Aggregate and Entity in The Partnership World

By Monte A. Jackel

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Monte A. Jackel is a *Tax Notes* contributing columnist and a managing director in PricewaterhouseCoopers LLP in Washington. All views expressed herein are his own and not those of any other person or organization.

In this article, Jackel surveys the law regarding the treatment of a partnership as a separate entity or as an aggregate of its partners and concludes that the results are difficult to predict, given the lack of a consistent theory to apply to the various situations in which the issue can arise.

A. Introduction

Entity and aggregate concepts are a consistent theme in partnership taxation.[1] Under the entity concept, the partnership is treated as a separate tax person or entity much like a corporation is treated as a separate tax person or entity. Under the aggregate concept, transactions or other events at the partnership level are in effect treated as if engaged in by the partners of the partnership directly.

The resolution of whether a particular partnership transaction should be treated under the aggregate or entity concept can have significant effects on matters such as character of income or loss and whether income earned by the partnership is subject to tax in the hands of the partners.

There is a substantial amount of authority supporting the proposition that a partnership should be treated either as an aggregate of its partners or as an entity separate from its partners based on which approach is more appropriate in applying the policy aspects of the code provision at issue. That principle is derived from the following statement in the 1954 legislative history to the then-new subchapter K of the code:

> Both the House provisions and the Senate amendment provide for the use of the ''entity'' approach in the treatment of the transactions between a partner and a partnership which are described above. No inference is intended, however, that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions. An illustration of such a provision is section 543(a)(6), which treats income from the rental of property to shareholders as personal holding company income under certain conditions.[2]

This article provides a survey of the many authorities that have addressed the aggregate-entity partnership question. I have not expressed a view on the result in any of the authorities surveyed, and readers should draw their own conclusions about any common thread or theory in the results from those authorities. I believe there is no common thread or theory and that each authority appears to be based on the drafter's point of view regarding which approach results in the most appropriate tax policy result. That can lead to confusion and ambiguity in applying aggregate-entity principles to cases for which there is no direct authority.

B. Sales of Partnership Interest

The sale of a partnership interest has generated a substantial body of law relating to whether the aggregate or entity view would be controlling. The key focus is whether the taxpayer should be treated as selling the underlying assets of the partnership or as selling an actual separate property interest in

[1]For general background, see Alfred Youngwood and Deborah Weiss, ''Partners and Partnerships — Aggregate vs. Entity Outside of Subchapter K,'' *Tax Lawyer* (Fall 1994); Robert Staffaroni, ''Partnerships: Aggregate vs. Entity and U.S. International Taxation,'' *Tax Lawyer* (Fall 1995); Kimberly Blanchard, ''Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Attributes to Partners'' (Sept. 8, 1997), *Doc 97-25288*, *97 TNT 173-69*.

[2]H.R. Rep. No. 2543 (1954).

a partnership. Character of income, loss, and taxability questions depend on the answer to that question. A survey of authorities follows.

1. 1954 House and Senate reports on sections 741 and 751.

a. House report.

Under present decisions the sale of a partnership interest is generally considered to be a sale of a capital asset, and any gain or loss realized is treated as capital gain or loss. It is not clear whether the sale of an interest whose value is attributable to uncollected rights to income gives rise to capital gain or ordinary income. There is also doubt under present law whether the basis of the assets of the partnership may be adjusted, or is required to be adjusted, to reflect the purchase price paid by a new partner for his interest. . . . Because of the confusion in this area, basic rules have been set forth in order to clarify the tax treatment and at the same time to prevent the use of the sale of an interest in a partnership as a device for converting rights to income into capital gain. . . . The general rule that the sale of an interest in a partnership is to be treated as the sale of a capital asset is retained. . . . In order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests, certain rules have been adopted by your committee which will apply to all dispositions of partnership interests. The bill provides that, if in connection with the transfer of a partnership interest, the partner receives any amount attributable to his share of (1) the unrealized receivables and fees of the partnership, or (2) substantially appreciated or depreciated inventory or stock in trade, such amounts are to be treated as ordinary gain or loss. *In effect, the partner is treated as though he disposed of such items independently of the rest of his partnership interest*.[3]

b. Senate report.

In order to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests or by distributions of property, certain rules have been adopted by the House and your committee which will apply to all dispositions of partnership interests. The bill provides that, if in connection with the transfer of a partnership interest, the partner receives any amount attributable to his share of (1) the unrealized receivables of the partnership, or (2) substantially appreciated inventory or stock in trade, such amount is to be treated as ordinary gain or loss. *In effect, the partner is treated as though he disposed of such items independently of the rest of his partnership interest. . . .* Except for technical amendments, this section corresponds to the House provision. It provides that the sale or exchange by a partner of his interest in the partnership shall be treated generally as the sale or exchange of a capital asset. Any gain or loss shall be treated as capital gain or loss unless the partnership has unrealized receivables, or inventory items which have substantially appreciated in value, as defined in section 751. If section 751 is applicable, a portion of the gain or loss shall be treated as ordinary income or loss.[4]

2. 1984 Joint Committee on Taxation general explanation relating to section 453(i) and depreciation recapture and section 751(f) tiered partnerships.

a. Section 453(i).

The taxpayer may own a partnership interest which, if sold by the taxpayer for cash, would generate some depreciation recapture income to the taxpayer under section 751. If the taxpayer sold his interest on the installment basis, the provisions of the Act would apply. This is because depreciation recapture, like some other items, is a severable part of the taxpayer's partnership interest. (See the discussion relating to section 76 of the Act.)[5]

b. Section 751(f) (section 76 of the 1984 act).

