The simplified system of rules on partnership formation in Germany largely—although not entirely—eliminate the need for I.R.C. §§ 704(c) and 752. Accordingly, Germany has no close analog to either statute.<sup>46</sup> Under I.R.C. § 704(c), losses and gains inherent in property on contribution to the partnership are allocated to the contributing partner.<sup>47</sup> I.R.C. § 704(c) exists to prevent taxpayers from shifting a gain or loss to another taxpayer through the vehicle of the partnership.<sup>48</sup> Germany has little need for a statute similar to I.R.C. § 704(c) because gain is frequently recognized upon contribution of the property to the partnership and loss is typically recognized prior to contribution under the net worth system.<sup>49</sup> Despite the limited need for a statute comparable to I.R.C. § 704(c), situations may still arise in Germany where such a rule may be necessary. For example, a partner's gain is not always recognized on contribution, and it is possible for a loss to be inherent in contributed property.<sup>50</sup> Given the net worth system of income determination in Germany, however, these issues may seldom arise. Accordingly, a statute comparable to I.R.C. § 704(c) with its associated complexities may not be worth the effort.<sup>51</sup>

---

46. See *supra* note 8 and accompanying text (discussing gain and loss in German partnership taxation).

47. I.R.C. § 704(c)(1)(B)(i).

48. See *id.* § 704(c)(1)(B) (stating that a contributing partner recognizes gain or loss when shifting property to the partnership). Without I.R.C. § 704(c), for example, a high-bracket taxpayer could shift income to a lower-bracket taxpayer by contributing appreciated property to a partnership. When the property is sold, gain could be allocated in whole or in part under the partnership agreement to the lower bracket partner. I.R.C. § 704(c), however, prevents this type of income shifting.

49. See *supra* notes 8-9 and accompanying text (discussing allocation of gain and loss in property upon contribution).

50. See *supra* note 36 and accompanying text. If a loss is inherent in property, a putative partner might be reluctant to contribute it to the partnership, since the loss could be allocated to other partners. Germany does not permit "special allocations" of gains and losses to particular partners. The latter problem, however, might be avoided in Germany by having the partner retain the property but permitting the partnership to use such property. See *infra* notes 52-53 and accompanying text. Thus, in Germany, it is possible to have the best of both worlds, to avoid gain and keep a loss.

51. Germany has a procedure similar to I.R.C. § 704(c) in its use of "supple-

In the United States, under I.R.C. § 752(a), a partner's tax basis is increased by his or her share of partnership liabilities.<sup>52</sup> If that share of liabilities decreases, there is a concomitant decrease in the partner's tax basis.<sup>53</sup> The inclusion of liabilities in basis is important because a partner may only deduct losses to the extent of the partner's tax basis.<sup>54</sup> Liabilities are not included in a partner's capital account.<sup>55</sup> The inclusion of such liabilities, however, is not necessary—as it is with respect to basis—because a partner's loss deductions are not limited to the positive capital account balances, provided the partner has an obligation to restore the deficit.<sup>56</sup> Because capital accounts are designed to mea-

---

mentary balance sheets." A partner can contribute property at a value in excess of its basis and receive a corresponding capital account increase. *See supra* note 36. Instead of having the partner recognize the gain, the partner maintains supplementary accounts for "reduction of capital" and "reduction of asset value." These supplementary accounts must continue to be maintained and are relevant for profit determination. Under this system depreciation will be allocated away from the partner who contributed the property and to the partners who contributed the property. *See Gumpel, supra* note 1, ¶ 9/10.2(b) (showing the allocation of depreciated property on a balance sheet). Similarly, under I.R.C. § 704(c), if a partner contributes appreciated property, depreciation will normally be disproportionately allocated to the other partners, and away from the contributing partners, to equalize capital accounts. *See* Treas. Reg. § 1.704-3(b)(2) (showing examples of calculating allocation of depreciation to partners).

52. *See* I.R.C. § 752(a) (treating an increase of a partner's liabilities as a contribution of money to the partnership). A partner's share of liabilities varies depending on whether the partnership debt is recourse or nonrecourse. If the debt is recourse, it is shared by the partners based on how they share the "economic risk of loss" with regard to the debt. *See* Treas. Reg. § 1.752-1(a)(1) (defining recourse liability). If the debt is nonrecourse, it is shared under a stacking rule: first, based on the partner's share of "minimum gain" attributable to the property securing the nonrecourse debt; second, if the nonrecourse debt is secured by contributed property, the amount of gain the contributing partner would recognize if the property were disposed of for the amount of the nonrecourse debt; and finally and most frequently, based on partnership profits. *See* Treas. Reg. § 1.752-3(a)(1)-(3) (explaining a partner's share of nonrecourse liabilities).

53. *See* I.R.C. § 752(b) (treating decrease in partner's share of liability as a distribution of money to the partner by the partnership); *see also id.* § 731(a)(1) (stating that partner shows gain to the extent of excess if distribution exceeds partner's basis in the partnership interest).

54. *Id.* § 704 (d).

55. *See supra* note 43 and accompanying text (explaining the calculation of increases and decreases in capital accounts).

56. *See* Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (explaining the requirements for determining allocation of income, gain, loss, or deduction and its economic effect on partner's capital account).

sure a partner's economic investment, and liabilities are, in a sense, an investment by the creditor, there would be little logic to including such liabilities in the capital account calculation. Since Germany has a capital account based system, and does not calculate a separate tax basis, Germany has no need for a statute analogous to I.R.C. § 752 and, accordingly, has not enacted one.

In the United States, partnership organizational expenses and start up costs are not currently deductible, but may be amortized over sixty months.<sup>57</sup> The situation in Germany is more favorable. Organizational expenses and start up costs are currently deductible, provided they can be related to a specific business.<sup>58</sup>

## VI. SPECIAL ALLOCATIONS

In the United States, under certain circumstances, partners are permitted to make "special allocations" of partnership income and expenses.<sup>59</sup> Thus, for example, someone who is otherwise a twenty percent partner may be allocated eighty percent of depreciation deductions. For these allocations to be effective, they generally must have a "substantial economic effect" on the partners.<sup>60</sup> A full discussion of this topic is well beyond the scope of this article, but a brief explanation might be helpful.<sup>61</sup> Under the "economic effect" part of the rules, a partner's capital account is, for example, reduced by the amount of an allocation of depreciation.<sup>62</sup> The substantial economic effect rules ensure that the partner bears the economic burden of the allocation because the capital

---

57. I.R.C. §§ 197(d), 709(b)(1).

58. Judgment of June 14, 1955, Entscheidung des Bundesfinanzhofs [BFH], 1961 Bundesfinanzhofentscheidungen [BFHE] 319; see Gumpel, *supra* note 1, ¶ 7/2.13a (discussing available deductions). Organizational expenses are incurred in the formation of a partnership and generally include attorney's fees incurred for the preparation of a partnership agreement. Start-up costs, on the other hand, are incurred prior to the formation of a business and include market studies on the viability of a potential business.

59. I.R.C. § 704(b).

60. *Id.* § 704(b)(2).

