DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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August 30, 2002

Number: **200250012**
Release Date: 12/13/2002
POSTF-114285-02/CC:PA:APJP:B3
UILC: 6231.09-00; 7701.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR Associate Area Counsel LM:HMT:CLE:PIT

FROM: Susan Mosley, Senior Technician Reviewer
Branch 3, APJP CC:PA:APJP:Br03

SUBJECT:

Effect of Disregarded Entity Rules on Small Partnership Exception To TEFRA

This Chief Counsel Advice responds to your memorandum dated May 7, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Source LLC =

Tier LLC =

Corp A =

Corp B =

Parent =

Year 1 =

Year 2 =

Year 3 =

ISSUES

1. Whether Source LLC qualified as a small partnership within the meaning of I.R.C. § 6231(a)(1)(B) in Year 2.

2. If the TEFRA provisions apply, may the Service designate the parent of a dissolved partner as tax matters partner where both direct partners have dissolved.

CONCLUSIONS

1. Source LLC did not qualify as a small partnership in Year 2. A disregarded entity remains a "pass-thru partner" for purposes of applying the small partnership exception to the TEFRA provisions; i.e., it is not disregarded for purposes of applying the small partnership exception to TEFRA.

2. The Service may designate the parent of a former partner as tax matters partner if there are no direct partners available since it qualifies as a "partner" under section 6231(a)(2)(B).

FACTS

In Year 1, the Limited Liability Company in issue ("Source LLC") was taxed as a partnership. It had two members, both of which were C corporations; Corp A and Corp B. Corp A files a consolidated return with its parent corporation. Source LLC qualified as a small partnership excluded from the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234, pursuant to section 6231(a)(1)(B) in Year 1.

In Year 2, Corp A merged into a new single-member LLC ("Tier LLC") owned by the corporate parent of Corp A.

In Year 3, Tier LLC acquired the interest of Corp B, terminating Source LLC's existence as a partnership for tax purposes as of the acquisition date. Tier LLC and Corp B then liquidated out of existence. Source LLC filed a short year partnership tax return for Year 3, with the year ending on the date Tier LLC acquired Corp B's interest.

LAW AND ANALYSIS

ISSUE 1

Small Partnership Exception

Section 6231(a)(1)(B)(i) excludes "small partnerships" from the unified partnership audit and litigation procedures of I.R.C. §§ 6221 through 6234. Section 6231(a)(1)(B)(i) defines a small partnership as a partnership having 10 or fewer partners each of whom is an individual, a C corporation, or an estate of a deceased partner.[1] The small partnership exception does not apply, however, if any partner during the taxable year is a pass-thru partner as defined in section 6231(a)(9). Treas. Reg. § 301.6231(a)(1)-1(a)(2). Section 6231(a)(9) defines a "pass-thru" partner as "a partnership, estate, trust, S corporation, nominee or other similar person through whom other persons hold an interest in the partnership."

The determination of whether a partnership meets the requirements for the small partnership exception under § 6231(a)(1)(B) is made with respect to each partnership taxable year. Thus, a partnership that qualifies as a small partnership in one tax year may not qualify as a small partnership in the succeeding tax year, if the requirements for the exception are no longer met. Treas. Reg. § 301.6231(a)(1)-1(a)(3).

Treas. Reg. § 301.7701-3(a) provides for "classification [of entities] for federal tax purposes". A business entity that is not classified as a corporation is a "domestic eligible entity" subject to this regulation. A domestic eligible entity, if it has a single owner, can elect to be classified as an association or to be disregarded as an entity separate from its owner. Subsection (b) provides that, in the absence of an election, a domestic eligible entity is "[d]isregarded as an entity separate from its owner if it has a single owner." Treas. Reg. § 301.7701-3(b)(1)(ii).

In our case, Tier LLC did not make an election, and, therefore, this domestic eligible entity is disregarded as an entity separate from its owner for the above federal tax classification purposes.

This does not affect Tier LLC's classification as a "pass-thru" partner under section 6231(a)(9) and Treas. Reg. § 301.6231(a)(1)-1(a)(2). Section 6231(a)(9) defines a

[1] For taxable years ending after August 5, 1997, section 6231(a)(1)(B) was amended to allow C corporations to be partners in small partnerships within the meaning of section 6231(a)(1)(B).

