SHOP TALK

Section 721(b)-A Partnership Issue, a Corporate Issue, or Just a Jumble?

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com; Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com; and Adam M. Cohen , 555 17th Street, Suite 3200, Denver, Colorado 80202, ACohen@hollandhart.com.

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Recent Ltr. Rul. 202016013, an intriguing "partnership investment company" ruling under Section 721(b) by IRS Chief Counsel's Corporate group, involves a jumble of partnership and corporate issues. As discussed in this article, the question in the ruling turns on whether, in the case of a contribution of corporate stock to a partnership treated (for investment company purposes) as a corporation, a subsidiary partnership can be treated as a corporation. To understand that jumble, we first explore the factual set-up for the ruling.

The transaction at hand almost surely is the acquisition of SemGroup Corporation by Energy Transfer LP (see Energy Transfer LP Form S-4, filed with U.S. Securities and Exchange Commission on 10/03/2019 and amended 10/28/2019 (the S-4)) and, as such, we will discuss the transaction on that assumption.

Energy Transfer LP (ET) has limited partner common units traded on the New York Stock Exchange (NYSE). ET describes itself as being engaged in natural gas operations, including natural gas midstream and intrastate transportation and storage, interstate natural gas transportation and storage, and crude oil, natural gas liquids (NGL) and refined products transportation, terminalling services and acquisition and marketing activities, as well as NGL storage and fractionation services. ET directly owns interests in other entities through which some of these activities are conducted. Specifically, ET owns Energy Transfer Operating, L.P. (ETO), which itself has limited partner preferred units traded on the NYSE. ETO in turn owns various operating subsidiaries and interests in two other partnerships that have units traded on public exchanges (Sunoco LP and USA Compression Partners, LP). ET, ETO, and the other two partnerships claim to be partnerships for U.S. federal tax purposes.

In the S-4, ET announced that it had entered into an Agreement and Plan of Merger with its wholly owned subsidiary, Nautilus Merger Sub LLC (in the ruling, New LLC) and SemGroup Corporation (SEMG; and in the ruling, Target), whose common stock traded on the NYSE (prior to SEMG's being acquired by ET on 12/05/2019). The proposed transaction, under this agreement, would merge New LLC into SEMG with SEMG surviving and with SEMG's outstanding stock being converted into cash and common units in ET, followed by the contribution by SEMG of all of its assets to ETO in exchange for ETO units.

For federal income tax purposes, the merger is characterized differently. Because New LLC is wholly owned by ET and apparently has not made a check-the-box election to be taxed as a corporation, it is disregarded as separate from ET for federal income tax purposes. Thus, the merger is treated as a contribution to ET of SEMG's stock by SEMG's shareholders in exchange for the cash and ET's units. Whether that contribution will trigger recognition of gain or loss depends entirely on Section 721. (As part of the transaction, SEMG transferred all its business assets to ETO for ETO units. That seemingly is a tax-free transfer under Section 721.)

Section 721 has its general rule of non-recognition, i.e., no gain or loss is recognized by the transferor, the partnership, or any of its other partners when property is contributed to the partnership in exchange for an interest in the partnership. That general rule, however, is subject to three exceptions. Two of them, regarding transfers of intangibles and transfers by non-United States persons, are not relevant here. The third, Section 721(b), provides that the general rule does not apply "to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of Section 351) if the partnership were incorporated." The scope of Section 721(b) is elusive and potentially far-reaching; it may even apply when holders of options to acquire partnership interests exercise their options and when interests in a

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partnership investment company are converted (e.g., general partner into limited partner interests, general or limited partnership interests into LLC interests, or vice versa). See TD 9612, 02/05/2013; Carman and Banoff, "Final Regulations on Noncompensatory Options: Worth the Wait?," 118 JTAX 164 (April 2013); Banoff, "Partnership Ownership Realignments in Partnership Reallocations, Legal Status Changes, Recapitalizations and Conversions: What Are the Tax Consequences?," 83 Taxes, No.3 (March 2005) 105, 122.