61. See generally MCKEE ET AL., *supra* note 25, ¶ 10.02 (discussing partnership taxation); Lawrence Lokken, *Partnership Allocations*, 41 N.Y.U. TAX L. REV. 547 (1986) (discussing the special allocations of partnership income and expenses); Gregory J. Marich, *Substantial Economic Effect and the Value Equals Basis Conundrum*, 42 N.Y.U. TAX L. REV. 509 (1987) (discussing partnership allocations).

62. See Treas. Reg. § 1.704-1(b)(2)(iv)(b) (stating that capital accounts are reduced by allocation of partnership loss and deduction).

account determines how much a partner receives upon liquidation of the partnership.<sup>63</sup> It is possible to manipulate these rules. For that reason, the Treasury Regulations contain a "substantiality" test to ensure that the economic impact of an allocation on a partner is genuine.<sup>64</sup>

German income tax laws dispense with this complexity. Generally, Germany does not allow special allocations.<sup>65</sup> While the German approach simplifies matters, this approach comes at a price. Special allocations can serve legitimate business purposes. For example, if the funds to purchase a particular business asset come from a single partner, there is nothing inherently offensive about allocating the depreciation deductions attributable to the property to that partner. Moreover, without the special allocation of depreciation, it will be harder to persuade the partner to contribute the funds. While it might be possible to change the overall partnership percentages to take into account the funds that partners contributed, overall allocation percentages average all of the partnership activities. Accordingly, partners might prefer to make allocations

---

63. *Id.* § 1.704-1(b)(2)(ii)(b).

64. *See id.* § 1.704-1(b)(2)(iii) (explaining general substantiality test). For example, if a nonresident alien and a United States citizen enter into a 50%-50% United States partnership engaged in international business transactions, they often would prefer to allocate foreign source income to the nonresident alien, thereby permitting him or her to avoid the United States tax. Generally, nonresident aliens are only taxable by the United States on their United States source income. *See* I.R.C. § 871 (listing all taxes, with exceptions, levied on nonresident aliens). The United States partner would not be as concerned with the source of the income since United States citizens are taxable on their worldwide income. *See id.* § 61 (defining taxable income). Assuming that domestic and foreign sources of income are not predictable, the Treasury Regulations permit partnerships to allocate foreign source income to the 50% foreign partner and United States source income to the 50% United States partner. *Treas. Reg.* § 1.704-1(b)(5), Example 10(i). Given the unpredictable nature of the income source, each partner risks receiving less than 50% of the overall partnership income. Of course, partners would prefer not to take that risk. Instead, they might prefer to allocate the foreign source income to the foreign partner, provided that the foreign partner is guaranteed a 50% overall profit share. Under the Treasury Regulations, this allocation would not be allowed. *Id.* § 1.704-1(b)(5), Example 10(ii). The taxpayers are assured the same amount of overall income that they would have received if they had been allocated 50% of each type of income. *Id.* The preferential allocation of the foreign source income has a tax impact, but no ultimate economic impact. Accordingly, the "economic effect" of the allocation is not considered to be "substantial," and thus the allocation is not allowed. *Id.* Each partner would be required to take into account half of each type of income. *Id.*

65. *See* CCH, *supra* note 1, ¶ 127-600 (stating that since Germany treats the partnership as one entity, components of income cannot be allocated among partners differently). As such, there is no statutory provision allowing special allocations.

which vary based on each partnership activity, thereby being more precise.

All is not lost, however, since the German system permits backdoor special allocations. Under German law, a partner may own property while at the same time, in his or her capacity as a partner, permitting the partnership to use the relevant property (*Sonderbetriebsvermögen*). In such an event, the depreciation is allocated to the property-owning partner.<sup>66</sup> The United States system, in contrast, does not envision this intermediate possibility. Under United States law, a partner either may contribute the property or rights for the use of the property to the partnership or, acting in a third party capacity, may rent the property to the partnership.<sup>67</sup> Furthermore, German law does not consider partnership expenses incurred by a particular partner as an expense of the partnership, but rather allocates partnership expenses to the partner who paid them.<sup>68</sup> Under United States law, the payment would likely constitute a contribution to the partnership to be allocated under the allocation provisions of the partnership agreement. Finally, in Germany, allocations of partnership income can effectively be achieved by giving the relevant partner a salary.<sup>69</sup>

## VII. TAX YEAR

Many of the rules concerning tax years in the United States are designed to prevent tax deferral. Under United States law, a partner must include as income his/her share of partnership income for the personal income tax year in which the partnership tax year ends.<sup>70</sup> Take for example, the case of an individual partner who in year one is on a calendar year. If a partnership had the option of electing a partnership year ending in January 31 of year two, the partners could potentially defer payment of the associated partnership tax. With a tax year ending on January 31, most of the partnership's income would accrue in the prior

---

66. CCH, *supra* note 1, ¶ 127-600; *see supra* note 1 (discussing how the United States and Germany address property contributed to the partnership).

67. *See supra* notes 48-49 (explaining the allocation of property within a partnership).

68. *See, e.g.*, CCH, *supra* note 1, ¶ 127-600 (discussing the tax treatment of expenses attributable to a partner); Gumpel, *supra* note 1, ¶ 7/1.4(b) (same); BRANDMÜLLER, *supra* note 38, at 43 (same); KNOBBE-KEUK, *supra* note 40, at 406 (same).

69. EstG, *supra* note 1, § 15(2); BRANDMÜLLER, *supra* note 38, at 36.

70. I.R.C. § 706(a).



tax year, while only being includible by the partner in year two. Since personal income tax would not be payable for year two until April 15th of year three, partners could take advantage of a potential tax deferral of 27 1/2 months, (subject to a possible obligation to make quarterly estimated tax payments).<sup>71</sup> I.R.C. § 706(b) prevents this abuse. In the United States, the tax year of the partnership is a function of the tax years of the partners. Thus, if all of the partners are on a calendar year, the partnership normally also must be on a calendar year.<sup>72</sup>

In contrast, German partnerships registered in the Commercial Register, as required,<sup>73</sup> must use the same year for tax purposes as the year used for the partnership's financial statements.<sup>74</sup> This may be a noncalendar fiscal year. Surprisingly, there is no analog in Germany to I.R.C. § 706(d). However, nonsalaried taxpayers are required to make estimated quarterly tax payments.<sup>75</sup> Once a partnership has elected a fiscal year, the partnership may change such year to a year other than the calendar year only with the consent of the local tax office.<sup>76</sup> The tax office will grant such consent only if good cause is shown,<sup>77</sup> thereby avoiding tax year changes for tax avoidance purposes.<sup>78</sup>

### VIII. RETROACTIVE ALLOCATIONS

In both Germany and the United States, persons entering the partnership late in the year are normally not allowed a retroactive allocation of

---

71. See *id.* § 6654(D) (stating that payment of estimated taxes limits the value of deferral).

72. Unless a partnership has legitimate business reasons for being on a different tax year, a partnership must be on the same tax year as a majority of its partners. If a majority of the partners are not on the same tax year, the partnership must be on the same tax year as all of its principal partners, i.e., those who hold a five percent or greater interest in the partnership. I.R.C. § 706(b). If all of the principal partners are not on the same tax year, a partnership is placed on a tax year that generates the least deferral for its partners. Temp. Treas. Reg. § 1.706-1T(a) (1994).

