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ABSTRACT: Annie H. Jeong discusses a letter ruling that concerned practitioners because of its application of *reg. section 1.267(b)-1(b)*, and she argues that the regulation should no longer be considered valid.

SUMMARY: Published by Tax Analysts(R)

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AUTHOR: Jeong Law PC Jeong, Annie H.

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Can a Regulation Survive Statutory Amendments?

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Annie H. Jeong is a tax and business attorney and principal of Jeong Law PLLC. She advises small businesses, investors, and investment funds on tax and legal matters.

In this article, Jeong discusses a letter ruling that concerned practitioners because of its application of *reg. section 1.267(b)-1(b)*. She argues that in light of the original purpose of the regulation and subsequent changes to the tax code, the regulation should no longer be considered valid.

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Introduction

On September 23, 2011, the IRS released LTR 201138015 (Doc 2011-20346), which described a taxpayer's consequences under *section 267(a)(1)* and applied an aggregate approach to partnerships for purposes of determining *section 267(b)* relatedness. While the ruling on its face appeared to apply *section 267* in a relatively straightforward manner, the ruling triggered concern among tax practitioners regarding the validity (and continued application) of the aggregate approach provided under *reg. section 1.267(b)-1(b)*. While the IRS applied the regulation in the ruling, many practitioners believe that the regulation was superseded by the enactment of *sections 707(b)(1)(A)* and 267(b)(10). This article summarizes the applicable rules regarding *section 267(a)(1)* as applied to the ruling and concludes that the regulation should be considered invalid.

Partnership Loss Disallowance Rules

Section 267(a)(1) generally provides that if a sale or exchange of property results in a loss between related persons, the loss is disallowed. Congress enacted *section 267* to prevent related persons from entering into tax avoidance schemes that generate artificial deductions. n1 Related persons could easily manipulate transactions so that a taxpayer would recognize losses for tax purposes but continue to hold the property generating the losses (that is, in substance, obtain the tax benefit of the losses without a sale or other loss-generating disposition of the property).

A laundry list of related persons is provided under *section 267(b)*. When *section 267* and its predecessor were enacted, this list did not include partnerships. However, in 1954 Treasury promulgated *reg. section 1.267(b)-1(b)*, which added a look-through rule for partnerships, providing that if a transaction occurs between a person and a partnership, the transaction is effectively treated as occurring between the person and each partner. Thus, a partnership was treated as an aggregate of its partners. For purposes of applying *section 267*, one would look to each partner and each other person involved in the transaction to determine whether the requisite relationship existed.

The regulation provides an example in which ABC -- consisting of three one-third partners A, B, and C -- sells property at a loss to M, a corporation wholly owned by A. n2 The example concludes that the transaction is treated as occurring separately between each of A, B, and C on one hand and M on the other. Thus, while B and C are entitled to claim a loss on their distributive share of partnership deductions for the loss, A's share of the losses is disallowed. Further, A must reduce his outside basis by the amount of his distributive share of the deduction.

In 1982 Congress added a relationship under *section 267(b)* to address overlaps in ownership between partnerships and corporations. *Section 267(b)(10)* provides that a corporation and a partnership are related if the same persons own more than 50 percent of the value of the outstanding stock of the corporation and more than 50 percent of the capital or profits interests in the partnership.

To illustrate this relationship, assume A, B, C, and D are shareholders of X Corp. and each owns 25 percent of the value of the outstanding shares of X Corp. stock. A, B, and C are also each one-third partners in ABC partnership. If X Corp.

sells property to ABC partnership at a loss, the loss would be disallowed because X and ABC are related persons under *section 267(b)(10)*.

Before 1986, *section 707(b)(1)(A)* also provided loss disallowance rules applying to partnerships and their partners. The former section disallowed losses from the sale or exchange of property (other than an interest in the partnership) occurring directly or indirectly between (a) a partnership and a partner owning directly or indirectly more than 50 percent of the capital or profits interest in the partnership or (b) two partnerships in which the same partners owned, directly or indirectly, more than 50 percent of the capital or profits interests. Thus, the rule applied specifically to transactions occurring between partners and partnerships.

