OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

Date: January 10, 2002

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB)
AREA 1, FINANCIAL SERVICES
ATTN: MICHELE J. GORMLEY, SENIOR ATTORNEY

FROM: John M. Breen, Senior Technical Reviewer, CC:INTL:Br.6

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated September 12, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

a =
b =
c =
d =
e =
Airline 1 =
Bank 1 =
Bank 2 =
City 1 =
Consortium =

Corporation A =
Corporation B =
Corporation C =
Corporation D =
Country A =
Date A =
Date B =

FSC =
Model A =
Partnership 1 =
State A =
State B =
State C =
Taxable Year 1 =
Trust 1 =
Trustee =

ISSUES

Whether Partnership 1 is eligible to make a section 761(a) election to be excluded from the application of the provisions of subchapter K of Chapter 1 of the Internal Revenue Code and the requirements of the unified audit and litigation proceedings of sections 6221 through 6234 (TEFRA).

CONCLUSIONS

Partnership 1 is not eligible to make a section 761 election to be excluded from the application of all or a part of the provisions of subchapter K of Chapter 1 of the Code. Since partners in a limited partnership are not coowners of partnership property under the section 761 regulations, Partnership 1 cannot elect to be excluded from the application of the provisions of subchapter K pursuant to section 721(a).

Because Partnership 1 is not eligible to make a section 761 election, it is subject to TEFRA, given that the small partnership exception did not apply.

FACTS

This case involved the purported purchase of a Model A aircraft by a foreign sales corporation, as defined under section 922, for the taxable year at issue followed by a lease of that aircraft to an unrelated lessee for use outside the United States. The relevant facts are as follows.

On or about Date A, Airline 1, a foreign airline, entered into an agreement with Corporation A, a U.S. aircraft manufacturer, to purchase several new Model A aircraft. Airline 1 made a deposit of $a with Corporation A at the time of the contract signing and made additional payments prior to completion of the individual aircraft. After construction of one of the aircraft was completed and a delivery date was set, Airline 1 sought to arrange financing for that aircraft.

To facilitate the financing of the Model A aircraft, Partnership 1 was formed under the State A Revised Uniform Limited Partnership Act (RULPA) as described below. Corporation B, a State B corporation, is a wholly-owned subsidiary of Corporation C. Corporation C is the parent company of a number of domestic subsidiaries and files a consolidated Federal income tax return with Corporation B. Bank 1 is a State C bank. Corporation D is a State A corporation and a wholly-owned subsidiary of Bank 1. Corporation B and Corporation D held all of the outstanding shares of FSC, a foreign sales corporation incorporated in Country A. In Taxable Year 1, Corporation B and Corporation D contributed their shares in FSC to form Partnership 1, an unincorporated organization. Corporation D was a b% limited partner and c% general partner, and Corporation B was a d% limited partner in Partnership 1. Partnership 1 was governed by the Limited Partnership Agreement dated Date B. This agreement specifically stated that the partners intended that the unincorporated organization be an investing partnership as defined in Treas. Reg. § 1.761-2(a)(2), and intended for the investing partnership to elect to be excluded from the application of the subchapter K provisions pursuant to section 761.

Partnership 1 also owned all the beneficial interest in Trust 1, a grantor trust established pursuant to a Trust Agreement dated Date B, a date during Taxable Year 1, between Trustee, a State A banking corporation and Partnership 1. Following the partners' contribution of all the outstanding shares of FSC to Partnership 1, on Date B Partnership 1 contributed these shares to Trust 1. Airline 1 assigned to FSC the right to purchase the Model A aircraft.

Also on Date B, to facilitate the purchase of the aircraft by FSC, FSC entered into a Contract and a Participation Agreement with Airline 1. Bank 1, through its City 1 Branch guaranteed the obligations of FSC to Airline 1. On the same day, Trustee entered into a loan agreement with Bank 2, as Agent, and Consortium, as lenders. Partnership 1 guaranteed the loan by pledging the stock of FSC as collateral. Trust 1 borrowed e% of the cost of the aircraft from the lenders and contributed this amount to FSC as an additional contribution to capital. FSC purchased the Model A aircraft using the contributed capital and then immediately leased the aircraft back to Airline 1. All of the above steps were in accordance with the stated purpose and terms of the Limited Partnership Agreement.

LAW AND ANALYSIS

A. SECTION 761 ELECTION

Section 761(a) defines the term partnership for purposes of the subchapter K partnership rules as including a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation, a trust or an

estate. In addition, the Service has determined that the mere coownership of property that is maintained, kept in repair, and rented or leased is not a partnership.

Section 761(a) also provides, in part, that under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of subchapter K, if the organization is availed of for investment purposes only and not for the active conduct of business.[1] The members of such organization must be able to compute their income without the necessity of computing partnership taxable income.

1. Section 761 Election Eligibility

For an unincorporated organization to be able to elect to be excluded from the application of the subchapter K provisions as an investing partnership under section 761, the participants must:

(1) own the property as coowners;

(2) reserve the right separately to take or dispose of their shares of any property acquired or retained; and

(3) not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for this account, but not for a period of more than a year.

