St. Mary's Law Journal

Volume 19 | Number 4 Article 13

1-1-1988

Federal Taxation - Publicly Traded Partnerships Deemed Corporations for Federal Taxation Purposes: New Internal Revenue Code Section 7704 Recent Development.

Edward D. Biggers

proper notice of a default judgment or they risk being summarily forced to re-litigate the action.

William B. Nash

FEDERAL TAXATION—PUBLICLY TRADED PARTNERSHIPS DEEMED CORPORATIONS FOR FEDERAL TAXATION PURPOSES: NEW INTERNAL REVENUE CODE SECTION 7704.

Since the enactment of the Payne-Aldrich Tariff Act of 1909, Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 11, 112-13 (repealed 1913), the federal government has continuously taxed the income of corporations. *See Flint v. Stone Tracy Co.*, 220 U.S. 107, 151 (1911)(tax on corporate income for "privilege of doing business in a corporate capacity"). Further, once corporate income is distributed to stockholders, they too are required to pay taxes on the revenues generated by the corporation. *See* I.R.C. § 61 (1984). This method of taxing the corporation and the stockholder by the federal government is generally known as "double taxation." In order for an entity to be taxed as a corporation, the Internal Revenue Code (Code) requires the entity to be an "association." *See* I.R.C. § 7701(3) (1980)(defines corporation as to "include[s] associations, joint-stock companies, and insurance companies"). However, Congress has never defined how an entity is to be classified as an "association." *See* I.R.C. § 7701 (1980). Due to the inherent vagueness of the term "association," taxpayers and the Internal Revenue Service have continually battled over what entities are classified as "associations" subjecting such entity to the double taxation imposed upon corporations. *See, e.g., Morrissey v. Commissioner*, 296 U.S. 344, 348-49 (1935) (disputing whether real estate trust should be subject to corporate taxation); *Zuckman v. United States*, 524 F.2d 729, 730 (Ct. Cl. 1975)(discussing whether real estate partnership considered corporation for tax purposes). Attempting to avoid classification as a corporation and thus its inherent double taxation, taxpayers have utilized various non-corporate business forms which, although avoid the "double taxation" attributed to corporations, still retain the advantage of limited liability. *See, e.g., Morrissey*, 296 U.S. at 361-62 (business trust operated to avoid corporate tax); *Larson*, 66 T.C. 159, 185 (1976)(real estate syndication set up as partnership avoided corporate taxation); *Glendser Textile Co. v. Commissioner*, 46 B.T.A. 176, 187 (1942)(company formed under limited partnership statute not taxed as corporation).

One entity that has emerged as a potent and popular device to avoid double taxation is the limited partnership. *See* Staff of Joint Comm. on Int. Rev. Tax., 94th Cong., 1st Sess., Tax Shelters: Use of Limited Partnerships, Etc. 1-3 (Comm. Print 1975). Limited partners traditionally enjoy restricted liability similar to that of a corporation, as well as the advantage of using the partnership as a conduit to pass nontaxable losses or gains directly to the partners. *See* I.R.C. § 701 (1980). Recently, a form of the limited partnership has arisen which is structurally similar to that of a corporation. This new entity is called a "master limited partnership" (MLP). *See* Stevens, *Master Limited Partnerships*, 1987 A.B.A. Sec. Tax'n i. Master limited partnerships usually consist of a general partner (a corporation) and many small investors (the limited partners). The master limited partnership may be registered with the Securities and Exchange Commission and the limited partnership interests or "units" are traded daily on the open market (such as NYSE, AMEX or NASDAQ) as any other listed security. *See* Stevens, *Master Limited Partnerships*, 1988 A.B.A. Sec. Tax'n 1. Master limited partnership units which are traded like shares of stock provide ease of transferability like corporate stock. Unlike corporation shareholders who receive dividends after being taxed as a corporate asset, the MLP "unit holders" receive a portion of the partnership gains or losses that has not been taxed prior to distribution. *Compare* I.R.C. § 701 (1974)(partnership gains or losses flow directly to unit holders without any tax consequences) *with Buick Motor Co. v. City of Milwaukee*, 48 F.2d 801, 803 (7th Cir.), *cert. denied*, 284 U.S. 655 (1931)(corporation's earnings and profits taxed by federal government before any distribution to shareholders). Furthermore, because the general partner of the MLP may also be a corporation, *see, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 6132a, § 2A (Vernon Supp. 1987)(corporation may be general partner), the general partner's liability is limited to the amount of capital which its shareholders have contributed to the general partner corporation. *See, e.g.*, *FMC Finance Corp. v. Murphree*, 632 F.2d 413, 421 (5th Cir. 1980)(liability of shareholder limited to amount invested in corporation); *Regal Ware, Inc. v. Fidelity Corp.*, 550 F.2d 934, 944 (4th Cir. 1977)(generally accepted that shareholders not liable for corporate indebtedness); *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 683 (4th Cir. 1976)(debts incurred by corporation not responsibility of stockholders). The similarity between limited partnerships and corporations has created confusion as to the classification of some entities. *See, e.g.*, *Zuckman v. United States*, 524 F.2d 729, 733 (Ct. Cl. 1975)(unclear whether real estate partnership included in treasury regulation definition of corporation); *Glendser Textile Co. v. Commissioner*, 46 B.T.A. 176, 182 (1942)(whether textile company formed under limited partnership statute should be considered corporation under the treasury regulation definition). The United States Treasury Department sought to remedy this problem with the promulgation of Treasury Regulation section 301.7701 and its revisions. *See* Treas. Reg. § 301.7701-2 (amended 1983). The regulation sets out six characteristics normally found in a corporation: associates, business purpose, continuity of life, centralized management, limited liability, and free transferability of interests. *See id.* Applying these factors, an organization will be classified as a corporation for tax purposes if it "more nearly resembles a corporation than a partnership or trust." *Id.* § 301.7701-2(a)(1). However, when courts have applied the entity classification test set out by the Treasury Department to MLP's, the entity usually fails to meet the characteristics of a corporation and is not considered as such for tax purposes. *See,. e.g., Zuckman*, 524 F.2d at 745 (real estate partnership considered a corporation for tax purposes under treasury regulation definition); *Larson v. Commissioner*, 66 T.C. 159, 185 (1976)(limited partnership in real estate syndication not meet test of corporation); *Glendser Textile Co.*, 46 B.T.A. at 187 (company formed under limited partnership statute not considered corporation under treasury regulation definition). Since the enactment of the Tax Reform Act of 1986, this entity classification problem has become even more significant. Individuals under the 1986 Act are taxed at a lower rate than corporations; this creates a powerful incentive for taxpayers to set up master limited partnerships. *Compare* I.R.C. § 1 (West Supp. 1987)(thirty-three percent individual tax rate including phaseout) *with id.* § 11 (thirty-nine percent corporate tax rate including phaseout).