"pass-thru" partner as "a partnership, estate, trust, S corporation, nominee **or other similar person through whom other persons hold an interest in the partnership**." (Emphasis supplied). This language indicates Congressional intent to make the TEFRA procedures apply whenever indirect partners exist whose identity will not be reflected on the face of the partnership return. The language in bold in particular suggests that the federal tax classification of the intervening person is irrelevant. Moreover, the disregarded entity regulations did not even exist when Congress enacted sections 6231(a)(1)(B) and 6231(a)(9). Thus, the statutory language indicates that Congress intended that the small partnership exception to TEFRA would not apply whenever, as a factual matter, ownership in the partnership is held through another person, regardless of the legal classification of that person. Congress strengthened this interpretation through the later enactment of section 6231(g) which indicates that the Service can rely upon the facts reported on a partnership return in determining whether TEFRA applies.[2]

Consequently, the test is simply whether title to the partnership interest is held through another person regardless of that person's tax classification. See, e.g., White v. Commissioner, T.C. Memo 1991-552 (Whether title is held by another is determinative of whether an interest is held through a "pass-thru" partner); Primco Management Co. v. Commissioner, T.C. Memo 1997-332 (The fact that a grantor trust is not required to file a return separate from its owner does not disqualify it as a "pass-thru" partner under the small partnership exception since the grantor trust and TEFRA provisions serve different purposes).

In Primco, the Tax Court dealt with an analogous issue involving whether a S corporation, whose sole shareholders were two grantor trusts, qualified as a small S corporation exempt from the unified S corporate audit and litigation procedures.[3] To qualify as a small S corporation, Primco had to have five or fewer shareholders, each of whom was a natural person or an estate. None of the shareholders could be a "pass-through shareholder", which was defined in Treas. Reg. § 301.6241-

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[2] Section 6231(g) is titled "PARTNERSHIP RETURN TO BE DETERMINATIVE OF WHETHER SUBCHAPTER APPLIES." Section 6231(g)(1) provides that "[i]f, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter [TEFRA] applies . . . then the provisions of this subchapter are hereby extended to such partnership. . ."

[3]Former section 6241 and 6244 made the TEFRA partnership provisions generally applicable to S corporations except as modified by regulation. These provisions were repealed for S corporation for taxable years ending after December 31, 1996.

1T(c)(2)(iii) as a trust, nominee or other similar pass-through person through whom other persons had an interest in the stock of the S corporation.

The court found that the entity classification statute at issue served a wholly independent purpose from the pass-thru partner provision of the small entity exception. The court held that, although the regulations indicate that a grantor trust generally is not "treated as a separate taxable entity for purposes of the Federal income tax", it is clear that a grantor trust, to the extent it constitutes a form of pass-through entity, is not disregarded with respect to the application of the TEFRA rules.

We agree with the court's determination in Primco because any other rule would be unworkable. For instance, it is not uncommon for a partnership to have another partnership (a "tier partnership") as a partner. We have seen several recent cases where the tier partnership, in turn, is held by several LLC's which have the same ultimate owner. Under these circumstances, the tier partnership and tier LLC's are disregarded for federal tax classification purposes. If the federal tax classification of the tier partnership and LLC's controlled the application of the small partnership exception, the source partnership would be a small partnership excluded from the TEFRA provisions. But it would be impossible to make this determination from the face of the partnership return.

Requiring the Service to investigate the chain of ownership down two or more levels in order to determine whether TEFRA applies is inconsistent with a plain reading of Treas. Reg. § 301.6231(a)(1)-1(a)(2) and section 6231(a)(9). Further, it is inconsistent with section 6231(g) which indicates that the Service can rely upon the facts reported on a partnership return in determining whether TEFRA applies, if such reliance is reasonable. See also, Harrell v. Commissioner, 91 T.C. 242 (1988) (Determination of whether TEFRA applies must be made on the basis of the information reported on the partnership return with respect to the "same share" requirement of the predecessor small partnership exception). Using the disregarded entity rules to determine whether the small partnership exception to TEFRA applies would make section 6231(g) meaningless. It would no longer be reasonable to rely on the identification of an entity as a partner on the return to determine whether TEFRA applies. Accordingly, we conclude that Source LLC did not qualify as a small partnership in Year 2 because it had a pass-thru partner.

ISSUE 2

Since the small partnership exception does not apply, the issue then arises as to who can act as Tax Matters Partner ("TMP") for Source LLC for the TEFRA years. A TMP determination is made separately for each partnership taxable year.