Under the Act, in determining whether partnership property is an unrealized receivable or an inventory item under section 751, the partnership is to be treated as owning its proportionate share of the property of any other partnership in which it is a partner. Thus, *the ordinary income rules of section 751 are applied by regarding income rights (as section 751 was intended to under prior law) as severable from the partnership interest, and a partner is treated as disposing of such items independently of the rest of his partnership interest*. This rule applies regardless of how many tiers of partnerships exist between the transferring or distributee partner and the ordinary income assets.[6]

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[3]H.R. Rep. No. 1337, at 70-71 (1954) (emphasis added).

[4]S. Rep. No. 1622, at 4731-5733 (1954) (emphasis added).

[5]JCT, ''General Explanation of the Deficit Reduction Act of 1984,'' JCS-41-84 (Dec. 31, 1984), at 333-335.

[6]*Id.* at 241-242 (emphasis added).

3. Rev. Rul. 72-172. In Rev. Rul. 72-172,[7] a husband and wife sold all the interests in a partnership to a controlled corporation. If they had sold the assets held by the partnership to the corporation directly, section 1239 would have applied.[8] The ruling found that the sale of all partnership interests to the controlled entity in effect was to be treated as a sale of the underlying assets of the partnership in applying section 1239 — a clearly aggregate result. Given that the partnership terminated as a result of the sale because the controlled entity ended up owning 100 percent of the partnership, that conclusion is not surprising. What is not clear is the result under current law if less than all the partnership interests have been transferred. There have been legislative proposals recently to treat the partnership as an aggregate in that context,[9] but current law remains unclear.

4. Rev. Rul. 87-51. In Rev. Rul. 87-51,[10] the question was whether a technical termination of an upper-tier partnership under section 708(b)(1)(B) caused the lower-tier partnership interest held by the upper-tier partnership to be treated as sold or exchanged in applying section 708(b)(1)(B) to that partnership. The ruling found that the sale of the upper-tier interest in a partnership is not treated as a sale of the lower-tier partnership interest for purposes of section 708(b)(1)(B) unless the upper-tier partnership is technically terminated on the sale; the IRS applied the entity theory of partnerships because it believed, without citation to any authority, that section 708(b)(1)(B) is an entity-oriented provision:

> Under the provisions of subchapter K of the Code, a partnership is considered for various purposes to be either an aggregate of its partners or an entity, transactionally independent of its partners. Generally, subchapter K adopts an entity approach with respect to transactions involving partnership interests. See Rev. Rul. 75-62, 1975-1 C.B. 188. Whether an aggregate or entity theory of partnerships should be applied to a particular Code section depends upon which theory is more appropriate to such section. See S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954), and H.R. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954); *Casel v. Commissioner*, 79 T.C. 424 (1982). The termination of a partnership under section 708(b)(1)(B) depends on whether there was a sale or exchange of a partnership interest and on whether there was a transfer of at least 50 percent of the total interest in partnership capital and profits. *Because section 708(b)(1)(B) is an entity-oriented provision, an entity approach is more appropriate for that section.*[11]

5. Rev. Rul. 89-108. In Rev. Rul. 89-108,[12] the question was whether a partnership interest could be sold on the installment method if the partnership held substantially appreciated inventory assets. The IRS held that the sale of a partnership interest holding substantially appreciated inventory under section 751 is not eligible for installment sale treatment under section 453[13]; the IRS relied on section 751 for its holding and did not discuss aggregate-entity issues:

> Gain recognized under section 741 of the Code on the sale of a partnership interest is reportable under the installment method. See Rev. Rul. 76-483, 1976-2 C.B. 131. However, because section 751 effectively treats a partner as if the partner had sold an interest in the section 751 property of the partnership, the portion of the gain that is attributable to section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the section 751 property would be reportable under such method. Because the installment method of reporting income would not be available on a sole proprietor's

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[7]1972-1 C.B. 265.

[8]Section 1239(a) provides that for a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if the property, in the hands of the transferee, is of a character that is subject to the allowance for depreciation provided in section 167. Technically, a partnership interest is not depreciable property, although with a section 754 election, in effect section 743(b) can create depreciation deductions attributable to the purchase price. However, in the absence of the applicability of section 751(a), section 741 would provide for capital gains treatment on the sale or exchange of a partnership interest.

[9]H.R. 1935, section 3(a)(1)(a) (2009), *Doc 2009-8791*, *2009 TNT 73-49*, provides:

> (a) PARTNERSHIP INTERESTS. — (1) IN GENERAL. — Subsection (a) of section 1239 of the Internal Revenue Code of 1986 is amended to read as follows: ''(a) TREATMENT OF GAIN AS ORDINARY INCOME. — In the case of a sale or exchange of property, directly or indirectly, between related persons, any gain recognized to the transferor shall be treated as ordinary income if — ''(1) such property is, in the hands of the transferee, of a character which is subject to the allowance for depreciation provided in section 167, or ''(2) *such property is an interest in a partnership*, but only to the extent of gain attributable to unrealized appreciation in property which is of a character subject to the allowance for depreciation provided in section 167.'' [Emphasis added.]

[10]1987-1 C.B. 158.

[11]*Id.* (emphasis added).

[12]1989-2 C.B. 100.