Another advantage of the MLP is that no double tax occurs on the sale or liquidation of partnerships. *See* I.R.C. § 731(b) (1974)(nonrecognition of gain or loss by partnership on distribution to partner). Further, with the 1986 Act's repeal of the *General Utilities* doctrine, which allowed corporations to forego a taxable gain upon the distribution of appreciated assets as dividends to shareholders, *see General Util. Co. v. Helvering*, 296 U.S. 201, 206 (1935), corporations must now recognize a taxable gain from property distributed to shareholders. *See* I.R.C. § 311(b) (West Supp. 1987)(corporation recognizes gain or loss incurred before distribution to shareholders). Furthermore, a property distribution to the corporate shareholder gives him a taxable gain equivalent to the fair market value of the property received. *See id.* § 301(b). Conversely, when a partnership distributes property to partners, they do not recognize any taxable gain or loss. *See id.* § 731(b) (1974). Additionally, a corporation can defend against hostile corporate takeovers by shifting valuable assets into an MLP and distributing the MLP "units" to its shareholders as dividends, thereby preventing the take-over corporation from obtaining anything of value. *See* Stevens, *Master Limited Partnerships*, 1987 A.B.A. Sec. Tax'n 4.

In December of 1987, Congress passed the Revenue Act of 1987, which substantially reduced the effectiveness of the MLP as a tax "loophole" by adding Code section 7704, which treats any publicly traded partnership as a corporation for tax purposes. *See* Revenue Act of 1987, Pub. L. No. 100-23,§ 10211, 101 Stat. 1330, 1403-05 (to be codified at 26 U.S.C. § 7704 and hereinafter referred to by section number). The 1987 amendment provides that partnerships which are "traded on an established securities market" or "readily tradeable on a secondary market" are to be considered corporations for tax purposes. *See* I.R.C. § 7704(b). This amendment is effective beginning January 1, 1988, but only applies to those partnerships formed after December 31, 1987. *See* Revenue Act of 1987, Pub. L. No. 100-23, § 10211(c), 101 Stat. 1330, 1405. For those partnerships already in existence, the effective date of the new amendment is January 1, 1998. *See id.* § 10211(c)(1)(B). In order to be an "existing partnership," a partnership must be publicly traded on December 17, 1987, and registered with the Securities and Exchange Commission. *See id.* § 10211(c)(2)(A).

The new amendment provides one major exception for publicly traded partnerships created after December 31, 1987. For any taxable year and each preceding taxable year commencing after December 31, 1987, if ninety percent of a partnership's gross income is derived from "certain qualifying revenues," a publicly traded partnership will not be considered a corporation for tax purposes, even though publicly traded. *See* I.R.C. § 7704(c). Qualifying revenues under the exception include interest, dividends, real property rents, gains from sale or disposition of real property or capital assets, and income or gains from exploration, development, mining or production, refining, transportation, or marketing of any mineral or natural resource. *See id.* § 7704(d). Under the amendment, if a partnership is deemed a corporation for tax purposes, the partnership will be treated as if all its assets have been exchanged for shares of stock in the corporation and such stock has been distributed to the partners in liquidation of their interests. *See id.* § 7704(f). However, this amendment does not modify any other aspects of the partnership form including an individual partner's liability.

The 1987 tax amendment is an effective Congressional response to abuse of the limited partnership form wherein taxpayers would effectively avoid "double taxation" while maintaining all other beneficial attributes of a corporation. Due to the reduction of the individual tax rate below the corporate tax rate by the Tax Reform Act of 1986, the use of MLPs had even greater potential for misuse. If the use of master limited partnerships being publicly traded had not been limited, the possibility of a substantial depletion of corporate tax revenues could have caused an upward trend in individual tax rates to offset the lost corporate tax revenues. The amendment is an effort to prevent abuse of the federal tax system by one of the last loopholes after the Tax Reform Act of 1986, while not affecting the traditional form of the limited partnership. Individuals can still have the advantages of limited liability under the limited partnership while maintaining the advantage of a lower tax rate than corporations. Those partnerships considered as being "publicly traded" that want the ease of transferability of their interests on a secondary exchange market, however, will have to look toward the corporate form and its burdensome double taxation.

Edward D. Biggers