

Applying the Look-Through Rules in Determining ‘Investment Partnership’ Status Under Section 721(B)

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Careful Evaluation and Planning Should Be Undertaken When the Partnership Is Formed and When Assets Are Contributed to Evaluate the Potential Impact of Section 721(b).

Many taxpayers choose partnership structures (including LLCs taxed as partnerships) to operate their businesses. The tax consequences of setting up and contributing property to a partnership can be beneficial because contributing property in exchange for interest in the partnership generally does not result in recognition of gain or loss for the contributing partner or the partnership.¹ However, when property is contributed to an “investment partnership,” that same contribution may be treated as a taxable exchange to the contributing partner. Under section 721(b), an “investment partnership”² is a partnership in which more than 80 percent of the value of the assets of the partnership is from “stock and securities” that are “held for investment” (the 80 Percent Test).³ Under the 80 Percent Test, “stocks and securities” include a variety of liquid assets, such as cash, stock in corporations and interests in other entities that hold such liquid assets. The determination of whether a partnership is an investment partnership with respect to a contribution is made immediately after the contribution. However, if subsequent events occur pursuant to a plan in existence at the time of the contribution, the determination takes into account those subsequent events.⁴

‘Stock or Securities’ Defined

While cash is generally included in the 80 Percent Test, it is not clear if cash that is working capital is included. Although cash is included in the list of liquid assets treated as stocks or securities, all of the liquid assets considered in the 80 Percent Test must be “held for investment.” Accordingly, since working capital presumably is not “held for investment,” it would not be considered cash that is within the definition of stock or securities for purposes of the 80 Percent Test.

Certain practitioners appear to agree that cash held for working capital should not be included in the 80 Percent Test, but, in the absence of formal authority, the most conservative approach would be to treat operating cash as stock or securities for purposes of the 80 Percent Test. If faced with a situation in which the treatment of working capital is critical to the status of the partnership under the 80 Percent Test, it may be difficult to determine the appropriate amount of cash to treat as working capital. A reasonable methodology might be to determine the typical cash balances carried by companies in a similar industry, with a similar capital structure and cash-flow needs, though this data may be less available than metrics based on all current assets (rather than just cash). No formal guidance has been issued, however, to support a particular methodology for partnerships hoping to validate

that their cash is not within the scope of “stock and securities” under section 721(b).

Additionally, if there is a defined plan in place to use cash to acquire property that would not be treated as stock or securities under the 80 Percent Test, it likely should not be treated as stock or securities.⁵

The Look-Through Rules

When applying the 80 Percent Test to a partnership, two look-through rules apply:

A partnership is treated as owning directly its ratable share of the assets held by any corporation in which it owns a 50 percent (by vote or value) or greater interest.⁶

The value of an interest in a lower-tier partnership is treated as being apportioned between “stocks and securities” and other assets based on the assets held by the partnership when the partnership’s holdings of assets that are treated as “stock and securities” constitute 20 percent or more of its total assets and 90 percent or less of its total assets by value.⁷

Corporate Subsidiary Look-Through Rule

While there appear to be few ambiguities associated with the corporate look-through rule, two common issues can arise.

First, how does the look-through rule apply in the context of tiered corporate subsidiaries? For example, if a partnership (P) owns 75 percent of the stock of a first-tier corporate subsidiary (S1), and S1 owns 65 percent of the stock of a second-tier corporate subsidiary (S2), it is unclear whether P may apply the look-through rule to S2. The applicable regulatory language states:

[S]tock and securities in subsidiary corporations shall be disregarded and the **parent** [partnership] shall be deemed to own its ratable share of its subsidiaries’ assets. A corporation shall be considered a subsidiary if the **parent** owns 50 percent or more of (i) the combined voting power of all classes of stock entitled to vote or (ii) the total value of shares of all classes of stock outstanding.⁸

Although P owns less than 50 percent of the stock of S2 indirectly (49 percent), you could take the view that, because it owns more than 50 percent of S1, the assets of S2 are pushed up to P. Because S1 owns more than 50 percent of S2, P would be able to look through to the assets of S2 under this approach. However, the literal language of the regulation, which focuses on the ownership of the “parent” (the tested partnership) with respect to the subsidiary, suggests that the assets of S2 are not taken into account by P.

