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A Partnership Is Not a Corporation

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Recent troubling developments in the cross-border tax treatment of partnerships are the latest manifestation of a fundamental confusion over the nature of a partnership that has been escalating for years. Although many would claim (and the IRS has in fact claimed, as discussed below) that these developments arise from the fact that the check-the-box regulations make partnership status widely elective, this was really nothing new,[1] and the confusion long predates those regulations. I believe that the real explanation for the trend described in this short piece is tendency of tax people — in and out of the government — to feel the need to search for some nonexistent partnership analog to some corporate tax rule.

It should go without saying, but is often forgotten, that many if not most corporate tax rules are necessary only because a corporation is a separate taxpayer. Because a partnership is not a separate taxpayer, it will usually be the case that there is no partnership analog to a given corporate rule. Yet we seem bent upon searching for analogs even where none is needed.

Almost nothing in Subchapter K refers to any corporate rule. It is evident that Congress, when it enacted Subchapter K in 1954, did not think that any corporate rules were needed. As is well known, Subchapter K as it originally took form in 1954 embodies an amalgam of what are referred to as the ''aggregate'' and ''entity'' approaches to taxation of partnerships and their partners. Subchapter K was and is a law unto itself, and generally has no need to refer to corporate rules.

It is true that in the early days of Subchapter K, obvious gaps had to be filled by the IRS, because Congress had not envisioned that the partnership form would be used outside the traditional areas of energy, law, brokerage, accounting, and the like. Small businesses generally used Subchapter S to limit individual liability. Large investment partnerships such as private equity funds were unknown. For example, an obvious gap that had to be filled was how to treat the sale of only a portion of a partner's partnership interest. Suppose that Partner A has a basis of $10 in her partnership interest and sells 40% of that partnership interest to an unrelated person for $40. What is her gain — $30 or $36? The Code provides no answer, probably because Congress didn't imagine that partners, who are regarded as mutual agents of one another, would ordinarily sell a portion of their partnership interests as if the partnership interest consisted of shares of stock. The Code has long contained a unified basis principle for partnerships, so there is nothing like the share-by-share identification regime that applies to corporate stock.

As a result, the IRS was required to make up a rule, which it duly did in Rev. Rul. 84-53,[2] providing for proration of basis when only a portion of a partnership interest is sold. So the gain in the simple example

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[1] It is precisely because the entity classification rules were largely elective in practice that the government saw fit to make them explicitly elective. The really revolutionary aspect of the check-the-box regulations was the recognition of disregarded entities, a subject not relevant to this piece.

[2] 1984-1 C.B. 159, citing Reg. §1.61-6(a).

above is $36 (40% of $ 10 basis, or $4, subtracted from $40 amount realized). The seller is not allowed to recover full basis first; that rule is the aggregate-flavored rule of §731[3] applicable to partnership distributions, not the entity-flavored rule of §741 applicable to sales of partnership interests.

Note that the IRS did not feel the need to analogize the rule it created to anything in the corporate tax area, which would have required some share-by-share determination of basis. Instead, the ruling was based on regulations issued in 1957 under §61, which did not provide any special rule for sales of partnership interests but rather applied to partial sales generally.

In those early days, the IRS also resisted the impulse to engraft corporate principles upon partnerships in the context of the Subchapter C rules themselves. For example, Rev. Rul. 95-69[4] addressed the continuity-of interest issue[5] in a case where a partnership received stock in a tax-free corporate reorganization and promptly distributed that stock to its partners. If the partnership had been treated as a corporate-like entity, the subsequent distribution might well have given rise to a continuity problem, rendering the corporate reorganization taxable. But the IRS sensibly reasoned that because a partnership is only an aggregation of its partners, as long as the partners remain the same before and after the distribution, nothing had happened to destroy continuity.

The IRS came to the same sensible conclusion in the reverse case, where the ''control immediately after'' requirement of §351 is implicated. Even though there is no rule in the Code that blesses a subsequent ''drop'' to a partnership owned by the transferors, the IRS ruled in PLR 201133006 that the drop is not a decontrol transaction. But by this time, the IRS was beginning to be confused about partnerships. In its rationale for the private ruling, the IRS erroneously relied upon a corporate analogy, Rev. Rul. 2003-51.[6] This was superfluous: As in the continuity case, there is simply no need for a rule to conclude that the drop to a partnership does not bust control.

The source of this unfortunate tendency to view transfers to and from partnerships as relevant to the characterization of an underlying transaction would appear to be Rev. Rul. 84-52.[7] This much-debated ruling found a realization event in a simple, formless conversion of a general partnership into a limited partnership. If the partnership were a corporation, one might analogize the conversion to an ''F'' reorganization. But there is no need for such a rule in the partnership context. Because nothing of tax import is happening in the conversion, it should be regarded as simply a nothing.[8]

The confusion created by Rev. Rul. 84-52 was magnified by the partnership merger and division regulations issued under §708 in 2001.[9] These regulations are notable, among other reasons, for their deliberate failure even to define what a partnership merger is. Taxpayers are left wondering whether a state law merger of a partnership into a new partnership with the same partners is covered by the partnership merger regulations. It should not be; it's a nothing. One doesn't need to resort to analogies such as F reorgs and transitory merger subs to get to the right answer under Subchapter K.

Another aspect of the confusion over partnerships is the tendency to assume that where a specific rule of the Code mentioned corporations, it was intended to exclude partnerships. It seems not to have been imagined that there may simply be no need for the rule in the partnership context. For example, §118, titled ''Contributions to the capital of corporations,'' provides: ''In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.'' Although it is obvious that no such rule is needed for contributions to a partnership, the IRS has uniformly taken the position that the exclusion provided by §118 for nonshareholder contributions and grants does not apply to partnerships.[10]

Similarly, §108(e)(6) excludes from the income of a corporation debt contributed by a shareholder, to the

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[3] All section references are to the Internal Revenue Code, as amended (the ''Code''), or the Treasury regulations thereunder.