However, in the Tax Reform Act of 1986, Congress amended *section 707(b)(1)(A)* by substituting the term "person" for "partner." The change expanded the scope of *section 707(b)(1)(A)* to include not only partners and their partnerships but also any persons related to partners. n3

Once Congress enacted *section 267(b)(10)*, some practitioners believed that *reg. section 1.267(b)-1(b)* should no longer be considered valid and that the regulations should be updated to reflect the enactment of *section 267(b)(10)*. The revision to *section 707(b)(1)(A)* provided further support to the idea that the regulation had become obsolete.

LTR 201138015

As mentioned above, on September 23, 2011, the IRS released LTR 201138015, applying *reg. section 1.267(b)*-(1)(b). The taxpayer in the ruling was a corporation that was placed into bankruptcy. The taxpayer was owned through a series of tiered ownership structures, which included some of the taxpayer's lenders, as well as individuals B and C. Before the loss-generating transaction, B and C (who are siblings) owned approximately 36.2 percent of the taxpayer's stock directly and constructively through partnerships and family attribution. In a G reorganization, B, C, and the lenders would form a partnership that would acquire the taxpayer's assets. In the aggregate, B, C, and the lenders owned no more than 48.7 percent of the taxpayer's stock and owned 100 percent of the partnership.

The IRS determined that *section 267(a)(1)* did not apply to the transaction, reasoning that the partnership and the taxpayer were not related persons under *section 267(b)(10)*. However, the IRS also applied *reg. section 1.267(b)-1(b)*, ruling that under the regulation, *section 267(a)(1)* did not apply because the taxpayer was not related to any of the partners (that is, no individual partner was deemed to own more than 50 percent of the corporation).

Analysis of *Section 267(a)(1)* After Ruling

While the taxpayer might have requested the IRS to rule that *reg. section 1.267(b)-1(b)* would not apply, the IRS clearly applied the regulation as if it were valid. Perhaps a private letter ruling is not the proper venue to determine the validity of a Treasury regulation. However, the application of this regulation should concern tax practitioners.

It is doubtful that the regulation should be treated as valid after the enactment of *section 267(b)(10)* and the amendment to *section 707(b)(1)(A)*. In *Casel v. Commissioner*, n4 the taxpayer challenged the validity of the regulation, asserting that the aggregate theory should not apply. The Tax Court disagreed, reasoning that while *section 707*, as drafted in the Internal Revenue Code of 1954, applied the entity theory, the legislative history of *section 707* provided that "no inference is intended 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." n5 The Tax Court reasoned that in light of *section 267*'s purpose of preventing taxpayers from deducting payments to related persons, applying the entity theory would allow a partner to interpose a partnership between himself and a corporation and thus circumvent *section 267(a)*. n6 Therefore, to prevent this use of partnerships to avoid the law, the transaction should fall within the scope of *section 267(a)*.

However, *Casel* was decided in 1982, and the tax years at issue were 1974 and 1975. Thus, the transaction described in *Casel* predated the enactment of *section 267(b)(10)* and the amendment to *section 707(b)(1)(A)*. The circumstance that concerned the Tax Court in *Casel* -- the ability to interpose a partnership to prevent the application of *section 267(a)(1)* -- is now covered by *section 267(b)(10)* if there is sufficient overlapping ownership. Under *section 267(b)(10)*, a taxpayer cannot use a partnership to sell property to a corporation at a loss to circumvent *section 267(a)(1)* if the taxpayer owns more than 50 percent of the capital or profits interests in the corporation and more than 50 percent of the value of the corporation's stock.

While it is true that *reg. section 1.267(b)-1(b)* is broader than *section 267(b)(10)*, Congress limited the application of *section 267* to situations in which a partnership and a corporation have the requisite overlap of ownership. Congress could have drafted a specific rule requiring application of the aggregate theory to partnerships and other persons; however, *section 267(b)(10)* clearly contemplates an entity approach. Thus, applying *section 267(b)(10)*, *section 267(a)(1)* should not apply to a one-third partner in a partnership that sells property at a loss to a corporation 100 percent owned by the one-third partner (that is, it should not apply in the case of Example 2 in *reg. section 1.267(b)-1(b)(2)*).