[13]For a contrary view, see Monte A. Jackel, ''Installment Sales of Partnership Interests: Aggregate or Entity,'' *95 TNT 202-75*.

sale of the inventory, the installment method is not available for reporting income realized on the sale of a partnership interest to the extent attributable to the substantially appreciated inventory which constitutes inventory within the meaning of section 453(b)(2)(B).[14]

6. Rev. Rul. 89-85. In Rev. Rul. 89-85,[15] the question was whether the sale of a partnership interest between consolidated group members could be deferred as an intercompany transaction despite the fact that the consolidated group deducted depreciation on the partnership's assets due to a section 754 election that was in effect for the partnership. The IRS relied on section 743(b), which reflects the aggregate theory of partnership taxation, and on the principle in the consolidated return rules to prevent a distortion of the deferred intercompany transaction (DIT) rules, and it ruled that the DIT was restored to income by the selling group member of the partnership interest to the extent the purchasing group member claimed depreciation on the section 743(b) adjustment created because of the sale of the partnership interest:

> Subchapter K of the Code is a blend of the ''aggregate'' and ''entity'' treatment for partners and partnerships. Compare section 751 of the Code with section 741. Moreover, for purposes of interpreting provisions of the Code not contained in Subchapter K, a partnership also may be treated either as an aggregate of its partners or as an entity distinct from its partners. . . . The treatment of partnerships in each context must be determined on the basis of countervailing factors applicable to such context. . . .
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> Section 754 of the Code and the related adjustments provided in section 743(b) reflect an aggregate approach to partnership taxation. . . . Upon the sale by P to X of its interest in PS, the adjusted bases of the partnership assets are increased with respect to X as a consequence of the section 743(b) adjustment. There is no express statement in the deferred intercompany transaction rules as to how adjustments under section 743(b) factor into the restoration to income of deferred gain. The application of the deferred intercompany transaction rules without taking into account the adjustments under section 743(b), however, would permit a group to avoid the intended application of the deferred intercompany transaction rules (i.e., to prevent the group from obtaining a double benefit by claiming increased cost recovery deductions resulting from a positive section 743(b) adjustment without taking into account any of the deferred gain to which that additional basis is attributable).[16]

7. Rev. Rul. 91-32. In Rev. Rul. 91-32,[17] the question was whether the sale by a non-U.S. person of a partnership interest in which the partnership was engaged in a U.S. trade or business was itself effectively connected income.[18] The IRS applied the

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[14]Rev. Rul. 89-108.

[15]1989-2 C.B. 218, now incorporated in reg. section 1.1502-13(c)(7)(ii), Example 9.

[16]*Id.*

[17]1991-1 C.B. 107.

[18]The partnership did not hold U.S. real property and so section 897(g) did not apply.

A recent Treasury budget proposal would codify the result of the ruling. One of the international tax reform proposals reads:

> **Tax Gain From the Sale of a Partnership Interest on Look-Through Basis**
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> **Current Law**
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> In general, the sale or exchange of a partnership interest is treated as the sale or exchange of a capital asset. Capital gains of a nonresident alien individual or foreign corporation generally are subject to federal income tax only if the gains are or are treated as income that is effectively connected with the conduct of a trade or business in the United States (ECI). Section 875(1) provides that a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged. Revenue Ruling 91-32 holds that gain or loss of a nonresident alien individual or foreign corporation from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent of the partner's distributive share of unrealized gain or loss of the partnership that is attributable to property used or held for use in the partnership's trade or business within the United States (ECI property). A partnership may elect under section 754 to adjust the basis of its assets upon the transfer of an interest in the partnership to reflect the transferee partner's basis in the partnership interest.
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> **Reasons for Change**
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> Nonresident alien individuals and foreign corporations may take a position contrary to the holding of Revenue Ruling 91-32, arguing that gain from the sale of a partnership interest is not subject to federal income taxation because no Code provision explicitly provides that gain from the sale or exchange of a partnership interest by a nonresident alien individual or foreign corporation is treated as ECI. If the partnership has in effect an election under section 754, the partnership's basis in its assets is also increased, thereby preventing that gain from being taxed in the future.
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> **Proposal**
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> The proposal would provide that gain or loss from the sale or exchange of a partnership interest is effectively connected with the conduct of a trade or business in the United States to the extent attributable to the transferor

(Footnote continued on next page.)

aggregate theory[19] to the sale by a nonresident alien of a partnership interest not involving U.S. real property (and, thus, not subject to aggregate treatment under section 897(g)); it is not clear from the text of the ruling exactly what authority the IRS relied on to reach that ''appropriate'' answer:

> Subchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships. *Compare* section 751 of the Code *with* section 741. For purposes of applying provisions of the Code not included in subchapter K, a partnership may be treated as an aggregate of its partners or as an entity distinct from its partners, depending on the purpose and scope of such provisions. Rev. Rul. 89-85, 1989-2 C.B. 218, 219; *see Casel v. Commissioner,* 79 T.C. 424 (1982). The treatment of amounts received by a foreign partner from a disposition of a partnership interest must therefore be considered in connection with the general purpose and scope of section 864(c) and section 865(e). Pursuant to section 865(e)(3) the principles of section 864(c)(5) are applied to determine whether gain or loss from a sale is attributable to an office or fixed place of business for purposes of section 865(e)(1) and (2), so the same analysis applies to both sections 864(c) and 865(e).[20]

8. *Clinton Pollack*. In *Clinton Pollack v. Commissioner*,[21] the Tax Court held that the sale of a partnership interest should be accorded capital loss treatment under section 741 despite the potential application of the then-viable *Corn Products* doctrine. Based on the legislative history to section 741, the court stated, ''Section 741 was enacted by Congress as part of subchapter K of the Internal Revenue Code of 1954. Subchapter K was enacted to resolve the chaos which permeated the partnership area under the 1939 Code.'' It continued:

> A prime example of such confusion under the 1939 Code was the treatment of gain or loss from the sale or exchange of a partnership interest. Prior to 1950 the Government took the position, under the so-called aggregate theory of partnership, that the selling partner actually sold his undivided interest in each of the partnership's assets, and the character and amounts resulting from the disposition of those assets should be considered individually. See *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *aff'g* 7 T.C. 1088 (1946), cert, denied 334 U.S. 819 (1948). . . . This position, however, found no acceptance in the courts, which consistently held a partnership interest to be a capital asset in its entirety regardless of the nature of the underlying partnership assets. See *Swiren v. Commissioner*, 183 F.2d 656 (7th Cir. 1950), *rev'g* a Memorandum Opinion of this Court dated October 11, 1949, cert, denied 340 U.S. 912 (1951). Faced with this situation, Congress, in the 1954 Code, sought to eliminate the confusion on this point by codifying the Government's concession in G.C.M. 26379 and, at the same time, reduce the availability of the collapsible partnership as a tax avoidance device. See H. Rept. No. 1337, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess. 71 (1954). Congress accomplished its dual purpose by enactment of section 741, which treated the sale of a partnership interest as the sale of a capital asset, and section 751, which specifically excluded from capital gain or loss treatment, that portion of the partnership interest representing income from unrealized receivables and substantially appreciated inventory items. See S. Rept. No. 1622 to accompany H.R. 8300 (Pub. L. No. 591) 83d Cong., 2d Sess. 96 (1954).
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> In view of the foregoing legislative record and the plain language of the statute itself, we conclude that Congress intended section 741, if applicable, to provide capital gain or loss treatment on the sale or exchange of a partnership interest by a partner without regard to section 1221. Indeed, Congressional use of the phrase ''shall be considered as'' in section 741 is unambiguous and mandatory on its face. See *Helvering v. Flaccus Leather Co.*, 313 U.S. 247 (1941). Furthermore, the singular meaning of such phrase is demonstrated by its consistent interpretation in sections 731, 735, 736, and 751. See sections 1.731-1(a)(3), 1.735-l(a), 1.736-1(a)(4), and 1.751-l(a)(l), Income Tax Regs. In fact, where Congress has intended section

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> partner's distributive share of the partnership's unrealized gain or loss that is attributable to ECI property. The Secretary would be granted authority to specify the extent to which a distribution from the partnership is treated as a sale or exchange of an interest in the partnership and to coordinate the new provision with the nonrecognition provisions of the Code. . . . The proposal would be effective for sales or exchanges after December 31, 2012.

See Treasury, ''General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals'' (Feb. 13, 2012), *Doc 2012-2947, 2012 TNT 30-32*.

[19]For a view that the IRS applied not aggregate principles but rather ''attributional'' principles in attributing the trade or business of the partnership to the selling partner, see Blanchard, *supra* note 1.

[20]Rev. Rul. 91-32.

[21]69 T.C. 142 (1977).

> 1221 to apply despite similar statutory specificity, it has generally either expressly or impliedly said so. See e.g., sections 302, 331,1232, 1233; compare section 1235.[22]

9. *PDB Sports.* In *PDB Sports Ltd. v. Commissioner*,[23] the Tax Court held that the sale of a partnership interest in which the partnership held section 1056 player contracts should be treated as a sale of a separate capital asset (the partnership interest) and not as a sale of the underlying player contracts. Nevertheless, the Tax Court rejected a universal application of the entity theory under section 741, stating:

> Petitioner contends that section 1056 is unambiguous, makes no reference to partnership transactions, and applies only to transactions directly involving sports franchises not including the sale of a partnership interest. Finally, petitioner argues that the legislative history is inconclusive and, in any event, irrelevant because the statute is unambiguous. Because partnerships can be and have been treated as an aggregate or entity, we must disagree with petitioner's contention that section 1056 is unambiguous. Petitioner is of the view that the entity approach is to be applied to Internal Revenue Code provisions that are outside of subchapter K unless Congress provides otherwise. No such presumption favoring the entity approach exists.[24]

10. *Casel.* In *Casel v. Commissioner*,[25] the Tax Court applied aggregate principles to invoke section 267 in which a partnership accrued, but did not pay, management fees to a corporation controlled by one of the partners. The court held that the related partner could not take a distributive share of the loss for that accrual even though section 267 did not then technically defer losses between a partnership and a corporation related to a partner of the partnership:

> When the 1954 Code was adopted by Congress, the conference report, discussed and excerpted in part above, clearly stated that whether an aggregate or entity theory of partnerships should be applied to a particular Code section depends upon which theory is more appropriate to such section. Section 267(a)(2) serves to foreclose a loophole to the tax laws that would otherwise permit a deduction for a payment never made to a related party that may never seek enforcement of its contractual rights. If we were to apply an entity theory of partnerships to such section, then that loophole would continue to exist whenever an individual partner interposed his partnership between himself and his related corporation in transactions encompassed by section 267(a). Under the 1939 Code, the courts rejected such an approach and applied an aggregate theory of partnerships to section 24(b) and (c), the predecessor of section 267. Section 267, insofar as pertinent to the issue before us, embodies essentially the same language and policies as section 24(b) and (c) of the 1939 Code. When the Secretary issued section 1.267(b)-1(b)(1) and (2), Income Tax Regs, he simply followed the long-standing position taken by the courts with respect to section 24(b)(1)(B), 1939 Code, a position followed by the Court of Claims in *Liflans Corp. v. United States, supra*, which arose under the 1954 Code. Since section 267 embodies essentially the same language and policies as section 24(b) and (c) of the 1939 Code, and since the conference report to the 1954 Code recognizes, when appropriate, the concept of a partnership as a collection of individuals (i.e., the aggregate theory), we are unable to say that section 1.267(b)-1(b)(1) and (2), Income Tax Regs., is inconsistent with, or an unreasonable interpretation of, section 267. Consequently, we hold that it is a valid regulation. See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948).[26]

