

Code Sec. 355 and Partnerships

By Robert W. Wood • Wood & Porter • San Francisco

Code Sec. 355 is never far away from our hearts or minds. Of course, Code Sec. 355 is exclusively a Subchapter C rule, so using Code Sec. 355 and partnerships in the same breath may seem a bit odd. Yet, for many years now, there have been some circumstances in which a partnership is considered to be engaged in the active conduct of a trade or business.

It is axiomatic that the active conduct of a trade or business does *not* include holding property for investment. [See Reg. §1.355-3(B)(2)(iv).] But what of corporations that hold partnership (or LLC) interests? This may be an active joint venture, or it could involve

mere portfolio investments. The fact that a partnership engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation does not necessarily mean that each partner in the partnership is considered to be engaged in the active conduct of that trade or business.

Indeed, whether a partner is considered to be so engaged must be based on the requirements of Code Sec. 355 and its regulations. Those regulations indicate one should take into account the activities of the partner (if any), the partner's interest in the partnership and the activities of the partnership.

Recently, the IRS weighed in on this topic in Rev. Rul. 2007-42, IRB 2007-28, 1.

History Channel

This isn't the first ruling on this topic. Back in 1992, the IRS issued Rev. Rul. 92-17, 1992-1 CB 142, which evaluates whether a corporate general partner in a limited partnership was engaged in the active conduct of a trade or business for purposes of Code Sec. 355(b). In that 1992 ruling, the corporate general partner had owned a 20-percent interest in the limited partnership for more than five years. The limited partnership owned several commercial office buildings all leased to unrelated third parties.

The corporate general partners officers performed active and substantial management functions with respect to the limited partnership, including significant business decision making of the partnership. Moreover, these officers regularly participated in the overall supervision, direction and control of the partnership's employees in operating its rental business. In this situation, Rev. Rul. 92-17 concluded that the corporate general partner was engaged in the active conduct of a trade or business under Code Sec. 355(b).

Then came Rev. Rul. 2002-49, 2002-2 CB 288. It reaches a similar conclusion where the corporate general partner and another corporation each owned a 20-percent interest in a member-managed LLC that was classified as a partnership for tax purposes. The key to these earlier rulings, of course, is the provision of significant services, providing some management functions, some genuine actions, if you will, to substantiate the "activeness."

Rev. Rul. 2007-42

In the latest iteration of this active conduct inquiry, the question was whether D, a corporation that owned a membership interest in an LLC, was engaged in the active conduct of a trade or business under Code Sec. 355(b). This ruling posits two situations, both in large part resting on the facts of the earlier ruling. In Situation One, the LLC (a partnership for tax purposes) had for more than five years owned several commercial office buildings leased to unrelated third parties.

The LLC had one class of membership interests, and for more than five years, D (the

corporation in question) owned a 30-percent membership interest in the LLC. D also held all of the stock of a subsidiary corporation (C) that had been engaged in *another* active trade or business for more than five years. The LLC seeks out additional properties, and when they are located, negotiates their purchase and finance, conducts renovations, repaints and refurbishes existing properties, *etc.*

The LLC also provides day-to-day upkeep and maintenance for the buildings. This includes trash collection, ground maintenance, electrical and plumbing repair, *etc.* The LLC advertises for new tenants, handles lease applications and negotiations, handles tenant complaints and evictions, *etc.*

The employees of the LLC perform all the management and operational functions with respect to the LLC's rental business. Neither D nor any other members of the LLC perform services with respect to the LLC's business. In Situation One, for valid business reasons, D now proposes to distribute all of its C stock *pro rata* to D's shareholders in a Code Sec. 355 transaction.

We are told that the transaction meets all of the other requirements of Code Sec. 355, if D is engaged in the active conduct of a trade or business under Code Sec. 355(b). The revenue ruling holds that D is engaged in the active conduct of the LLC's rental business. The IRS reasons that D owns a "significant" interest in the LLC (30-percent is significant), and the LLC performs the required activities that constitute an active trade or business under the regulations.

Situation Two

In Situation Two, the facts are the same as in Situation One, except that D owns only a 20-percent interest in the LLC. Here, the IRS concludes that D is *not* engaged in the active conduct of the LLC's rental business for purposes of Code Sec. 355(b). The reason given is that D neither owns a significant interest in the LLC, nor performs active and substantial management functions for the LLC. That's a two-fold failure.

Implicitly, a 20-percent interest is not significant, while a 30-percent interest is. Where one draws the line between 20 percent and 30 percent may turn out to be critical, but that line is not described here. The bottom

line of this is that if the corporate member of the LLC (or partner in a partnership) owns a significant interest in the LLC or partnership, it is not necessary for the corporate partner to actually perform significant services (or for that matter *any* services) in connection with the conduction of the partnership's business.

Significant interests (I use the word "interests" because using the word "investment" for a share of an active trade or business just doesn't sound right!) need not be accompanied by the performance of substantial services by the holder of the interest. Conversely, if the corporate partner (or LLC member) does not own a "significant" interest in the partnership or LLC, it would be necessary for the corporate partner (or member of an LLC) to perform substantial services pursuant to the partnership's (or LLC's) active trade or business.

To that extent, the IRS indicates that it modifies Rev. Rul. 92-17. As noted above, that ruling indicated a partner must perform management functions in order for the partner to be treated as engaged in the active conduct of a trade or business of the partnership.

Aggregate vs. Entity

We may never have an entirely consistent partnership tax law. After all, for some purposes a partnership is an aggregate, and for some purposes it is an entity. But, this latest ruling will be a big help to facilitate some Code Sec. 355 transactions. When in doubt, I would guess that corporate investments (or, rather "interests") in trades or businesses conducted by partnerships or LLCs are likely to rise to 30 percent whenever that's possible.

Of course, a 20-percent interest in a big enterprise might be worth a lot more than a 30- or even a 40-percent interest in a smaller one. Presumably, that won't matter. Likewise, it presumably won't matter if the corporate partner holds a 20-percent interest and is the biggest single interest holder versus a corporate partner that holds 20 percent along with four other equal corporate co-owners.

Maybe the fact that such variations in size and numbers of owners are evidently not take into account is troubling. Still, it is hard not to be happy with the flexibility this new ruling offers.

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