73. See *supra* note 10 and accompanying text (discussing the tax impact for a corporation of filing with The Commercial Registry).

74. EstG, *supra* note 1, § 4a(2).

75. Smaller businesses, however, are not required to register in the Commercial Register. Their tax year, as the tax year for individuals, must be the calendar year. EstG, *supra* note 1, § 4a(3).

76. *Id.* § 4a(2).

77. Judgment of Sept. 8, 1971, Entscheidung des Bundesfinanzhofs [BFH], 1972 BStBl II 87 (F.R.G.).

78. Judgment of Apr. 24, 1980, Entscheidung des Bundesfinanzhofs [BFH], 1981 BStBl II 50 (F.R.G.).

income and losses attributable to a period before they entered the partnership. When partnership interests change,<sup>79</sup> under United States law, the partnership is permitted, but is not required, to close its books.<sup>80</sup> If the books are closed, the partners determine their respective shares of the partnership income and losses after the closing based on the postclosing income and expenses incurred and their postclosing partnership interests. Alternatively, the partnership may use the "proration method."<sup>81</sup> This method assumes that all income and expenses are incurred ratably over the course of the year. Thus, if a party becomes a one-third partner on the first of December, one-third of one-twelfth of the partnership's annual income and expenses would be allocated to the new partner. If the books are closed there is a potential for abuse in cash method partnerships. A cash method partnership, for example, after closing its books may pay a large cash expense attributable to a preclosing part of the year. Since the books were closed prior to the expense payment, the expense would be allocated based on the partnership percentages as they existed after the closing. Consequently, the partnership may allocate to a new partner a full one-third of the expenses, even though such expenses arose prior to the new partner's joinder of the partnership. In an attempt to close this loophole, I.R.C. § 706(d) provides that certain "allocable cash basis items" must be allocated prorata over the year, whether or not the books are formally closed.<sup>82</sup> Allocable cash basis items include interest, taxes, and payments for services or for the use of property.<sup>83</sup>

The tax abuse addressed by I.R.C. § 706(d) arises primarily with respect to cash method taxpayers. The accrual method of accounting, by its terms, allocates expenses to the time when the expenses arose, not to the time when the partnership paid the expense.<sup>84</sup> Generally, Germany

---

79. Partnership interests may change when a new partner enters the partnership, a partner retires, a partner dies, or a partner makes additional contributions.

80. I.R.C. § 706(c)(1); *see* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 93 (Comm. Print 1976) [GENERAL EXPLANATION OF THE TAX REFORM ACT].

81. GENERAL EXPLANATION OF THE TAX REFORM ACT, *supra* note 80, at 94.

82. I.R.C. § 706(d)(2).

83. *Id.* § 706(d)(2)(B).

84. Accrual taxpayers can in some cases benefit from using the proration accounting method. If the accrued expense is attributable to an earlier part of the year, then at least part of the expense may be attributed to the incoming partner since proration allocates the expense over the entire year. If accrual method taxpayers, however, close the partnership books, then the accrued expense would be allocated to the

requires commercial taxpayers to be on the accrual method of accounting.<sup>85</sup> In addition, German tax law does not recognize agreements having a retroactive effect.<sup>86</sup> Consequently, Germany has little need for and, thus, has not enacted a provision similar to I.R.C. § 706(d). On one hand, the area of retroactive allocations illustrates how much simpler the German partnership tax system is as compared to its United States counterpart. On the other hand, taxpayers usually prefer the cash method of accounting because it is easier to apply. Therefore, by mandating that all commercial taxpayers adopt the accrual method of accounting, Germany, while simplifying its tax system, has placed a greater burden on German commercial taxpayers.

The German Tax Court has permitted one wrinkle in its otherwise fairly consistent approach to retroactive allocations. For example, assume that A and B form a partnership in 1993, that the partnership incurs a DM 100 loss in 1993, and that the partnership incurs a DM 200 loss in 1994. When C enters the partnership as an equal partner on October 1, 1994, the partnership may allocate up to DM 100 of the partnership loss to C (i.e., an amount equal to one-third of the loss for both years) if at least DM 100 of the 1994 loss is incurred after October 1, 1994. This illustration illuminates another loophole to the German rule against special allocations.<sup>87</sup> In the United States, the partnership would be permitted to allocate to C, from the example above, all of the losses incurred after the first of October. Thus, the end result in both the United States and Germany could be the same in this regard.<sup>88</sup>

## IX. LIMITATIONS ON DEDUCTION OF LOSSES

The United States tax code includes several provisions limiting a partner's ability to deduct losses.<sup>89</sup> Foremost, a partner may not deduct

---

period before the books were closed. Under these circumstances, the incoming partner would not receive any part of the expense.

85. Gumpel, *supra* note 1, ¶ 6/4.3; *see* Abgabenordnung [AO] §§ 140-41 (containing accounting requirements).

86. CCH, *supra* note 1, ¶ 127-600; Gumpel, *supra* note 1, ¶ 7/1.4(b).

87. Judgment of May 22, 1990, Entscheidung the Bundesfinanzhofs [BFH], 1990 DB 2301 (F.R.G.).

88. *See* I.R.C. § 704 (stating that solely the partnership agreement determines a partner's distributive share).

89. *Id.* § 704(d) (allowing a partner to deduct only his or her share of the total loss).

losses in excess of his or her basis in the partnership interest.<sup>90</sup> If this hurdle is cleared, a partner must confront additional hurdles posed by the "at risk rules."<sup>91</sup> Under these rules, a partner may claim a deduction from a partnership activity only to the extent that the partner has an amount "at risk" in such activity.<sup>92</sup> A partner's "amount at risk" depends on the amount of money the partner invested, the basis of contributed property, and the extent of the partner's unprotected liability with regard to partnership recourse debt.<sup>93</sup> A limited partner who does not have recourse against the general partner, can be at risk on a partnership debt by guaranteeing the debt or securing it with property owned by such partner and held outside the partnership.<sup>94</sup> It is also possible for a taxpayer to be at risk on certain nonrecourse debt secured by real property.<sup>95</sup>

Finally, if a partner survives both I.R.C. §§ 704(d) and 465, the partner will encounter the passive loss rules of I.R.C. § 469.<sup>96</sup> If a taxpayer has "passive losses" from a particular activity, these losses may be deducted only to the extent of the taxpayer's passive income from other activities.<sup>97</sup> The partner may carry unused passive losses forward indefinitely until passive income is generated.<sup>98</sup> If the taxpayer disposes of

---

90. *Id.*

91. See *infra* note 95 (discussing "at risk rules").

92. I.R.C. § 465(a)(1)(B).

93. *Id.* § 465(b)(1)-(4).