C. Holding of Property Through a Partnership

In the authorities surveyed below, the key inquiry is whether the taxpayer should be treated as holding the underlying assets of the partnership or as holding a separate property interest in a partnership.

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[22]*Id.* (citations omitted). *See also* LTR 9651001, *Doc 96-32601*, *96 TNT 248-27*. The IRS there ruled that the sale of a partnership interest by a tax-exempt entity in which the partnership held section 514 debt-financed property should be treated as unrelated business income tax, applying the aggregate theory of partnership taxation.

[23]109 T.C. 423 (1997).

[24]*Id.*

[25]79 T.C. 424 (1982).

[26]*Id. See also* H.R. Rep. No. 1167 (1980) (legislative history to section 897(g)), which states:

> In order to impose a tax on gains from the sales of U.S. real estate, it is also necessary to impose a similar tax on gain from the disposition of interests in entities that hold substantial U.S. real property. Otherwise, a foreign investor could, as *under present law,* avoid tax on the gain by holding real estate through a corporation, partnership or trust and disposing of his interest in that entity rather than having the entity itself sell the real estate. [Emphasis added.]

1. Rev. Rul. 75-62. In Rev. Rul. 75-62,[27] the IRS applied the entity theory of partnerships for purposes of section 805(b)(4), whereby an interest in a partnership that held real property was treated as personal property and not real property. Under the applicable law, real property was valued based on actual fair market value, whereas personal property was generally valued at adjusted basis. The IRS stated that in the absence of tax avoidance and because of the lack of legislative history stating that aggregate principles were most appropriate, entity principles should apply, thereby enabling the taxpayer to use adjusted basis rather than FMV. The IRS stated that ''there exists no exclusive rule as to when a partnership will be viewed as an entity or an aggregate. The resolution is generally dependent upon the question to be resolved.''

2. Rev. Rul. 90-112. In Rev. Rul. 90-112,[28] the IRS treated a partnership interest that was not itself U.S. property under section 956 as U.S. property to the extent that the partnership held U.S. property; the IRS applied the aggregate theory of partnership taxation because it believed that it ''would not be appropriate'' to frustrate the purpose of section 956 by treating the partnership as an entity. The IRS never explained why it was appropriate to apply section 956 by using the aggregate theory:

> Section 956 of the Code, and the regulations thereunder, do not specifically address the treatment of a CFC's investment in United States property through a partnership. Whether a CFC partner is treated as holding, on the last day of its taxable year, a portion of the United States property owned by the partnership depends upon whether the partnership is viewed as an ''entity'' separate from its partners or as an ''aggregate'' of its partners for purposes of section 956. There is no exclusive rule as to when a partnership will be treated as an entity or as an aggregate for purposes outside of subchapter K. The resolution depends upon which approach is more appropriate to the specific Code section involved. See, e.g., Rev. Rul. 89-72, 1989-1 C.B. 257 (a CFC's distributive share of income from a non-controlled partnership is treated as foreign base company sales income, if it would have been treated as such had it been realized directly by the CFC). See also Rev. Rul. 89-85, 1989-2 C.B. 218, and the authorities cited therein.
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> For purposes of section 956 of the Code, a CFC is considered to hold United States property if it holds the property directly or indirectly. *See* section 956(a)(1). This rule is a specific application of the general principle that section 956 is concerned with the substance of a transaction and not merely its form. *See* Rev. Rul. 89-73, 1989-1 C.B. 258. The House Report on the Revenue Act of 1962, which adopted section 956, stated that an objective of that section was ''to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation.'' H.R. Rep. No. 1447, 87th Cong., 2d Sess. 58 (1962). While taxpayers with excess foreign tax credits may desire to trigger a section 956 inclusion, it is still appropriate to construe section 956 in a manner consistent with this statement under these facts.
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> The purpose of section 956 of the Code would be frustrated if it were construed not to reach the United States property held by a CFC through a partnership. Thus, in the context of section 956, it is appropriate to apply the aggregate view of a partnership so that the United States property of the CFC includes United States property held by the CFC through a partnership. This result applies section 956 according to the substance of the arrangement, without regard to whether the form of the ownership is direct or indirect.[29]

3. Rev. Rul. 99-57. Rev. Rul. 99-57[30] applied section 1032 and aggregate principles relating to section 704(c) gain allocable to a corporate partner that had contributed its own stock to a partnership that thereafter sold the stock:

[27]1975-1 C.B. 188.

[28]1990-2 C.B. 186. This ruling is now incorporated in the *Brown Group* regulations issued in July 2002; *see* reg. section 1.956-2(a)(3).