Thus, ET was faced with the question of whether, if ET was a corporation, the transfer of SEMG's stock to ET would be a transfer to an investment company under Section 351. ET indicated in the S-4 that it was seeking a private letter ruling to determine the answer to this question. (And Ltr. Rul. 202016013, dated 01/08/2020 and released 04/17/2020, undoubtedly is that ruling.)

Section 351 has one subsection that talks about investment companies. Since 1967, Section 351(e)(1) has stated, "This section [351] shall not apply to a transfer of property to an investment company." Congress's concern has been described as follows: if two or more unrelated persons transfer separately owned property to a controlled corporation in exchange for the corporation's stock, Section 351 permits the transferors to achieve a degree of diversification without recognizing gain, and if the diversification is sufficiently dramatic, the transaction may be financially tantamount to a sale. Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (WG&L), Para. 3.15[1].

In 1997, Section 351(e) was amended by The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 105th Cong., 1st Sess., Sec. 1002, by greatly expanding the type of tainted investment assets for this purpose. Section 351(e) now lists several types of property that are to be treated as stock and securities for purposes of the determination of whether a company is an investment company. Two of these statutorily listed property types are look-through rules. Section 351(e)(1)(B)(vi) provides that, if substantially all the assets of an entity consist (directly or indirectly) of any of the enumerated types of property, all of the interests in that entity are considered stock and securities for the investment company determination. Section 351(e)(1)(B)(vii) provides that, if less than substantially all of the assets of the entity consists of the enumerated types of property, the interests in the entity are considered stock and securities to the extent the value of such interest is attributable to the enumerated types of property. Thus, these limited look-through rules only look through for "bad" assets.

The regulations under Section 351, promulgated in 1967, provide more color to the statutory concept of an "investment company." Reg. 1.351-1(c)(1) tells us that there is a transfer to an investment company if the transfer results in diversification and the transferee is a regulated investment company (RIC), a real estate investment trust (REIT), or a corporation more than 80 percent of the value of whose assets are held for investment and are readily marketable stocks or securities, or interests in a RIC or REIT. Reg. 1.351-1(c)(2) gives us a timing rule (i.e., that the testing occurs after the transfer or later, if there is a plan). Reg. 1.351-1(c)(4) provides another look-through rule, stating that stock and securities in a "subsidiary corporation" (defined as a corporation where the parent owns 50 percent or more of the vote or value of all classes of stock) is disregarded and the "parent corporation" is deemed to own its ratable share of its subsidiaries' assets.

Now, let's return to the ruling at hand. The transaction in Ltr. Rul. 202016013 is a transfer of corporate stock to a partnership that owns other partnerships. In the ruling, ET represented that immediately following the proposed transaction ET's direct ownership interest in ETO represented more than 50 percent of the value (based on capital accounts) of all equity interests in ETO and that at the time of the transaction there would be no plan to have ET's direct ownership interest in ETO reduced to less than 50 percent of the total value of all equity interests in ETO. ET also represented that, immediately after the proposed transactions, "after applying the look-through rule of Treas. Reg. § 1.351-1(c)(4)," not more than 80 percent of (1) the FMV of ET's assets (excluding its direct interests in ETO) plus (2) ET's ratable share (determined by reference to Section 704(b) capital accounts) of the FMV of ETO's assets, would be assets described in Section 351(e).

Thus, the ruling turns on the application of the look-through rule of Reg. 1.351-1(c)(4). Section 721(b) says to treat partnership ET as a corporation, but it does not go further (i.e., it does *not* say to treat any entity owned by ET as a corporation). Reg. 1.351-1(c)(4) only applies to corporations. After the transaction, for purposes of the investment company rules, SEMG is a corporate subsidiary of ET and Reg. 1.351-1(c)(4) clearly applies to SEMG, but SEMG's sole asset, at that point, will be interests in ETO. The regulatory look-through rule does not appear to apply to ETO, a partnership for federal income tax purposes, or to any tax partnership owned by ETO.