94. Treas. Reg. § 1.752-2(f), Example 3. For the limited partner to be "at risk," he or she must be ultimately responsible for the liability. For example, if a limited partner personally guarantees a loan against the event of a partnership default, this guarantee does not necessarily mean the limited partner has ultimate exposure on the debt. Guarantors usually step into the shoes of the creditor, giving the limited partner the right to proceed against the general partner, and insulating the limited partner from risk. This right, thus, would need to be waived if the limited partner wants to be at risk on the guarantee. See generally *Pritchett v. Commissioner*, 827 F.2d 644 (9th Cir. 1987) (discussing the liability of limited partners); *Melvin v. Commissioner*, 88 T.C. 63 (1987); *Abramson v. Commissioner*, 86 T.C. 360 (1986) (stating the proposition that limited partners ultimately may be at risk since their liability is determined based on the terms of the actual transaction).

95. I.R.C. § 465(b)(6) (in order for the limited partner to be considered at risk, the debt must be nonrecourse, secured by real property, not be convertible, and normally must be borrowed from a commercial lender who does not have an interest in the activity).

96. I.R.C. § 469(a)(1) (allowing a partner to deduct passive losses only against the corresponding passive activities).

97. *Id.*

98. *Id.* § 469(b).

the interest in the passive activity in a fully taxable transaction, the taxpayer is released from the strictures of I.R.C. § 469, and, therefore, may deduct any unused passive losses from the disposed of activity from regular income, if insufficient passive income is available.<sup>99</sup> Passive income and losses are those arising from a trade or business activity, in which the taxpayer does not materially participate.<sup>100</sup> The Code defines material participation as an involvement that is regular, continuous, and substantial.<sup>101</sup> Since a limited partner is not normally allowed to participate in the conduct of the partnership's business, a limited partner cannot normally materially participate in a partnership activity, and any losses incurred would typically be passive.<sup>102</sup>

Germany does not appear to have loss limitation rules applicable to general partners. In practice, the United States differs little from Germany in this regard. In theory, I.R.C. § 704(d) could apply. United States "at risk" and "passive loss" rules commonly could have limited application as well. However, in the United States, the general partners will normally have joint or joint and several liability for partnership debts, usually giving them adequate basis in their partnership interests after the application of I.R.C. § 752.<sup>103</sup> The general partners will also be at risk to the extent of their potential liability on the recourse debt. Typically, general partners materially participate in a partnership's activities, and, in such instances, the passive loss rules would not apply.

Germany has a general rule on loss limitations for limited partners under which a limited partner may not deduct losses in excess of the partner's positive capital account balance.<sup>104</sup> A limited partner, however, may deduct losses or receive distributions beyond the partner's positive capital accounts to the extent the partner has obligations, as indi-

---

99. *Id.* § 469(g).

100. *Id.* § 469(c)(1).

101. *Id.* § 469(h)(1).

102. *Id.* § 469(h)(2); *see* Temp. Treas. Reg. § 1469-5T(e)(2) (providing exceptions to this rule). Under these exceptions, a limited partner's participation is deemed material if the limited partner participates (i) in the partnership activity for more than 500 hours during the year in the capacity as an officer or director of a corporate general partner; (ii) in the current activity for five of the ten taxable years that immediately preceded the taxable year; (iii) in a personal service activity of the partnership for any three taxable years preceding the taxable year. *Id.*

103. Unif. Partnership Act § 15 (1994) (stating that in most instances, general partners are jointly liable for all debts and obligations of the partnership and partners are jointly and severally liable for wrongful acts or breaches of trust); *see supra* notes 52-55 and accompanying text.

104. EstG, *supra* note 1, § 15a.

cated in the commercial registry, to make additional contributions to the partnership.<sup>105</sup> A partner may carry unused losses forward and deduct these losses against income of the partnership in future years.<sup>106</sup>

Even if a limited partner in Germany does not have an obligation to make additional contributions to the partnership, the limited partner can still develop a negative capital account if the partnership makes distributions in excess of the partner's positive capital account balance. If this occurs, the limited partner will have ordinary income to the extent of the negative balance,<sup>107</sup> increasing the capital account to zero.

Similar situations occur in the United States, but not as regularly as in Germany. Any partner of a United States partnership, limited or otherwise, is allowed to have a negative capital account to the extent the partner is obligated to restore the deficit when either the partnership or the partner's interest in the partnership is liquidated.<sup>108</sup> A United States partnership may not allocate to partners losses which would create a deficit capital account which the partner is not obligated to restore.<sup>109</sup> If the distributions received from the partnership creates a deficit capital account in excess of any deficit restoration obligation, an offsetting income allocation to the partner is normally required.<sup>110</sup>

Germany, unlike the United States, does not have a provision under which a limited partner may deduct losses simply because the partner has guaranteed a debt. In the United States, a limited partner would be at risk under I.R.C. § 465 for any unprotected guarantee.<sup>111</sup>

Thus, in Germany it is vital that a limited partner have sufficient obligations to make additional contributions to the partnership, as evidenced in the commercial registry, if such limited partner seeks a loss allocation or a distribution resulting in a negative capital account balance. Presumably, a German bank is more likely to lend money to a partnership if such obligations are registered. A direct limited partner's

---

105. *Id.* § 15a(1); HGB, *supra* note 1, § 171; *see* Judgment of May 14, 1991, Entscheidung des Bundesfinanzhofs, 1992 BStBl II 167 (F.R.G.) (discussing loss deductions by limited partners).

106. EstG, *supra* note 1, § 15a(2).

107. *Id.* § 15a(3).

108. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (limiting the time the partner has to restore his negative capital account and requiring that the partner be unconditionally obligated to restore the deficit balance by the end of the tax year the partnership is liquidated or within 90 days after the date of liquidation).

109. *Id.*

110. *Id.* §§ 1.704-1(b)(2)(ii)(d)(3), 1.704-(b)(2)(ii)(d)(6).

111. I.R.C. §§ 465(a), (b)(2).

guarantee to the bank, however, would appear preferable over a limited partner's mere general obligation to make contributions. Under the German system, however, a limited partner might be reluctant to give such a guarantee because the guarantee might be an additional obligation beyond the partner's obligation to make contributions to the partnership. Should the partnership develop financial difficulties, creditors may be able to enforce the general obligation to make contributions, thereby exposing the limited partner to liability both for the contribution and the guarantee. The German rule on limited partner guarantees seems unnecessarily restrictive, thereby unduly limiting economic activity. As an alternative, German law should permit a limited partner to have a negative capital account to the extent of the partner's guarantees. In such instances, either the partnership will earn income with which to pay the debt or the limited partner will be called upon to fulfill the guarantee, this being effectively a contribution to the partnership. In either case, the negative capital account would be restored. Germany should consider the benefits of a flexible rule on limited partner guarantees modeled on the United States rule.