See Treas. Reg. § 1.761-2(a)(2). The Service has ruled that coownership is determined under state law, not by the definition of a cotenancy, but rather by reference to each party's rights in the property as specified by a lease or other contract between the parties.

Under RULPA, partners of a limited partnership own partnership interests in that partnership. Partnership interests are personal property that consist of the right to a share of the profits and surplus of the partnership. Ownership of a partnership interest generally does not give a partner the right to take separately or dispose of its share of the partnership property. In short, partners in a partnership under

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[1] Section 1.761-2(a) of the Treasury Regulations also allows the members of an unincorporated organization to elect to be excluded from the application of all or part of subchapter K, if the organization is availed of: (1) for the joint production, extraction, or use of property, but not for purposes of selling services or property produced or extracted, or (2) by dealers in securities for a short period for the purposes of underwriting, selling, or distributing a particular issue of securities.

RULPA are not coowners of partnership property and cannot take their share of the property at will.

2. Method of Making a Section 761 Election

Section 1.761-2(b)(2) of the Treasury Regulations provides that an eligible unincorporated organization must make the election provided in section 761(a) in a statement attached to, or incorporated in, a properly executed partnership return, Form 1065, which shall contain the required information prescribed under the regulations. Such return shall be filed with the internal revenue officer with whom a partnership return, Form 1065, would be required to be filed if no election were made. The partnership return must be filed not later than the time prescribed by Treas. Reg. § 1.6031-1(e) (including extensions thereof) for filing the partnership return with respect to the first taxable year for which exclusion from subchapter K is desired.

In the alternative, an unincorporated organization may be deemed to have made the election pursuant to section 761 if it can show from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to secure exclusion from the application of all of subchapter K beginning with the first taxable year of the organization. See Treas. Reg. § 1.761-2(b)(2)(ii). The regulations provide that although the following facts are not exclusive, either one of such facts may indicate the requisite intent:

> (a) At the time of the formation of the organization there is an agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or
>
> (b) The members of the organization owning substantially all of the capital interests report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization.

Treas. Reg. § 1.761-2(b)(2)(ii).

Under the facts as stated above, the terms of the Limited Partnership Agreement explicitly state that the partners intend that Partnership 1 be an investing partnership as defined in Treas. Reg. § 1.761-2(a)(2), and intend for Partnership 1 to elect to be excluded from the application of the subchapter K provisions pursuant to section 761. Nevertheless, because Partnership 1 is a limited partnership formed under RULPA, the partners are not considered to be coowners of the partnership property and thus, Partnership 1 is not an eligible entity for purposes of

section 761(a). Accordingly, Partnership 1 may not elect to be excluded from the application of the subchapter K provisions pursuant to section 761.

B. TEFRA PROVISIONS

Section 6221 provides that the tax treatment of any partnership item (i.e., items required to be taken into account for the partnership's taxable year under Subtitle A of the Code) are determined on the partnership level under the unified audit and litigation proceedings of sections 6221 through 6234 (TEFRA). As a general rule, the TEFRA proceedings apply to any partnership that is required to file a return of partnership income under section 6031. I.R.C. § 6231(a)(1)(A). Section 6233 also provides that the TEFRA proceedings apply to an entity that files a partnership return, even if it is determined that the entity is not a partnership. For purposes of applying TEFRA, the entity filing the partnership return is treated as a TEFRA partnership and the persons holding an interest in the entity are treated as partners. Section 301.6233-1T(d)(1)[2] of the Temporary Treasury Regulations provides, however, that section 6233 does not apply to an entity that: (1) qualifies as a small partnership under section 6231(a)(1)(B), or (2) files a partnership return solely for purposes of making the election of partnership status described under section 761(a). Partnerships that properly elect to be excluded from the application of the subchapter K provisions pursuant to section 761 are not subject to the TEFRA proceedings because they are not required to file partnership returns. Treas. Reg. § 1.6031-1(b)(1)(ii). As discussed above, Partnership 1 was not an eligible entity under section 761 and thus was not able to make the election to be excluded from the application of the subchapter K provisions pursuant to section 761(a).

As to whether Partnership 1 qualifies as a small partnership, for the taxable year at issue the definition of a small partnership was contained in section 6231(a)(1)(B).[3] Section 6231(a)(1)(B)(i) defined a small partnership as a partnership with ten or fewer partners, each of whom is an individual (other than a nonresident alien) or an estate, and each partner's share of each partnership item is the same as his share of every other item. Applying this definition, Partnership 1 is not a small partnership because the partners include corporations.

In summary, based on the analysis above and our understanding of the facts provided, Partnership 1, as a limited partnership, was not eligible to make a section 761 election. Moreover, Partnership 1 does not fall within the small partnership exception. Accordingly, based on the information available to us, we conclude that

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[2] The temporary regulations apply to the tax years at issue.

[3] Section 1234(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 1024, subsequently amended section 6231(a)(1)(B) to allow a partnership with a corporate partner to qualify for the exception for small partnerships. The amendment is effective for partnership taxable years ending after August 5, 1997.

Partnership 1 is generally subject to both the subchapter K provisions and TEFRA proceedings.

Please call (202) 874-1490 if you have any further questions.

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JOHN M. BREEN
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Office of Associate Chief
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