ET might turn to the statutory look-through rules. However, those only give you "bad" assets. The statutory provisions of Section 351(e)(1)(B)(vi) and (vii) only tell you when to treat interests in an entity as "stock and securities." They do not allow a taxpayer to truly look through interests in an entity to the assets of the entity.

This raises the significant issue of whether you take at face value the reference in a statute or regulation to the classification of an entity. When a statute or regulation refers to a "corporation," does that mean only entities treated as corporations for federal income tax purposes? Or, can you apply those rules to entities treated as partnerships for federal income tax purposes, at least in a situation where the operative statute (Section 721(b)) imposes corporate tests and standards (under Section 351(e)) on partnerships?

Interestingly, as noted above, Ltr. Rul. 202016013 was issued by the Corporate side of Chief Counsel's office. The ruling starts by stating that it is issued pursuant to section 6.03(2) of Rev. Proc. 2019-1, 2019-1 IRB 1, regarding one or more significant issues under Section 351 (among other provisions). Section 6.03(2) says that the IRS will not rule on the qualification of any transaction

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under Section 351 (among other Code sections), regardless of whether the transaction is part of an integrated transaction, but will only issue rulings on significant issues "presented in a transaction described in § ... 351 ...." But, looking at the entities involved, this is really a ruling on a transaction described in Section 721 that involves the application of the "investment company" rules in Section 351; it is not a "transaction described in Section 351," and therefore it is not a "no ruling" transaction. We note that the application of Section 721(b) occurs if the transfer "would be" a transfer to an investment company if the transferee partnership were incorporated (and therefore subject to indirect application of Section 351(e)).

So, it may be that, only in this bizzaro world of "would be" transfers that the federal income tax classification of an entity as a corporation or a partnership is conflated. One might also think that the addition of the statutory rules that look through an entity (rather than specify a corporation or partnership), which came 30 years after the regulations were issued, should mean that the regulatory rule should be read to refer to entities generically and not solely to corporations, as Reg. 1.351-1(c)(4) says on its face. However, the 1997 Blue Book (i.e., the General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97) prepared by the Joint Committee on Taxation staff (12/17/1997) that accompanied the statutory change to Section 351(e) made by The Taxpayer Relief Act of 1997) at page 184 specifically states, "the Act did not override the rule that, for purposes of determining whether a corporation or partnership is an investment company, the assets of a corporation are treated as owned proportionally by any shareholder (whether a corporation or other entity) owning 50 percent or more of its stock (Treas. Reg. sec. 1.351-1(c)(4))." This sentence itself refers to "corporation or partnership" in one place but solely "corporation" in another, implicitly indicating a conscious differentiation. (On the other hand, as your editors have previously noted over the past 30 years, the legal effect of Blue Books was, is, and perhaps always will be, unclear. See, e.g., Shop Talk, "What Will the TCJA Blue Book's Legal Effect Be?," 131 JTAX 32 (September 2019).)

This might leave one to wonder how the IRS was able to conclude that the look-through rule in the regulations could be applied to a partnership (ETO) when testing a transaction under Section 721(b). Other respected commentators indeed have been discussing this quandary. For example, Monte Jackel, while praising the policy rationale for Ltr. Rul. 202016013, called the issuance of this ruling "lawless behavior." Jackel, "Letter Ruling on PTP Look-Through Is Illegal," 2020 TNTF 77-12 (04/21/2020), *Tax Notes Federal*, 04/27/2020, p. 647. Robert Willens responded, indicating that he believed the "would be" language of Section 721(b) should also be applied to treat partnerships owned by the partnership receiving the contribution as also being corporations. Willens, "Willens Offers Possible Explanation for PTP Look-Through Ruling," 2020 TNTF 81-19 (04/27/2020), *Tax Notes Federal,* 04/27/2020, p. 649. Benjamin Willis added that he believed that the treatment of interests in a publicly traded partnership as "stock and securities" under Section 351(e)(1)(B)(iv) means that the partnership issuing those interests itself should be considered a corporation for the regulatory look-through rule. Willis, "Taking Stock of PTP Interests," 2020 TNTF 86-2, *Tax Notes Federal*, 05/04/2020, p. 825. Note that the three above-named commentators and others (including us) agree that the Service has reached the correct policy answer in applying the look-through rule to subsidiary partnerships. See, e.g., Willis (Arthur, not Benjamin), Postlewaite & Alexander, Partnership Taxation Sec. 4.02 fn. 248; Lay and Scaramella, "IRS Ruling Looking Through Lower-Tier Publicly Traded Partnership for Purposes of Determining Investment Company Status," J. Passthrough Entities, Vol. 19, Issue 3 (May-June 2016), pg. 7. The crux of the debate (and this article) is, how do you get there?