On the other hand, Germany should be lauded for not having passive loss rules. Arguably, a loss should not be disallowed simply because a partner does not materially participate in a business. The point of contention should be the partner's economic exposure. If a taxpayer currently may not deduct a passive loss because of insufficient passive income, the partner will be less likely to invest in the relevant activity. This result needlessly would limit economic development.<sup>112</sup>

## X. DISTRIBUTIONS

In the United States, gain or loss is normally not recognized on the distribution of property by the partnership to the partner; rather, the

---

112. Prior to the enactment of the passive loss rules of I.R.C. § 469 in 1986, the combination of the investment tax credit and fairly short depreciation periods, and accelerated depreciation rates for real estate made it possible for taxpayers to generate very large loss deductions in the early years of an investment. If this had continued, there might have been an argument for the passive loss rules since they would have prevented these losses which many considered excessive. At the very time the passive loss rules were enacted, however, Congress repealed the investment tax credit, significantly increased the depreciation terms for real estate, and limited depreciation methods for real estate to straight line. Changes to the alternative minimum tax rules also limited the ability of taxpayers to benefit from excessive early losses. The policy justification for the passive loss rules under these circumstances is not readily apparent.

recipient takes a carryover basis in the property received.<sup>113</sup> The rule in Germany is more complex than in the United States because the transfer is not automatically tax free. Under German law, the partnership must recognize all gains and losses if the partner receiving the distribution no longer uses the transferred asset in a trade or business.<sup>114</sup> If the partner does use the asset in a trade or business, the partnership has the option of recognizing the gain or loss.<sup>115</sup> The recipient of the distribution takes a carryover basis if no gain or loss is recognized, and a fair market value basis if gain or loss is recognized.<sup>116</sup>

## XI. OTHER PARTNER/PARTNERSHIP TRANSACTIONS

In the United States and Germany, partners and partnerships may deal with each other as independent third parties. Thus, a partner can sell property to a partnership, and the partnership can sell property to a partner, with each party fully recognizing any gain or loss.<sup>117</sup> Germany does not have an analog to the complex antiabuse rules in I.R.C. § 707(a)(2) and (b). Congress enacted I.R.C. § 707(a)(2) and (b) partially

---

113. I.R.C. § 732; *see id.* § 731(a)(1) (recognizing gain if the amount of money distributed exceeds the partner's basis in the partner's partnership interest); *see also id.* § 751(b) (requiring gain recognition if the distribution results in a disproportionate change in the partners' shares of I.R.C. § 751 "hot assets"). I.R.C. § 751 "hot assets" are defined as unrealized receivables or substantially appreciated inventory. *Id.* A taxable exchange results if a partner receives an uneven share of either hot assets or property other than hot assets from a partnership distribution. *Id.* If, for example, the partner receives a disproportionate share of hot assets, the partner is deemed to have first been given a distribution of a share of the non-hot assets which are then deemed to be exchanged in a fully taxable transaction for the hot assets actually received over and above the proportionate share. *Id.* Both the partner and the partnership may recognize gain or loss on the exchange. *Id.*

114. CCH, *supra* note 1, ¶ 128-200; BRANDMÜLLER, *supra* note 38, at 48-49; KNOBBE-KEUK, *supra* note 40, at 411.

115. *See, e.g.,* BRANDMÜLLER, *supra* note 38, at 48-49 (providing unequivocally for this treatment); KNOBBE-KEUK, *supra* note 40, at 411 (agreeing with this rationale, albeit in a rather circumspect manner); Gumpel, *supra* note 1, at ¶ 6/5.5(d) (distinguishing between the transfer for business use of individual assets and the transfer of an entire business or an "independent division"). In the former case, no gain or loss is recognized. In the latter case, the partnership computes its gain or loss under the net income method for the period up to the time of the transfer. An "independent division" would adjust the bases of the business assets for depreciation and the transferee then would take a carryover basis in the distributed assets.

116. BRANDMÜLLER, *supra* note 38, at 48-49.

117. I.R.C. § 707(a); KNOBBE-KEUK, *supra* note 40, at 407-408; CCH, *supra* note 1, ¶ 127-800.



to prevent partnerships from using allocations as a means of avoiding capitalization of items. For example, assume a real property partnership has an attorney as a partner. Attorney fees incurred as part of the acquisition of the property must be capitalized.<sup>118</sup> To avoid capitalization, a partnership might allocate an appropriate amount of partnership income to the attorney rather than treating the attorney as a third party and paying him or her a fee. Such action would not have any different tax consequences for the attorney who would have income in the amount received regardless.<sup>119</sup> The other partners' shares of the partnership income, however, would be reduced by the equivalent of an expense deduction for what should have been a capital item. Alternatively, a partner might make a contribution of the property to a partnership, coupled with a prompt distribution of money from the partnership to the partner, in order to avoid recognizing the gain resulting from the sale of an asset. Viewed independently, both events occur tax free.<sup>120</sup> Viewed together, the contribution and distribution effectively constitute a sale. I.R.C. § 707(a) and (b) contain rules which require tax treatment consistent with the substance and not the form of a transaction.<sup>121</sup>

Germany has not enacted a provision comparable to I.R.C. § 707 arguably because German partnerships cannot make special allocations.<sup>122</sup> This prohibition prevents much of the abuse discussed in the attorney example above. In Germany, parties often have the option of recognizing gains or losses on the contribution of property to a partner-

---

118. Rev. Rul. 68-528, 1968-2 C.B. 331.

119. Actually, if the allocated income were long term capital gains, the attorney would also benefit, since they are subject to maximum rate of tax of 28%. I.R.C. § 1(h).

120. *Id.* §§ 721, 731. *But see id.* § 731(a)(1) (stating that gain would be recognized if the money distributed exceeds the partner's basis in his or her partnership interest).

121. *See id.* § 707(a)(1) (providing that if a partner engages in a transaction with the partnership and the partner is acting in a role other than that of a partner, such as a partner offering year-end bookkeeping services, the transaction will be treated as occurring between the partnership and one other than a partner); *see also id.* § 707(a)(2) (extending this treatment by providing that if a partner performs services for, or transfers property to, a partnership and the partnership in turn distributes a related direct or indirect allocation to this partner, the transaction will be treated as occurring between the partnership and a partner acting as other than a member of the partnership). Therefore, the transaction could become a taxable event and not a tax free distribution under I.R.C. § 731 and/or contribution between a partner and partnership under I.R.C. § 721.

122. *See supra* notes 60-65 and accompanying text (discussing special allocations).

ship.<sup>123</sup> Under German law, if the parties opt not to recognize the gain, a partner may contribute property to the partnership and the partnership, in response, may distribute money to the partner in an effectively related transaction without having the transaction reconstituted as a sale as would be the case under I.R.C. § 707(b). The antiabuse rules of I.R.C. § 707 are of relatively recent origin in the United States<sup>124</sup> and Germany may simply not have had an opportunity to implement such rules. Alternatively, the abuse in Germany may not be at a level that would require a response. After all, the other partners must be willing to pay for the property while taking a carryover basis, which means smaller depreciation deductions. There may be circumstances in which the other partners would be willing to suffer smaller depreciation deductions in return for purchasing the property, such as where the partners have a particular need for the asset or where they are related—nevertheless, it appears unlikely that such situations arise frequently. The author has frequently wondered whether the abuse taking place in this country was sufficient frequent to justify the complex statutory response.