[4] 1995-2 C.B. 38.

[5] *See* Reg. §1.368-1(b).

[6] 2003-1 C.B. 938.

[7] 1984-1 C.B. 157.

[8] The conversion might have an effect on basis in debt under the §752 rules, given that those rules treat general partners and limited partners differently. But that issue was well covered in Rev. Rul. 84-53, above, and does not need to be addressed by creating a fictional realization event.

[9] T.D. 8925, adding Reg. §1.708-1(c) and §1.708-1(d). The preamble to the final regulations states: ''The IRS and Treasury have decided not to provide comprehensive definitions of what is a partnership merger or division in these final regulations.'' A more accurate statement would have been that the government decided not to provide *any* definition of the term, much less a comprehensive one.

[10] *See* Blanchard, *The Taxability of Capital Subsidies and Other Targeted Incentives*, Tax Notes (Nov. 9, 1999), p. 781; Doc. 1999-35675. The apparent concern is that qualification for the benefit of §118 is cabined by the requirement that the tax-free proceeds not give rise to basis, a rule that applies explicitly to corporation under §362(c). Non-partner contributions and grant to partnerships do not need a rule such as §362(c) to avoid a double deduction. All that is needed is a proper application of Subchapter K principles. Excluded income of this type, because any ''basis'' was not created by a partner or the partnership, should not give rise to basis at either the partnership or the partner level. In *Gitlitz et al. v. Commissioner*, 531 U.S. 206 (2001), the Supreme Court ruled that COD excluded from a Subchapter S corporation's income under §108(d)(7) gave rise to basis in the hands of a shareholder. This

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extent of the shareholder's basis therein. Because that paragraph applies only to corporations, the IRS takes the view that if a partner contributes partnership debt to a partnership, COD could result. This interpretation ignores the fact that an explicit rule was needed for corporations but is not needed for a partnership. The error here is tantamount to saying that a contribution to a partnership must be taxable because §1032 applies only to corporations. No one would seriously maintain that when a partnership issues property to a partner in exchange for a partnership interest, the partnership has gain. (Capital shifts result in income to other partners, not to the partnership.) A partnership is not a taxpayer, and does not need the protection of §1032.

The error of treating partnerships as if they were some type of non-taxpaying corporation has bedeviled the proper formulation of international and cross-border tax rules for many years. The original sin was to treat a domestic partnership as a U.S. person in its own right for purposes of subpart F. It was not difficult to foresee that treating a partnership as the inclusion shareholder while taxing only the partners would create all sorts of mischief;[11] yet this unthinking literalism persisted for many years, and has only recently been revisited in light of the enactment of GILTI.[12] More recently, Congress adopted an approach to partnerships in the interest cap rules of §163(j) that virtually everyone agrees was completely wrong-headed. By applying those rules at the level of the partnership taking into account only the partnership's items of income and deduction, the model invites the interposition of partnerships for planning purposes.

Meanwhile, the IRS has recently promulgated two sets of regulations that double down on this incorrect approach to partnerships. The foreign branch income regulations treat a partnership as the required single owner of a branch, but attribute foreign branch income only to the U.S. partners, recognizing, of course, that a partnership is not a taxpayer. The correct approach would have been to recognize that a branch must have one owner, and a partnership is not a single owner but an aggregation of owners. Put simply, a U.S. person can conduct activity through a branch or through a partnership, but not both.[13]

Saving the worst for last, the final PFIC regulations issued late in 2020[14] allow a foreign corporation being tested for PFIC status to look through only those partnerships that are at least 25% owned. Not only is there no basis in the statute for such a rule, the rule violates the canon of statutory construction known as *expressio unius exclusio alterius*. Section 1297(c) provides an express look-through rule for 25%-or-greater-owned corporations, which is necessary because a corporation is not otherwise a look-through entity. No rule is needed for partnerships, which are look-through entities.

The preamble to the PFIC regulations states that, following the check-the-box regulations, there is little to distinguish corporations from partnerships. The evident concern motivating the made-up rule was that a foreign corporation might invest in a portfolio of equity interests and "check open" the portfolio companies to avoid PFIC status. But the rule sweeps far more broadly, encompassing a true joint venture partnership in which a U.S. partner owns less than 25% of the business.

Partnerships are not taxpaying entities. Any rule that treats a partnership as a separate person for purposes of applying some non-Subchapter K provision will distort the proper functioning of the tax system. That is because you can't have it both ways: You can't pass through items of income and loss to partners while giving tax effect to a partnership as if it were the taxpayer being tested.

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result was reversed by legislation. The author is aware that the government had some doubts about its regulatory authority to write the correct result into regulations, which doubts may extend to the analogous §362(c) case. However, in the context of Subchapter K, the IRS's authority to write proper regulations is clear.

[11] For example, the need for the "domestic partner blocker" Notices. *See* Blanchard, *Notices 2010-41 and 2009-78: Thoughts on the Scope of IRS Authority*, 51 Tax Mgmt. Memo. 355 (Oct. 11, 2010) and *Notice 2010-41: Schrödinger's Cat*, 39 Tax Mgmt. Int'l J. 402 (July 9, 2010).

[12] *See* Blanchard, *Subpart F and Domestic Partnerships: One More Time, With Feeling*, 47 Tax Mgmt. Int'l J. 651 (Oct. 12, 2018).

[13] *See* Blanchard, *What Is a Foreign Branch?*, 48 Tax Mgmt. Int'l J. 184 (Apr. 12, 2019).

[14] T.D. 9936.

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