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IRS Rules Support Aggregate Treatment for Partnerships (1)

By Michael Rapoport

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An IRS shift toward treating partnerships as aggregates of their individual partners could create compliance challenges for the partners, tax practitioners said Monday.

The IRS made the shift clear in two sets of rules it issued Monday addressing domestic partnerships' holdings in different types of foreign companies. It confirmed and moved further toward the "aggregate" approach, in which partners are deemed to own the assets, rather than have the partnership considered as an entity separate from them. That means the partners count their shares of the partnership's foreign income in their own gross incomes.

But the shift means that individual partners will have to take on compliance and filing burdens they haven't seen before, said Irina Pisareva, a partner with Crowell & Moring LLP.Some large partnerships might handle those tasks for their partners, and wealthy, sophisticated individual investors should be able to handle the increased compliance responsibilities, Pisareva said, but that won't be the case for everyone.

"I think this is going to bring on a lot of practical challenges for the taxpayers," Pisareva said.

The extra step involved in the aggregate approach could also create concerns over withholding, said **Marina Vishnepolskaya, a principal with Offit Kurman**. Partnerships withhold taxes for their partners, and with the shift to the aggregate approach, making sure that's done properly is "definitely something that partners will have to look out for," she said.

The IRS issued a final set of rules (RIN 1545-BP79; TD 9960) concerning partnerships' stock ownership in foreign corporations under Section 958. The final rules confirmed the aggregate approach to partnerships' foreign income that the IRS had put forth in proposed rules issued in 2019.

Until now, the tax treatment of partnerships has been "a weird blend," said Peter Furci, co-chair of the global tax practice at Debevoise & Plimpton LLP—melding the aggregate approach and the "entity" approach, in which a partnership is treated as an entity separate from its partners. The effect of the new rules is to orient things more toward the aggregate approach, though it isn't universal—the IRS said the aggregate approach won't apply for the partnerships' investment in U.S. property.

Rules on PFICs

The agency also proposed rules (RIN 1545-BP94; REG-118250-20) addressing domestic partnerships' income from passive foreign investment companies, or PFICs—foreign companies that derive their income from passive sources like dividends and royalties. Aggregate treatment of partnerships will apply to PFICs under certain circumstances, including when a PFIC shareholder elects to treat a PFIC as a qualified electing fund, or QEF, to avoid harsher PFIC tax treatment.

In addition, in a change from current law, the proposed partnership/PFIC rules would require that QEF elections and other such partnership elections be made by the individual partners instead of the partnership as a whole, said Gary Scanlon, an international tax principal in KPMG LLP's Washington National Tax practice.

Aggregate treatment for QEF elections could play a role in cases where a partnership invests in growth companies like those in the biotech or high-tech fields, Pisareva said. In their startup phase, such companies are often treated as PFICs because their operating businesses aren't generating any earnings yet.

In those cases, a partner might elect QEF treatment because they'd realize a capital gain upon exiting the investment and don't want it subject to the harsher PFIC tax treatment, Pisareva said. That would lead to the aggregate approach.

Monday's rules don't address the "PFIC insurance exception"—the question of whether investment income that is derived from actively running an insurance business should be considered "passive." The IRS proposed rules in December 2020 regarding the insurance issue and has yet to finalize them.

—With assistance from Isabel Gottlieb.

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