In the United States, partners acting in an independent third party capacity may also loan money to and perform services for the partnership. Alternatively, a United States partner can engage in such transactions in a partner capacity, and receive a I.R.C. § 707(c) “guaranteed payment in return.”<sup>125</sup> In Germany, however, all such payments are treated as an allocation of the partner’s share of partnership income.<sup>126</sup> Accordingly, the German partnership is not entitled to a deduction for what is the equivalent to a salary, interest, or rent. In addition to increasing the partnership income allocated to the partners, the lack of a

---

123. See *supra* notes 35-41 and accompanying text (discussing the recognition of gain or loss on the contribution of property to a partnership).

124. I.R.C. § 707 was enacted by Congress through the *Internal Revenue Code of 1954*, Pub. L. No. 591 (1954). The “disguised sale” rule described in § 707(a)(2) was introduced into the Code through the *Tax Reform Act of 1984*, Pub. L. No. 98-369, 98 Stat. 591 (1984). The Treasury promulgated related “disguised sale rule” regulations, Treas. Reg. § 1.707-0 and §§ 1.707-2, -9, on September 25, 1992, which effectively implemented the statute. T.D. 8439, 1992-2 C.B. 126.

125. An I.R.C. § 707(c) guaranteed payment, if for an expense-type item, is deductible to the partnership and constitutes ordinary income to the recipient. I.R.C. § 707(c). A guaranteed payment and a payment to a partner in a true third party capacity, i.e. an I.R.C. § 707(a) payment, are distinguishable in that the guaranteed payment is paid for acts the partner performs in his capacity as a partner and normally is only payable if adequate partnership funds are available. *Id.*

126. EstG, *supra* note 1, § 15(2); Judgment of July 18, 1979, Entscheidungen des Bundesfinanzhofs [BFH], 1979 BStB II 750 (F.R.G.).

deduction means a larger trade tax. The trade tax is assessed at the partnership level.<sup>127</sup>

Another example of how the German partnership system follows aggregate principles more often than entity principles is that, under German law, the partners may also attribute expense items from themselves to the partnership. Basically, as long as the expense items are related to partnership matters, income and expenses can flow from the partner to the partnership. For example, if the partner borrows funds to make his or her investment in the partnership, the partnership's income will be reduced by the partner's interest expense (allocating the expense to the partner).<sup>128</sup> Similarly, if the partner permits the partnership to use equipment owned by the partner, German law considers the equipment to be part of the partnership assets, even if never formally contributed to the partnership. Furthermore, under German law, any depreciation on the equipment constitutes an expense of the partnership, albeit one that will be allocated to the partner who owns the equipment.<sup>129</sup>

## XII. SALE OF A PARTNERSHIP INTEREST

In the United States and Germany, the sale of a partnership interest can generate a gain or a loss based on the difference between the amount realized and either the partner's basis in the partnership interest under United States law or the capital account balance under German law.<sup>130</sup> In the United States, the partnership interest usually will qualify as a capital asset and any gain or loss will be capital in nature.<sup>131</sup> Under United States law, such gains will receive preferential capital gain treatment.<sup>132</sup> Germany, on the other hand, does not distinguish between capital and noncapital assets,<sup>133</sup> but when certain types of property, including partnership interests, are disposed of at a gain, preferential tax treatment is available under German law.<sup>134</sup> In the United States, capi-

---

127. EstG, *supra* note 1, § 15(1) (stating that this treatment also occurs if the partner forms one or more partnerships and makes such partnerships a partner in the partnership making the payment). In other words, the rule cannot be circumvented by interposing partnerships. *Id.*

128. CCH, *supra* note 1, ¶ 127-900; BRANDMÜLLER, *supra* note 38, at 42-3.

129. BRANDMÜLLER, *supra* note 38, at 42-43.

130. I.R.C. § 1001; EstG, *supra* note 1, § 16(1).

131. I.R.C. §§ 1221-22.

132. *Id.* § 1(h) (imposing a maximum capital gains tax rate of 28% on individuals).

133. Gumpel, *supra* note 1, ¶ 9/7.

134. EstG, *supra* note 1, §§ 16(4), 34(1)-(2) (imposing in this case a preferential

tal losses are deductible from capital gains. Additionally, individuals can deduct up to \$3,000 of capital losses from ordinary income.<sup>135</sup> Germany, in contrast, does not have any limitations on the deduction of losses arising from property transactions. Any loss, capital or otherwise, will fully reduce ordinary income.

Germany has no statutory provision equivalent to I.R.C. § 751, under which a portion of the proceeds of a sale of a partnership interest constitute ordinary income if there is ordinary income inherent in certain partnership assets. United States law is designed to prevent a partner from converting ordinary income into a capital gain by selling a partnership interest instead of waiting for the ordinary gain—which would flow through as such to the partner—to be realized by the partnership.<sup>136</sup> The German system lacks the equivalent of I.R.C. § 751, notwithstanding the fact that the German tax system can tax certain capital-like gains at preferential rates. Partners, therefore, possibly may convert ordinary income into more favorably taxed gains under German law by selling a partnership interest prior to the sale of the partnership's underlying ordinary income assets. This tax advantage constitutes a loophole that the German tax system may want to close.<sup>137</sup>

---

rate that is half of the regular rate for gains not exceeding DM 30,000,000; and, further, imposing no tax at all on the first DM 30,000 of gains, while phasing out this benefit for sales in excess of DM 100,000).

135. I.R.C. § 1211(b).

136. *Id.* §§ 702, 751. The partner selling a partnership interest, for example, which has increased in value because of uncollected trade accounts receivable, receives part of the value traceable to these yet-to-be collected receivables. Had these receivables been collected at the partnership level, the proceeds would be classified as ordinary in nature. Section 751 ensures that the gain attributable to the receivables continues to receive the same ordinary income treatment regardless of whether the receivables are collected by the partnership or whether a partner receives value for them as part of the sale of a partnership interest. I.R.C. § 751. Depreciation recapture under I.R.C. §§ 1245, 1250 is a I.R.C. § 751 "hot asset," i.e., it falls within the coverage of I.R.C. § 751. *Id.* Germany has no depreciation recapture rules which would cause capital-type gain to be recharacterized as ordinary income.

137. The selling partner is required to take into account his or her share of partnership income or loss up to the time of the sale. *See supra* notes 114-17 and accompanying text (discussing the recognition of gain or loss on the sale of property under German law). The net income method of calculating income or loss takes changes in the values of partnership property into account. Gain can only be recognized on the disposition of property. *See supra* note 113 and accompanying text (discussing the recognition of gain or loss under United States law).

## XIII. INSIDE VERSUS OUTSIDE BASIS

In the United States, if a partner inherits or purchases a partnership interest, his or her "outside basis" in the partnership interest may not equal the proportionate share of the "inside basis" of partnership assets. The partner's "outside basis" would be equal to the partnership interest's fair market value,<sup>138</sup> whereas the "inside basis" of the partnership assets might be more or less than their fair market value. This distinction under United States law can cause misalignments.<sup>139</sup> Under I.R.C.

