

Section 6231(a)(1)(B).—Definitions and Special Rules — Exception for Small Partnerships

26 CFR 1.6231(a)(1)–1: Exception for small partnerships.

Small partnership exception. This ruling addresses the issue of whether a partnership qualifies for the small partnership exception provided in section 6231(a)(1)(B) of the Code, and thus does not fall within the unified audit and litigation procedures under sections 6221 through 6234 (TEFRA partnership provisions), where one of the partners is either an organization that is exempt from taxation under section 501(a) that meets the definition of a C corporation for federal tax purposes or a foreign corporation.

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ISSUE:

Whether a partnership qualifies for the small partnership exception provided in I.R.C. § 6231(a)(1)(B), and thus does not fall within the unified audit and litigation procedures under sections 6221 through 6234 (TEFRA partnership provisions), where one of the partners is either an organization that is exempt from taxation under section 501(a) that meets the definition of a C corporation for federal tax purposes or a foreign corporation.

FACTS:

Situation 1. Partnership A (a domestic partnership required to file returns pursuant to section 6031(a)) consists of three partners, X, Y, and Z. X is an individual and U.S. citizen, Y is a domestic C corporation, and Z is an association that is ex-

empt from taxation under section 501(a). Z also meets the definition of a C corporation for federal tax purposes.

Situation 2. Partnership B (a domestic partnership required to file returns pursuant to section 6031(a)) consists of three partners, U, V, and W. U is an individual and U.S. citizen, V is a domestic C corporation, and W is a foreign corporation.

LAW AND ANALYSIS:

Section 6231 defines a partnership item as an item required to be taken into account for the partnership's taxable year under subtitle A, to the extent regulations provide that the item is more appropriately determined at the partnership level than at the partner level. Under section 6221, the tax treatment of any partnership item shall be determined at the partnership level under the TEFRA partnership provisions. As a general rule, the TEFRA partnership provisions apply to any partnership required to file a return of partnership income under section 6031. Section 6231(a)(1)(A). The TEFRA partnership provisions, however, do not apply to a partnership that qualifies as a small partnership under section 6231(a)(1)(B), unless the partnership elects to apply those provisions.

For taxable years ending after August 5, 1997, section 6231(a)(1)(B) defines a small partnership as a partnership in which there are ten or fewer partners each of whom is an individual (other than a nonresident alien), an estate of a deceased partner, or a C corporation. Treas. Reg. § 301.6231(a)(1)–1, which is effective for partnership taxable years beginning on or after October 4, 2001, addresses the exception for small partnerships and refers to section 1361(a)(2) for the definition of C corporation. Section 1361(a)(2) provides that “for purposes of [the Internal Revenue Code], the term ‘C corporation’ means, with respect to any taxable year, a corporation which is not an S corporation for such year.”

Section 7701(a)(3) defines the term corporation as including “associations, joint-stock companies, and insurance companies.” Treas. Reg. § 301.7701–2(b) states that the term corporation means: (1) a business entity organized under federal or state statute (or under a statute of a federally recognized Indian tribe) if the statute refers to the entity as incorporated or as a corporation, body corporate, or body politic; (2) an

association (determined under section 301.7701-3); (3) a business entity organized under state statute, if the statute refers to the entity as a joint-stock company or joint-stock association; (4) an insurance company; (5) a state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act (12 U.S.C. § 1811 *et seq.*), or a similar federal statute; (6) a business entity wholly owned by a state or any political subdivision thereof; (7) a business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than section 7701(a)(3); and (8) certain foreign entities.

Treas. Reg. § 301.7701-3 allows a business entity that is not classified as a corporation under Treas. Reg. § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) to elect its classification for federal tax purposes. Under Treas. Reg. § 301.7701-3(c)(1)(v), an eligible entity that is determined to be, or claims to be, exempt from tax under section 501(a) is treated as having made an election to be classified as a corporation.

As a general matter, an S corporation is defined in section 1361(a) as a “small business corporation.” A “small business corporation” is defined by section 1361(b), in part, as “a domestic corporation.” Treas. Reg. § 301.7701-5 defines a domestic corporation as one organized or created in the United States and a foreign corporation as one that is not domestic.

Thus, an exempt organization under section 501(a) can be a “C corporation” for purposes of the small partnership exception. Similarly, because a foreign corporation cannot be an S corporation, the corporation is a C corporation for purposes of the small partnership exception.

Accordingly, in each of the situations described above, all of the partners in the respective partnerships are either individuals (other than a nonresident alien) or C corporations.

HOLDINGS:

Situation 1. Partnership A qualifies for the small partnership exception to the TEFRA partnership provisions.

Situation 2. Partnership B qualifies for the small partnership exception to the TEFRA partnership provisions.

DRAFTING INFORMATION

The principal author of this revenue ruling is David A. Abernathy of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this revenue ruling, contact Mr. Abernathy at (202) 622-7940 (not a toll-free call).