Moreover, the change of the word "partner" to "person" in *section 707(b)(1)(A)* expanded the reach of *section 707(b)(1)(A)* to cover situations in which noncorporate entities engage in loss-generating transactions with partnerships. By changing the terminology, the persons engaging in transactions need not be partners. Rather, applying attribution and indirect ownership rules, even persons related to partners are now subject to *section 707(b)*.

The entity theory should apply to partnerships under *section 707(b)(1)(A)*. Congress could have required the aggregate theory to be used in this situation, but it chose not to do so. Instead, Congress disallowed loss-generating sale or exchange transactions between partnerships and persons only if the overlap in ownership exceeded the 50 percent threshold. It is difficult to see how the regulation can survive when Congress clearly intended partnerships to be respected as entities.

Finally, Congress referred to *reg. section 1.267(b)-1* as "prior law application of *section 267* to partnerships," at least in the context of the matching rule under *section 267(a)(2)*. n7 As part of the Deficit Reduction Act of 1984, Congress modified *section 267* regarding how the matching rules apply to cash and accrual basis taxpayers. For example, under the rule created by the act, if a corporation owned a 1 percent profits interest in partnership X (a partnership under the accrual method of accounting) and a 51 percent profits and capital interest in partnership Y (a partnership under the cash method of accounting), unpaid amounts owed by X to Y would not be deductible by X until paid by Y because Y is related to the corporation, a 51 percent partner in Y. However, the footnote to the example provides that if the corporation were a 40 percent partner in Y, the new rule would not apply (because Y is not related under *section 707(b)(1)*). Congress also refers to *reg. section 1.267(b)-1* as "prior law," inferring that under this law the corporation, as a 40 percent owner of Y, would be subject to this rule. If Congress believes that the regulation is old law for purposes of *section 267(a)(2)*, it is unclear why it should still apply to *section 267(a)(1)*.

Recommendation

It is true that *reg. section 1.267(b)-1(b)(1)* allows the IRS to disallow losses in more situations than it otherwise could under *sections 267(b)(10)* and 707(b)(1)(A). However, the regulation was enacted at a time when (a) partnerships were not specifically designated as related persons under *section 267(b)* and (b) the loss disallowance rules under *section 707(b)(1)(A)* applied only to partners and their partnerships. Under current law, Treasury and the IRS need not worry about drafting regulations to cover potentially abusive transactions that Congress did not consider. Congress has in fact spoken -- twice -- and it is clear that Congress applied (and intended to apply) the entity theory.

Moreover, while the regulation example involves a simple partnership with three partners, the complexity of partnership structures has increased exponentially since the regulation's promulgation in 1954. Today, multiple-tiered partnership structures and ownership by publicly traded companies make determining ownership a maddening exercise. Unless there is some ownership threshold regarding the disallowance of losses between partnerships and related persons, the determination of when a loss should be disallowed will be a daunting task for taxpayers. Not only would the application of the entity theory comport with congressional intent, it would also allow partnerships to operate with administrative ease and efficiency when the 50 percent threshold has not been breached.

FOOTNOTES:

n1

See Ronald Moran Cadillac Inc. v. United States, 385 F.3d 1230, 1233 (9th Cir. 2004) (Doc 2004-20041); *David Metzger Trust v. Commissioner, 76 T.C. 42, 75 (1981).*

n2

Reg. section 1.267(b)-1(b)(2), Example 2.

n3

Douglas A. Schaaf and Thomas S. Wisialowski, "Disallowance of Losses and Deferral of Deductions in Partnership Transactions," *9 J. Partnership Tax'n 191, 194 (1992).*

n4

Casel v. Commissioner, 79 T.C. 424 (1982).

n5

Id. at 432, citing H. Rept. 2543, 83d Cong., 2d Sess. 59 (1954).

n6

Id. at 432.

n7

See Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84 (1984).