138. I.R.C. §§ 1012, 1014.

139. A partner's sale of a partnership interest or a partner's death are among the circumstances that make an election under I.R.C. § 754 possible. I.R.C. § 754. Such an election increases or decreases the "inside" basis of the inheriting or purchasing partner's share of partnership assets to equal the "outside" basis of that partner's partnership interest. *Id.* If the inside basis of a partner's share of partnership assets are "stepped up" as a result of the election, when the relevant assets of the partnership are sold, the purchasing or inheriting partner will not recognize gain to the extent of pre-acquisition appreciation. *Id.*

Example

A and B are equal partners in a partnership:

Partnership

Real Property

FMV \$1000

Basis \$ 600

A

B

FMV \$500

FMV \$500

Basis \$300

Basis \$300

B dies and leaves her partnership interest to her husband, C. Under I.R.C. § 1014, a person acquiring property from a decedent takes a fair market value basis in the property as of the date of death. C's basis in the partnership interest, therefore, is its fair market value or \$500 (half the value of the partnership assets):

Partnership

Real Property

FMV \$1000

Basis \$ 600

A

C

FMV \$500

FMV \$500

Basis \$300

Basis \$500

If the partnership has an I.R.C. § 754 election in effect, C is entitled to a special inside basis step-up for "his half" of the real property from \$300 to \$500. This means that if the real property is sold for \$1000, C recognizes no gain. His share of the amount realized is \$500 and his share of the inside basis is \$500:

Partnership

Real Property

"A's Half"

"C's Half"

§ 754, the partnership may elect to give its partners a special inside basis in the partner's "share" of the partnership assets equal to the outside basis.<sup>140</sup> If such election results in an inside basis increase, the additional basis can generate extra depreciation for the relevant partner and/or decrease the partner's gain on the partnership's sale of the property.<sup>141</sup> The converse would apply with respect to an inside basis decrease.

Germany, in contrast, has no need for an I.R.C. § 754 election because Germany has the equivalent of a mandatory § 754 election. If a party purchases a partnership interest, inside basis of the partnership assets will be adjusted to reflect the purchase.<sup>142</sup> For example, if the price paid for the partnership interest exceeds the selling partner's basis in his or her partnership interest, the inside basis of the partnership assets will be proportionately increased under German law. The inside basis of the partnership's tangible and intangible assets may be increased only to the asset's fair market value. If the overall increase exceeds the asset's fair market value, any excess will be allocated to partnership goodwill.<sup>143</sup> In the United States, a partnership also may make an allocation to goodwill when the I.R.C. § 754 election is in effect, as is the case in Germany.<sup>144</sup> Similar to I.R.C. § 197, under German law, a partnership may amortize any amounts allocated to goodwill over fifteen years.<sup>145</sup>

---

FMV \$500	FMV \$500
Basis \$300	Basis \$500
A	C
FMV \$500	FMV \$500
Basis \$300	Basis \$500

I.R.C. § 754 elections can, of course, result in a basis *step-down*. Thus, in the prior example, if the fair market value had been \$600 and the basis had been \$1000, C's share of the inside basis would have been stepped down from \$500 to \$300. Once the I.R.C. § 754 election is made, it can only be revoked with the consent of the Service. In the example, if no election had been previously made at the time of B's death, and A is otherwise amenable, the parties can choose to make or not to make an election based on which option would be the most advantageous.

140. I.R.C. §§ 734, 743.

141. *Id.* § 755; Treas. Reg. § 1.755-1.

142. Judgment of Feb. 19, 1981, Entscheidung des Bundesfinanzhofs [BFH], 1981 BStB II 730; CCH, *supra* note 1, ¶ 128-000.

143. CCH, *supra* note 1, ¶ 128-000.

144. I.R.C. § 1060.

145. *Id.* § 197; EstG, *supra* note 1, § 7(1).

## XIV. LIQUIDATION OF A PARTNER'S INTEREST

In the United States, when a partner's interest is liquidated, the partner's capital account is adjusted for that partner's share of partnership income or loss incurred up to the time of the liquidation.<sup>146</sup> Normally, the partnership will pay to the partner the balance of the partner's positive capital account.<sup>147</sup> The capital account of the partner receiving the distribution is reduced by the cash and the fair market value of any property that is distributed.<sup>148</sup> If the payment is in cash, the partner will have a capital gain, if the amount is greater than the partner's partnership interest basis, or a loss, if the payment is less than such basis.<sup>149</sup> United States law treats payments to a partner, which are attributable to ordinary income assets, as ordinary income to the partner.<sup>150</sup> Finally, if a partner has a deficit capital account balance, the partner typically will be obligated to restore it on liquidation of the interest and will not have the right to any payment in liquidation of the interest.

In Germany, a partner's capital account is also adjusted by the partner's share of income or loss of the partnership at the time of departure.<sup>151</sup> German law, however, has no requirement that a partnership pay to the departing partner the positive balance of the partner's capital account on the liquidation of the partner's interest. There is no need for such a requirement in Germany because adjustments are made in a different manner. German law does not distinguish between a partner's capital account and tax basis. The departing partner recognizes gain or loss based on the difference between the money received and the partner's capital account balance.<sup>152</sup> The gain can be subject to favorable rates of taxation.<sup>153</sup> The loss should be fully deductible.<sup>154</sup> If the amount paid to the partner exceeds the capital account balance, the excess may be attributable to goodwill or gain inherent in partnership

---

146. I.R.C. § 706(d).

147. Treas. Reg. § 1.704-1(b)(2)(ii).

148. *Id.* § 1.704-1(b)(2)(iv).

149. I.R.C. §§ 731(a)(2), 1001.

150. *Id.* §§ 736(a), (b)(2), 751(b).

151. Gumpel, *supra* note 1, ¶ 6/5.5(d).

152. EstG, *supra* note 1, § 16(1).

153. *See supra* note 37 and accompanying text (discussing the imposition of favorable tax rates on such gain).

154. *See supra* notes 38-41 and accompanying text (discussing loss deductions under net worth system).

assets—such inherent gain is called latent reserves (*stille Reserven*). In either event the excess payment is capitalized, thereby increasing the book values of the relevant partnership assets.<sup>155</sup> Under the net income method of income recognition, a partnership incurs net income if the book values, with adjustments, at the end of one year exceed the book values at the end of the prior year. If book values are increased as a result of a partner's exit, the partnership will be more likely to incur ordinary income in the relevant tax year. If the partnership demonstrates that there is no goodwill or appreciation inherent in partnership assets, the excess payment is a deductible expense.<sup>156</sup>

If the amount paid is less than the partner's capital account balance, the partner will incur a loss and the partnership must proportionately reduce the basis of its assets.<sup>157</sup> Under the net income method of reporting, the partner's loss could generate reduced partnership income or a partnership loss. A payment of less than book value is less likely because a drop in the value of assets generates a loss—or reduced income—under German law for the year such drop occurs. Accordingly, any loss should already have been taken, and should already be reflected, in the capital accounts.<sup>158</sup>

If a general partner leaves a partnership with a negative capital account, as in the United States, the general partner has the obligation to restore the deficit.<sup>159</sup> A limited partner can only develop a negative capital account to the extent the partner has an obligation to restore the negative balance, and then only if the obligation is noted in the commercial registry.<sup>160</sup> Otherwise, the negative balance of the capital account is income to the limited partner in the year the negative balance arises.<sup>161</sup>

In Germany, where a partnership distributes property in liquidation of a partner's partnership interest, the partnership recognizes a gain or loss depending on the nature of the partner's use of the property. No gain or loss is recognized if the distributee partner continues to use the property in a trade or business.<sup>162</sup> To avoid a taxable event, the partner must

---

155. BRANDMÜLLER, *supra* note 38, at 137-142; Gumpel, *supra* note 1, ¶ 9/7.2(f).

156. Gumpel, *supra* note 1, ¶ 9/7.2(f).

157. *Id.* ¶ 9/7.2(f).

