

## Section 6321.—Definitions and Special Rules

*26 CFR 301.6231(a)-1(a)(2): Pass-thru partner disqualifies a partnership from the “small partnership” exception to the unified audit and litigation procedures of I.R.C. §§ 6221 through 6234.*

*Also, § 301.6231(a)(7)-1(b); 301.7701-1; 301.7701-3.*

**TEFRA partnership; disregarded entity; pass-thru partner; tax matter partner.** This ruling addresses whether a disregarded entity partner will disqualify a partnership from being a “small partnership” excluded from the TEFRA partnership provisions. The ruling also addresses whether a disregarded entity may be designated as the tax matters partner of a partnership.

## ISSUE

1. Is a partnership that has a disregarded entity as a partner considered a “small partnership” that is excluded from the unified partnership audit and litigation procedures set forth in I.R.C. §§ 6221 through 6234 (the TEFRA partnership provisions)?

2. May a disregarded entity be designated the tax matters partner (TMP) of a partnership subject to the TEFRA partnership provisions?

## FACTS

P is a limited partnership with one general partner and four limited partners. The sole general partner is a Limited Liability Company (LLC) that is treated as a disregarded entity under section 301.7701-3(b)(1)(ii). LLC is owned by A, an individual who is not a nonresident alien. The four limited partners in P are individuals who are not nonresident aliens. On its partnership return for the 2002 taxable year, P designates LLC as its TMP.

## LAW AND ANALYSIS

## Issue 1

Section 6231(a)(3) defines a partnership item as any 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 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 partnership 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.

Section 6231(a)(2) defines a “partner” as including both a partner in the partnership and 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.

Section 301.6231(a)(1)-1(a)(2) provides that the small partnership exception does not apply if any partner during the taxable year is a “pass-thru partner” as defined in section 6231(a)(9). A “pass-thru partner” is defined in section 6231(a)(9) as “a partnership, estate, trust, S corporation, *nominee or other similar person through whom other persons hold an interest in the partnership. . .*” (Emphasis added). If legal title to a partnership interest is held in the name of a person other than the ultimate owner, the holder of legal title is considered a pass-thru partner within the meaning of section 6231(a)(9). *Compare White v. Commissioner*, T.C. Memo. 1991-552 (custodian for minor children was not a pass-thru partner because, under state Gift to Minors Act, the children held legal title to partnership interests rather than custodian; small partnership exception applicable) *with Primco Management Co. v. Commissioner*, T.C. Memo. 1997-332 (grantor trust holding legal title to an interest in an S corporation was a “pass-thru shareholder”; small S corporation exception under the parallel provisions of section 301.6241-1T(c)(2)(iii) inapplicable).

Section 6231(a)(10) defines an indirect partner as a person holding an interest in a partnership through one or more pass-thru partners.

Section 301.7701-3(a) provides rules for the classification of certain business entities for federal tax purposes. A business entity that is not classified as a corporation is a “domestic eligible entity” and, in the absence of an election, the domestic eligible entity is “[d]isregarded as an entity separate from its owner if it has a single owner.” Section 301.7701-3(b)(1)(ii). If the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. Section 301.7701-2(a).

Under the facts of this ruling, although LLC is a disregarded entity for federal tax purposes, LLC is a partner of P un-

der the law of the state in which P is organized. Similarly, although A, LLC’s owner, is a partner of P for purposes of the TEFRA partnership provisions under section 6231(a)(2)(B) because A’s income tax liability is determined by taking into account indirectly the partnership items of P, A is not a partner of P under state law. Because A holds an interest in P through LLC, A is an indirect partner and LLC, the disregarded entity, is a pass-thru partner under the TEFRA partnership provisions. Consequently, the small partnership exception does not apply to P because P has a partner that is a pass-thru partner.

## Issue 2

Section 6231(a)(7) provides that the TMP of any partnership is (A) the general partner designated as the tax matters partner, or (B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership. If no general partner has been designated as the TMP and the Secretary determines that it is impracticable to apply the largest profits interest rule, the partner selected by the Secretary shall be treated as the tax matters partner.

Section 301.6231(a)(7)-1(b) provides that the partnership may designate a person as the TMP of a partnership if that person (i) was a general partner in the partnership at some time during the taxable year for which the designation is made, or (ii) is a general partner in the partnership at the time the designation is made. A partnership may designate only a general partner as the TMP because only a general partner is authorized to bind the partnership. A partner’s status as a general partner is determined under state law for this purpose. *Transpac Drilling Venture, 1983-63 v. United States*, 26 Cl. Ct. 1245, 1247 (1992).

Although the regulations under sections 301.7701-1 through 301.7701-3 provide that a disregarded entity is disregarded for all federal tax purposes, these regulations do not alter state law, which determines a partner’s status as a general partner.

Under the facts of this ruling, A, LLC’s owner, does not become a general partner under state law by operation of sections 301.7701-1 through 301.7701-3. Although LLC is a disregarded entity for federal tax purposes, LLC remains a part-

ner in P and is the sole general partner authorized to bind the partnership under state law. A has no power to bind other partners as a general partner under state law. Accordingly, A cannot step into the shoes of LLC, the disregarded entity, as the TMP. *See Transpac Drilling Venture, 1983-63, 26 Cl. Ct. at 1248* (limited partner could not be the TMP because limited partner was not a general partner under Delaware law). *See also Montana Sapphire Associates, Ltd. v. Commissioner, 95 T.C. 477, 481 (1990)* (partnership could not designate a person who was not a member of the partnership as the TMP). Thus, only LLC, the disregarded entity, is eligible to be designated by P as its TMP or to become the TMP under the largest profits interest rule.

## HOLDINGS

1. LLC, a disregarded entity for federal tax purposes, is a pass-thru partner under section 6231(a)(9). Consequently, because P has a pass-thru partner, LLC, as a partner, the small partnership exception

to the TEFRA partnership provisions does not apply to the partnership.

2. LLC, a disregarded entity for federal tax purposes, but a general partner of P under state law, may be designated the TMP of P, a partnership subject to the TEFRA partnership provisions.

## DRAFTING INFORMATION

The principal author of this revenue ruling is William Heard 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. Heard at (202) 622-7950 (not a toll-free call).