Second, what ratable percentage of the underlying assets is treated as being owned when the partnership owns a different percentage of voting interest in the corporation than it does in the value of the corporation (e.g., when the tested partnership holds both voting and nonvoting stock with equal economic rights)? From a practical standpoint, when testing a particular partnership, it may be sufficient to use the lesser ownership percentage if this does not have a material effect on the assets being treated as held by the tested partnership. However, at least one commentator has suggested that value (rather than vote) is the appropriate measure.

Partnership Look-Through Rules

The partnership look-through rules are based primarily on a reference in legislative history to rules similar to the regulations promulgated under section 731(c)(2). These rules look to the value of assets that constitute stocks or securities owned by the partnership. A critical question in determining which assets are treated as owned by a lower-tier partnership is whether the lower-tier partnership is treated as owning assets of a corporation in which it owns more than 50 percent of the vote or value. Within the context of section 731(c)(2) and the associated corporate regulations, there is no corporate look-through rule. However, based on a private letter ruling, it appears that a lower-tier partnership may look through 50-percent-owned subsidiaries in determining the composition of its assets when applying the partnership look-through rules.

In the matter addressed by Private Letter Ruling 200211017, persons contributed property to a corporation (C1 — the tested entity) that included a percentage interest (the actual percentage ownership interest was redacted in the ruling) in a partnership (P1). P1 owned a percentage (also redacted in the ruling) of the stock of a corporation (C2), which owned 100 percent of a subsidiary corporation (S). The assets of S constituted more than 80 percent of C1's assets immediately after the contribution. The ruling concluded that the transfer of the P1 interest was not a transfer to an investment company under section 721(b). Thus, the redacted percentage interest in C2 was apparently greater than 50 percent, and P1 was treated as holding the assets of C2 and S, and, therefore, C1's interest in P1 was not treated as a stock or security.

Pepper Perspective

Because partnership structures are very commonly used for business operations, including for funds and other investment businesses, taxpayers need to carefully review the mix of assets to ensure tax-free treatment when the partnership is formed and assets are contributed to the partnership in exchange for interest in the partnership. The definition of “stocks or securities” under section 721(b) can be very inclusive, and there is very little guidance to provide a safe-harbor-type methodology for determining whether or not cash or assets fall outside the definition of under the rules. Thus, careful evaluation and planning should be undertaken when the partnership is formed and when assets are contributed to evaluate the potential impact of section 721(b).

Endnotes

¹ Section 721(a) of the Internal Revenue Code of 1986, as amended (the Code). All references herein to “section” refer to sections of the Code or the Treasury Regulations promulgated thereunder.

² More specifically, under the Code, “a partnership that would be treated as an investment company (within the meaning of Section 351) if the partnership were incorporated.” Section 721(b).

³ Notably, for the contribution to be treated as a taxable exchange, it must also result in “diversification.” This article generally assumes that a contribution will result in diversification and, thus, does not discuss the matter beyond this footnote. The general premise behind diversification is that a person should not be able to transfer assets to a partnership in exchange for interest in the partnership in a tax-free transaction if the person is contributing a single type of property, or a nondiverse selection of property, in exchange for an interest in a partnership that represents shares in a diversified portfolio of assets, because this represents a change in the type of investment, rather than a continuing investment in the contributed asset through interest in the partnership.

⁴ Treas. Regs. § 351-1(c)(2).

⁵ It would seem that there should be some level of certainty associated with the plan if it is being used to carve cash out of the definition of stock and securities.

⁶ This is consistent with the concept that only investment assets count towards the 80 Percent Test, because ownership interests of more than 50 percent are typically associated with the owner's exerting significant operational control over the entity. Thus, stock and securities in 50-percent-owned subsidiary corporations are disregarded, and the parent corporation is deemed to own its **pro rata share** of its subsidiaries' assets. Treas. Regs. § 1.351-1(c)(4).

⁷ If assets treated as stocks or securities constitute less than 20 percent, or more than 90 percent, of the partnership's assets, the partnership interest is treated as either wholly an asset treated as a stock or security (if more than 90 percent) or not a stock or security in any capacity. These rules are based on a reference in legislative history to regulations promulgated under section 731(c)(2).

⁸ Treas. Regs. §1.351-1(c)(4).

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