158. See BRANDMÜLLER, *supra* note 38, at 142 (discussing the treatment of losses in capital accounts).

159. *Id.* at 147.

160. EstG, *supra* note 1, § 15a(1).

161. *Id.* § 15a(3).

162. CCH, *supra* note 1, ¶ 128-200.



not necessarily receive a viable business unit; rather, German law requires only that the assets the partner receives be used in a trade or business.<sup>163</sup> To the extent the distributee partners do not continue to use the property in a trade or business, the partnership recognizes a gain or loss. Any gain is subject to favorable tax treatment, provided what is discontinued is either an entire business of the partnership or an independent division thereof.<sup>164</sup> Where the distribution is a taxable transaction, German law requires that the distributee partner's capital account be decreased by the partnership's basis in the distributed property plus any gain, less any loss, recognized.<sup>165</sup> If, depending on the circumstances, the basis or value of the distributed property differs from the partner's capital account balance, gain or loss should be recognized.

## XV. DISSOLUTION

Germany's partnership dissolution rules generally track those rules discussed above under the headings "*Distributions*" and "*Liquidation of a Partner's Interest*." In Germany, as is the case in the United States, the decision to dissolve a partnership does not automatically terminate the partnership's existence. Following a decision to dissolve, the affairs of the partnership first must be wound up.<sup>166</sup> In Germany, once a partnership embarks on the dissolution process, the partnership is no longer subject to Germany's trade tax.<sup>167</sup> If the partnership sells the entire business or an independent division thereof (*Teilbetrieb*) in a unitary transaction, as opposed to on a piecemeal basis, gains are subject to favorable tax treatment.<sup>168</sup> In the United States, to the contrary, gains or losses are always determined piecemeal based on the type of asset sold. If a capital asset is sold, any gain or loss is capital; if an ordinary income asset is sold, any gain or loss is ordinary. In the United States, if the assets of a dissolving partnership are not sold, but instead are distributed to the partners, the partners generally do not recognize any gain or loss, and take a carryover basis in the property received in dissolu-

---

163. Judgment of Dec. 10, 1991, Entscheidung des Bundesfinanzhofs [BFH], 1992 DB 1383 (F.R.G.).

164. EstG, *supra* note 1, §§ 16(4), 34.

165. See BRANDMÜLLER, *supra* note 38, at 48-49 (discussing the determination of a partner's capital account).

166. CCH, *supra* note 1, ¶ 128-200.

167. Judgment of Apr. 24, 1980, Entscheidung des Bundesfinanzhofs [BFH], 1980 Bstbl II 658 (F.R.G.).

168. EstG, *supra* note 1, §§ 16(4), 34.

tion of the partnership. Ordinary income is triggered if a partner converts his or her interest in an ordinary income asset to other property.<sup>169</sup>

In Germany, there is no special rule for ordinary income assets. As discussed above, a partnership's decision to recognize gains or losses depends on whether the distributee partners continue to use the property in a trade or business.<sup>170</sup> It is permissible to pay "boot" (e.g., cash) to equalize values without changing the tax free nature of the transaction. Thus, if the assets received by one equal partner have a value in excess of those received by another equal partner, the first partner can pay boot to the second partner to equalize the values without jeopardizing the tax free nature of the transaction.<sup>171</sup> In the United States, a transfer of money in exchange for an extra share of assets usually constitutes a taxable exchange of assets.<sup>172</sup>

### CONCLUSION

One of the reasons given for why the United States partnership tax system generally does not tax contributions to, and distributions from, partnerships is that simply doing business together or ceasing to do so should not be a taxable event. The difficulty with that view is that, unadorned, it can give rise to tax abuse. Taxpayers might try to avoid their share of partnership ordinary income by selling a partnership interest before the income is collected. The United States enacted I.R.C. § 751 to address this problem. Taxpayers might use the partnership as a vehicle to turn a taxable sale into a nontaxable contribution of property and distribution of money. I.R.C. § 707(a)(2)(B) arose in defense. The United States system has at times been a bit schizophrenic as to when to apply aggregate versus entity principles. For reasons that are not always apparent, the United States has been reluctant to integrate partner/partnership transactions. In some instances, the Code integrates such transactions and in other instances the Code does not, or as is the case with I.R.C. § 754, gives taxpayers the option. These considerations have given the United States partnership tax provisions a:

. . . distressingly complex and confusing nature . . . [which presents] . . .  
a formidable obstacle to the comprehension of these provisions without

---

169. I.R.C. §§ 731-733, 736, 751.

170. CCH, *supra* note 1, at ¶ 128-200.

171. *Id.*

172. I.R.C. §§ 1001, 351, 1031.

the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field.<sup>173</sup>

It is noteworthy that this statement was made by Judge Raum in 1964. Partnership tax law has increased in complexity manyfold since 1964. Indeed the I.R.S. has become so concerned that devious taxpayers might use that complexity to their advantage before the I.R.S. or Congress can catch up with them, that the I.R.S. recently promulgated the antiabuse regulations, a sort of catchall rule that says, among other things, that if taxpayers use partnerships inappropriately, the I.R.S. can ignore the partnership form.<sup>174</sup>

Germany has managed to avoid such complexity through a variety of methods. Contributions to and distributions from partnerships are not always tax free. Commercial taxpayers are required to be on the accrual method of accounting. Germany uses a net worth system of income determination. Germany does not share the United States obsession with closing every loophole, at times seemingly regardless of size. Outside of the arena of contributions and distributions, Germany is more consistent in its application of aggregate principles and has, to a larger extent, foregone entity principles.

That is not to say the German partnership tax system is not without its problems. Income determination under German law often requires businesses to appraise property, which poses a burden. Germany further has loopholes the United States system lacks, some of which seem quite significant. German tax statutes, at times, carry the virtue of brevity to an extreme. It is not immediately apparent why the German tax system should go the final mile in applying aggregate principles and not tax contributions to and distributions from partnerships—with the recipients taking a carryover basis. Yet, despite the surprising differences between the German and United States partnership tax systems, Germany's partnership tax system is impressive by virtue of its simplicity, and is more effective at times than its United States counterpart. Although the United States should not, and would not want to, adopt German partnership tax rules lock, stock, and barrel, the German system has important lessons to teach us.

---

173. *Foxman v. Commissioner*, 41 T.C. 535, 551 n.9 (1964).

174. Temp. Treas. Reg. § 1.701-2 (1994).