An LLC is subject to the same procedures as a partnership with respect to the selection of a TMP. Under Treas. Reg. § 301.6231(a)(7)-2(a), a member-manager is treated as a general partner for purposes of selecting a TMP, while all other members of the LLC are treated as partners other than a general partner. If there are no elected or designated member-managers, each member of the LLC is treated as a member-manager. Treas. Reg. § 301.6231(a)(7)-2(b)(3).

A partnership (LLC) may only designate as TMP a person who was a general partner (member-manager of the LLC) at some time during the taxable year for which the designation is made, or is a general partner at the time the designation is made. Treas. Reg. § 301.6231(a)(7)-1(b)(1). A designation can be made on the partnership return, Treas. Reg. § 301.6231(a)(7)-1(c), or after the partnership return is filed by the general partners (member-managers) with a majority interest. Treas. Reg. § 301.6231(a)(7)-1(e). If no designation is made, or if a prior designation is terminated without a new TMP subsequently designated, the general partner (member-manager) with the largest profits interest at the close of the taxable year involved is the TMP. Treas. Reg. § 301.6231(a)(7)-1(m)(2).

The liquidation or dissolution of an entity terminates its status as TMP and disqualifies it from being selected under the default largest profits interest rule. Treas. Reg. § 301.6231(a)(7)-1(l)(iii) and 301.6231(a)(7)-1(m)(2) and -1(m)(3)(last sentence). See Barbados #7 v. Commissioner, 92 T.C 804, 810 (1989).

If existing designations have terminated and the Service determines that it would be impracticable to apply the largest profits interest rule, it can select a partner to be the TMP. Treas. Reg. § 301.6231(a)(7)-1(n). If no general partner (member-manager) is available, the Service may select “a partner (including a general or limited partner)” in accordance with the criteria set forth in subparagraph (q) of the regulation.

Section 6231(a)(2) defines the term “partner” as including “any other person whose income tax liability under Subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership.” I.R.C. § 6231(a)(2)(B).

Here, as the above facts indicate, Corp A and its alter ego Tier LLC were designated as the TMP on the partnership returns filed for the years at issue. Both direct partners liquidated. Upon its liquidation, Tier LLC’s designation as the TMP of Source LLC terminated. See Treas. Reg. § 301.6231(a)(7)-1(l)(1)(iii). Subsequently, Corp B dissolved leaving no direct partners eligible to be designated as TMP.

Since Source LLC no longer is classified as a partnership and all of its members have been either liquidated or dissolved, a TMP can not be designated by any members at this point in time. Moreover, under the largest profits rule of Treas. Reg. § 301.6231(a)(7)-1(m)(2) there is no remaining partner who becomes TMP under the default largest profits interest rule. Thus, it is "impracticable" to apply the largest profits rule, as provided by Treas. Reg. § 301.6231(a)(7)-1(o)(2)(all possible general partners have been liquidated, and the Service is authorized to select any "partner" as TMP). Treas. Reg. § 301.6231(a)(7)-(q)(1).

The only "partner" left is the parent of Corp A and Tier LLC ("Parent"). Since Parent filed a consolidated return with Corp A/Tier LLC, its income tax liability is determined by taking into account partnership items of the partnership. See I.R.C. § 1503; Treas. Reg. § 1.1502-6(a) (Parent severally liability for tax on consolidated return). Since the parent was a "partner", as defined in section 6231(a)(2)(B), it may be designated by the Service as TMP for the partnership taxable years in issue pursuant to Treas. Reg. § 301.6231(a)(7)-p. See PAE Enterprises v. Commissioner, T.C. Memo 1988-222 ("partner" who may be designated as TMP by Service includes partners as defined under section 6231(a)(2)(B)).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Since we are under no obligation to select a TMP, an alternative approach is to secure separate statute extensions from Parent and the successor in interest to Corp B. See Seneca v. Commissioner, 92 T.C 363 368 (1989), aff'd, 899 F.2d 1225 (9th Cir. 1990) (Service is not required to select a TMP and existence of TMP at time FPAA is issued is not critical); Chomp v. Commissioner, 91 T.C. 1069 (1988) ("Generic" TMP notice of final partnership administrative adjustment is valid).

Section 6229(b)(1)(A) permits the Service to secure extensions from each partner individually. The Form 872-i is available for this purpose. Alternatively, a Form 872 may be used but only if it is modified to comply with the requirement of section 6229(b)(3).[4]

[4]This subsection provides that any agreement under section 6501(c)(4) (relating to statute extensions) shall apply to the period under section 6229(a) only if the agreement expressly provides that such agreement applies to tax attributable to partnership items.

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Please call if you have any further questions.