[29]Rev. Rul. 90-112. *See also* reg. section 1.701-2(e)(1) and -2(f), examples 1 (section 163(e)(5)) and 2 (section 1059), which states that the IRS can treat a partnership as an aggregate of its partners ''as appropriate'' to carry out the purpose of the code or regulation provision at issue, unless that other provision of the code or regulations clearly prescribes entity treatment. The term ''appropriate'' is not defined or otherwise given substantive context in cases when it either would or would not be appropriate to apply either aggregate or entity principles. Further, it seems odd that that ''abuse of entity'' rule is cast as one-sided, meaning that only the government can challenge the entity treatment of the partnership and treat the partnership as an aggregate. Being cast as an abuse of entity rule, the rule is not written to authorize the taxpayer to treat the partnership as an entity or an aggregate depending on which treatment was ''most appropriate.'' I think it would have been preferable if the rule were written to provide guidance to *both* taxpayers and the government on when it would be ''appropriate'' to apply aggregate principles and when it would be ''appropriate'' to apply entity rules. That is not the case under the current rule.

[30]1999-2 C.B. 678, *Doc 1999-38457*, *1999 TNT 234-9*.

> Partnership taxation is a mixture of provisions that treat the partnership as an aggregate of its members or as a separate entity. Under the aggregate approach, each partner is treated as the owner of an undivided interest in partnership assets and operations. Under the entity approach, the partnership is treated as a separate entity in which partners have no direct interest in partnership assets and operations. In enacting subchapter K, Congress indicated that aggregate, rather than entity, concepts should be applied if the concepts are more appropriate in applying other provisions of the Code. S. Rep. No. 1622, 83d Cong., 2d Sess. 89 (1954) and H.R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954); *See also* Treas. Reg. section 1.701-2(e) (1994).
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> Section 1032 is intended to prevent a corporation from recognizing gain or loss when dealing in its own stock. Under section 704(b) and 704(c), a corporate partner contributing its own stock generally will be allocated an amount of gain attributable to its stock that corresponds to its economic interest in the stock held by the partnership. Accordingly, use of the aggregate theory of partnerships is appropriate in determining the application of section 1032 with respect to gain allocated to a corporate partner.[31]

4. Rev. Rul. 60-352. In Rev. Rul. 60-352,[32] the IRS found that the charitable transfer of a partnership interest in which the partnership held section 453 installment obligations should be treated as a disposition of the underlying partnership assets in applying then-section 453(d) (now section 453B):

> Thus, while the partnership interest generally may be regarded as constituting a partner's interest in the profits and surplus of the partnership, the fundamental principles of Federal income taxation require that an interest in income earned by the partnership which has not been realized, or has not yet been subjected to taxation, be treated as distinct from any "partnership interest" which is recognized as a capital asset for income tax purposes. Therefore, unrealized or untaxed rights to partnership income may be transferred with, but not as a part of, the partnership interest which constitutes a capital asset. . . .
>
> Based on the foregoing, it is held that a transfer of a limited partner's interest in a partnership appurtenant to which is a right to share in unrealized partnership income reflected in installment obligations receivable by the partnership constitutes a transfer of a capital asset coupled with a disposition of such installment obligations subject to the provisions of section 453(d) of the Code. To the extent that the transaction constitutes a disposition of installment obligations receivable, the gain is taxable to the transferor as ordinary income.[33]

5. *Coggin Automotive Corp.* This case is meaningful because of the distinctly different treatment by the appeals and tax courts of a partnership holding last-in, first-out inventory at a time when a C corporation partner adopted S corporation status.

a. Appellate court. In *Coggin Automotive Corp v. Commissioner*,[34] the Eleventh Circuit, reversing the Tax Court, held that a holding company, on making an S corporation election, was not required to include a share of a partnership's inventory in gross income as its share of the LIFO recapture amount under section 1363(d) because the corporation had no LIFO inventory.

The court first determined whether there was a bona fide purpose for the formation of the partnership and the transfer of LIFO inventory to the

[31]*Id. See also George Edward Quick Trust*, 54 T.C. 1336 (1970), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); and *Woodhall v. Commissioner*, 28 T.C. Memo. 1438 (1969), *aff'd*, 454 F.2d 226 (9th Cir. 1972) (applying aggregate principles to treat accounts receivable held by a partnership when an individual died holding a partnership interest as income in respect of a decedent under section 691; aggregate approach applied to reach the "appropriate" answer). *But compare Holiday Village Shopping Center v. United States*, 773 F.2d 276 (Fed. Cir. 1985) (99 percent limited partnership interest distributed in corporate liquidation treated as the distribution of the underlying corporate property to apply the then-recapture exception to section 336) *with Petroleum Corporation of Texas Inc. v. United States*, 939 F.2d 1165 (5th Cir. 1991) (no statutory basis to apply aggregate theory of partnerships in applying section 336; *Holiday Village* distinguished as a tax avoidance case.)

[32]1960-2 C.B. 208.

[33]*Id. See also Tennyson v. United States*, 76-1 USTC 83,573 (1976) (limited partner's purported gift of two-thirds of his partnership interest was merely a statement of intention. The gift was not actually completed until a later year when the installment sale of partnership assets had taken place. The court held, without analysis or explanation, that the gift of the partnership interest was to be treated as a disposition of the underlying installment note):

> The gift contemplated by Mr. Tennyson in his letter agreement of June 10, 1962, was completed in September of 1964. At that time, Mr. Tennyson's contingent inter vivos gift to his children vested and he disposed of his interest in two-thirds of the remaining proceeds attributable to his interest in the installment sales obligation held by Olds, Ltd. Therefore, the recognition of the gain attributable to such disposition is accelerated under the provisions of Section 453(d) of the Code to the year of the disposition, *i.e.*, 1964.