While we would not go so far as to call the issuance of the ruling "lawless," the statutory language relied upon by Willens and Willis does not go so far as they would hope. Section 721(b) only directs the recipient partnership to be treated as incorporated, not any subsidiary of that partnership. Section 351(e)(1)(B)(iv) only directs the interests in a publicly traded partnership to be treated as stock and securities, which does not imply the issuing partnership is a corporation for purposes of the regulations, as supported by the above-discussed sentence in the 1997 Blue Book.

Willens and Willis reference Ltr. Rul. 201547003, which Willis supplements by citing to the nearly identical Ltr. Rul. 201633028. Ltr. Rul. 201547003, which reportedly appears to be the ruling obtained in connection with the proposed acquisition of Williams by ET, involved the potential contribution of interests in a publicly traded partnership (i.e., Williams) to another partnership (i.e., ET) when the recipient partnership represented that it owned 50 percent or more of the total value of a subsidiary partnership (i.e., ETO) and that it had no plan whereby the recipient partnership's direct ownership interest in the subsidiary partnership would become less than 50 percent of the total value of the equity interests outstanding in the subsidiary partnership. As in Ltr. Rul. 202016013, the IRS Chief Counsel's

Corporate group ruled in both Ltr. Ruls. 201547003 and 201633028 that the recipient partnership's equity interest in the subsidiary partnership would be disregarded and the recipient partnership would be deemed to own its ratable share of the subsidiary partnership's assets for determining whether the recipient partnership is an investment company under Section 351(e). Neither Ltr. Rul. 201547003 nor Ltr. Rul. 201633028 reference Reg. 1.351-1(c)(4), which *is* explicitly relied upon in Ltr. Rul. 202016013.

We observe that Section 1202 has (at least at first glance) a similar disconnect between subsidiary corporations and subsidiary partnerships. See Shop Talk, "Is LLC Business Attributed to Corporate Member for Section 1045 Purposes?," 93 JTAX 254 (October 2000). In that article, we hypothesized a taxpayer looking to roll over her sales proceeds from

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the sale of qualified small business stock (QSBS) within the meaning of Section 1045. (Coincidentally, Section 1045 (like the amendment to Section 351(e)) was enacted by The Taxpayer Relief Act of 1997.) Generally, under Section 1045(a), a noncorporate taxpayer may defer the recognition of otherwise taxable gain from the sale of QSBS that was held more than six months prior to the date of sale of the QSBS. In our 2000 Shop Talk article, we asked whether our hypothetical taxpayer could successfully invest those proceeds in a corporation that itself does not conduct a qualified small business but has an interest in a partnership or an LLC that engages in a business that otherwise would satisfy Section 1045 if the business were conducted by the corporation.

Section 1045 defines QSBS by incorporating the definition of QSBS contained in Section 1202. Stock will be treated as QSBS under Section 1202 if, among other things, during substantially all of the period during which the taxpayer holds the stock, the issuing corporation must be engaged in an active trade or business.