[34]292 F.3d 1326 (11th Cir. 2002), *Doc 2002-13763*, *2002 TNT 111-4*, *rev'g* 115 T.C. 349 (2000), *Doc 2000-26953*, *2000 TNT 203-7*.

partnership. Having thus determined that the formation of the partnerships served valid business purposes, the Eleventh Circuit applied the plain meaning rule. It looked to the literal words of section 1363(d) and determined that since the taxpayer corporation never directly owned the LIFO inventory, the partnerships did. The court refused to look to the legislative history of sections 1374 and 1363(d), as the Tax Court did, and held for the taxpayer.

Citing the Supreme Court's opinion in *Gitlitz*, the Eleventh Circuit stated that any inequity caused by the failure of section 1363(d) to on its face refer to partnerships holding LIFO inventory when the converting C corporation is a partner was a problem for Congress to fix. It was not the province of the courts to change the statute by applying the aggregate theory of partnership taxation on an ad hoc basis. The court cited reg. section 1.701-2(e), the partnership abuse of entity rule, but did not discuss either its validity or potential effect because the years before the court predated the regs' effective date.

b. Tax Court opinion. The Tax Court applied section 1363(d) to a C corporation that held a partnership interest (in which the partnership held inventory accounted for under the LIFO method) by applying the aggregate theory, stating:

> For tax purposes, a partnership may be viewed either (1) as an aggregation of its partners, each of whom directly owns an interest in the partnership's assets and operations, or (2) as a separate entity, in which separate interests are owned by each of the partners. Subchapter K of the Internal Revenue Code (Partners and Partnerships) blends both approaches. In certain areas, the aggregate approach predominates. See sec. 701 (Partners, Not Partnership, Subject to Tax), sec. 702 (Income and Credits of Partner). In other areas, the entity approach predominates. See sec. 742 (Basis of Transferee Partner's Interest), sec. 743 (Optional Adjustment to Basis of Partnership Property). Outside of subchapter K, whether the aggregate or the entity approach is to be applied depends upon which approach more appropriately serves the Code provision at issue. See *Holiday Village Shopping Ctr. v. United States*, 773 F.2d 276, 279 (Fed. Cir. 1985); *Casel v. Commissioner*, 79 T.C. 424, 433 (1982); Conf. Rept. 2543, 83d Cong., 2d Sess. 59 (1954). . . .
>
> After considering the legislative histories of sections 1374 and 1363(d), we conclude that the application of the aggregate approach (as opposed to the entity approach) of partnerships in this case better serves Congress' intent. By enacting sections 1374 and 1363(d), Congress evinced an intent to prevent corporations from avoiding a second level of taxation on built-in gain assets by converting to S corporations. Application of the aggregate approach to section 1363(d) is consistent with Congress' rationale for enacting this section and operates to prevent a corporate taxpayer from using the LIFO method of accounting to permanently avoid gain recognition on appreciated assets. In contrast, applying the entity approach to section 1363(d) would potentially allow a corporate partner to permanently avoid paying a second level of tax on appreciated property by encouraging transfers of inventory between related entities. This result clearly would be inconsistent with the legislative history of sections 1363(d) and 1374 and the supersession of the *General Utilities* doctrine.
>
> Courts have, in some instances, used the aggregate approach for purposes of applying nonsubchapter K provisions. For instance, in *Casel v. Commissioner*, 79 T.C. at 433, we upheld the Commissioner's use of the aggregate approach for purposes of applying section 267 (disallowance of losses between related parties). In *Holiday Village Shopping Ctr. v. United States*, 773 F.2d at 279, the Court of Appeals for the Federal Circuit applied the aggregate approach for purposes of determining the extent of depreciation recapture to each shareholder. Similarly, the Court of Appeals in *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991), *affg.* T.C. Memo. 1990-15, used the aggregate approach in determining a taxpayer's permanent establishment. In each of these instances, the court analyzed the relevant legislative history and statutory scheme in determining whether the aggregate or entity approach was more appropriate. Moreover, we are mindful that the aggregate approach is generally applied to various subchapter K provisions dealing with inventory and other built-in gain assets (i.e., receivables). See, e.g., secs. 704(c), 731, 734(b), 743(b), 751.
>
> We recognize that in several instances courts have found the entity approach better than the aggregate approach. For example, in *P.D.B. Sports, Ltd. v. Commissioner*, 109 T.C. 423 (1997), this Court used the entity approach for purposes of applying section 1056. Similarly, in *Madison Gas & Elec. Co. v. Commissioner*, 72 T.C. 521,564 (1979), *affd.* 633 F.2d 512 (7th Cir. 1980), this Court and the Court of Appeals for the Seventh Circuit applied the entity approach in determining whether expenses were ordinary

> and necessary under section 162. Likewise, in *Brown Group, Inc. & Subs. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), *revg.* 104 T.C. 105 (1995), the Court of Appeals for the Eighth Circuit concluded that the entity approach, rather than the aggregate approach, should be used in characterizing income (subpart F income) earned by the partnership. We do not believe the holdings in those cases to be dispositive here. The outcomes in those cases were based upon the specific legislative histories and statutory schemes of the respective Code provisions at issue. Each court viewed the respective statute in the context in which it was enacted and concluded that the entity approach was more appropriate than the aggregate approach to carry out Congress' intent. Here, as stated, both the legislative history and the statutory scheme of section 1363(d) mandate the application of the aggregate approach.[35]

6. *Unger*. Finally, in *Unger v. Commissioner*,[36] a limited partner was treated as having a PE in the United States by virtue of his holding a partnership interest when the partnership actually had a PE in the United States, with the court stating:

> The question, then, turns on the nature of a limited partnership. If Mr. Unger's interest as a limited partner in the Company gives him an interest in its offices, he has a permanent establishment in Boston that makes his share of the Company's profits taxable by the United States. If he has no permanent establishment here, this income is exempt.
>
> Two views have long competed regarding the basic nature of a partnership. The ''aggregate theory'' considers a partnership to be no more than an aggregation of individual partners. Under this theory, each partner has an interest in the property of the partnership; thus, Mr. Unger would be deemed to have a permanent establishment in the United States. The ''entity theory'' characterizes a partnership as a separate entity; under this view, the offices would be attributable to the partnership but not the partners, and Mr. Unger would not be deemed to have a permanent establishment in this country. Courts remain ambivalent in their treatment of partnerships, dealing with them as aggregates for certain purposes and as entities for others. See generally 1 A. Bromberg & L. Ribstein, Partnership section 1.03 (1988).
>
> The Internal Revenue Code also treats partnerships as aggregates for some purposes and as separate entities for others. A partnership must calculate income as a discrete entity. See 26 U.S.C. section 703 (1988). The obligation to pay taxes, however, passes through the partnership to the individual partners. *Id.* sections 701, 702; *United States v. Basye*, 410 U.S. 441, 448 (1973) (characterizing partnership as a ''conduit'' through which taxpaying obligation passes). The conflict between the aggregate and the entity views, then, carries over to the realm of federal taxation. See Pusey, The Partnership as an ''Entity'': Implications of Basye, 54 Taxes 143, 158 (1976) (''The entity-aggregate conflict has been, and will continue to be, one of the most controversial areas of partnership taxation.''). . . . In 1962, in *Donroy, Ltd. v. U.S.* (301 F.2d 200 (9th Cir. 1962)), the Ninth Circuit was called upon to deal with an almost identical case. It involved Canadian corporations that were limited partners of two California partnerships whose principal offices were located in San Francisco. The court examined the relevant California partnership law and concluded that the aggregate theory was to be applied in determining whether the Canadian partners had a permanent establishment in the United States. It concluded that ''the office or permanent establishment of the partnership is in law, the office of each of the partners — whether general or limited.'' 301 F.2d at 207. The court also noted that ''the United States and Canada look, not to the partnership as such, but to the distributive income of the individual partners for income tax purposes.'' *Id.* (citing section 701 of the Internal Revenue Code, 26 U.S.C. section 701, and section 6 of the Canadian Income Tax Act). Thus the application of the aggregate theory in *Donroy* was consistent with the manner in which partnership income was actually taxed by both parties to the Convention.
>
> For many years, *Donroy* and the principles it expresses have guided the Internal Revenue Service. See, e.g., Rev. Rul. 91-32, 1991-1 C.B. 107; Rev. Rul. 90-80, 1990-2 C.B. 170; Rev. Rul. 85-60, 1985-1 C.B. 187; Gen. Couns. Mem. 38201 (Dec. 14, 1979); Priv. Ltr. Rul.

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[35]115 T.C. 349 (2000). *See also* Rev. Rul. 85-60, 1985-1 C.B. 187 (relying on section 702(b) (character of distributive share determined at the partnership level) to attribute a PE to a partner).

In FSA 200026009, *Doc 2000-18059*, *2000 TNT 128-30*, the IRS found that a partnership with corporate partners should be treated as an aggregate for purposes of determining the fraction a foreign sales corporation wholly owned by the partnership should use in calculating the exempt portion of its foreign trade income under the foreign sales corporation administrative pricing rules of section 925.

[36]936 F.2d 1316 (D.C. Cir. 1991).

5412105720A (Dec. 10, 1954); see also W. McKee, W. Nelson & R. Whitmire, 1 Federal Taxation of Partnerships and Partners para. 9.03[4][a] (2d ed. 1990). Moreover, Canadian tax authorities have placed a similar interpretation on the Convention as it applies to the taxation in Canada of an American investor's interest in a Canadian partnership. See, e.g., *No. 630 v. Minister of National Revenue*, 13 D.T.C. 300, 302 (Can. Tax App. Bd. 1959).

Thus, a generation of investors on each side of the border has been on notice of the tax consequences of an investment in a limited partnership that is organized and has a permanent office in the other country. Given the desideratum of a uniform administration of federal tax laws, courts should be reluctant to disturb such long-established expectations without good cause. See, e.g., *Keasler v. United States*, 766 F.2d 1227, 1233 (8th Cir. 1985) (''Uniformity of decision among the circuits is vitally important on issues concerning the administration of tax laws. Thus, the tax decisions of other circuits should be followed unless they are demonstrably erroneous or there appear cogent reasons for rejecting them.'')[37]

D. Conclusion

It seems that the most one can say about this area of law is that the aggregate or entity results in the authorities surveyed was ''more appropriate'' based on the tax policy result desired by either the court having jurisdiction in the particular situation or the IRS. I do not believe that any consistent theory of what is ''appropriate'' can be derived from those authorities. If I am correct, then predicting the results of any situation is a matter of making the best guess at the most appropriate tax policy result. After almost 60 years of the existence of subchapter K, that should not be the case.

[37]*Id.* (citations and internal quotes omitted). *See also* TAM 200811019, *Doc 2008-5658*, *2008 TNT 52-18* (aggregate treatment applied in applying section 864(c)).