In order to satisfy the active business requirement, at least 80% of the issuer's assets (as measured by their FMV) must be used in the active conduct of one or more qualified businesses. A special look-through rule applies when a parent corporation owns stock in a subsidiary corporation that is engaged in a qualified business. Specifically, the parent corporation will be deemed to own a ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities. Section 1202(e)(5)(A). To get this look-through treatment, the parent corporation must own more than 50% of the combined voting power of all classes of stock or more than 50% of the value of all the outstanding stock of the subsidiary corporation. Section 1202(e)(5)(C).

Can the look-through rule that applies to parent and subsidiary corporations as described in Section 1202(e)(5) be extended to a corporation that owns an interest in a partnership or LLC, for purposes of Section 1202? Todd D. Golub, a Chicago CPA and attorney and author of a then-contemporaneous article on Section 1045 rollovers, provided Shop Talk in our 2000 article with these observations:

> If the corporation is not the sole member and the LLC is taxable as a partnership, the look-through rule applicable to parent-subsidiary corporations on its face does not apply.

> Further, Section 1045 provides special rules for persons who invest in a flow-through entity that invests in QSBS to obtain the benefits of Section 1045. See also Rev. Proc. 98-48, 1998-2 CB 367, providing further guidance for persons who invest in flow-through entities to get the benefits of Section 1045. Thus, both Congress and the IRS considered the application of the aggregate theory of partnerships when enacting Section 1045 but did not extend that theory to the determination of whether the qualified business requirement is met if a corporation invests in an LLC that engages in a qualified business. Thus, this omission may indicate that the look-through rule does not extend to a subsidiary LLC for purposes of Section 1045.
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> The 1997 Blue Book states at page 58 that Congress enacted Section 1045 with the hope that the deferral benefit would encourage investors to reinvest funds in qualified small businesses, making more capital available to new, small businesses that are important to the long-term growth of the economy. There is no indication of why Congress limited the deferral benefit to investors that provide funds to small businesses that operate only in corporate form. So long as Congress intended to provide such a benefit, there is no apparent reason why it should not be extended to flow-through entities. In fact, by limiting this benefit to parent-subsidiary corporate relationships, Congress actually may have limited the funding that otherwise might be available to businesses that choose not to incorporate.
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> Accordingly, it would seem that [for purposes of Sections 1045 and 1202] a look-through rule should apply to corporations that have an interest in LLCs or other entities taxed as partnerships that are engaged in a qualified business....
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> Congress, however, did not go so far as to specifically provide for a look-through rule when a corporation invests directly in an LLC or partnership. So, if one looks solely to the statute [Section 1202], the business of the LLC arguably may not be attributable to the corporate member.

Golub's conclusion in our 2000 Shop Talk article is eerily and equally applicable to the corporate-partnership conundrum discussed in this article with respect to Section 721(b): "One can only hope that future guidance will clarify that the deferral benefit of Section 1045 should apply to the shareholders of corporations that invest directly in qualified businesses regardless of the form of entity that engages in the qualified business."

Golub's plea for guidance under Section 1045 (via Section 1202) published in Shop Talk 20 years ago apparently has gone unheard; there seems to have been no further guidance issued with respect to the attribution of a partnership's or an LLC's trade or business to a corporate member for purposes of Section 1045, notwithstanding strong policy reasons to support that result (just as there are under

Sections 721(b) and 351(e)). Moreover, we are unaware of any letter rulings that provide relief to subsidiary partnerships and their corporate partners for purposes of Section 1045. On the other hand, Ltr. Rul. 202016013 (and the two predecessor letter rulings described above) have created a niche where certain qualifying (majority interest) contributors to partnerships would apparently be able to apply a corporate look-through rule to subsidiary partnerships. And these Section 721(b) rulings by analogy may give some (albeit indirect) comfort to taxpayers and practitioners for purposes of Section 1045 that the Service would similarly apply a corporate look-through/attribution rule to subsidiary partnerships for purposes of attributing their trades or businesses to corporate partners holding majority interests in their partnerships.

Readers, we welcome your comments, as always. (Co-editor Richard M. Lipton did not participate in the preparation of this article.)