

## Internal Revenue Bulletin: 2004-31

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**Disregarded entities.** This ruling concludes that, if an eligible entity has two owners under local law, but one of the owners is, for federal tax purposes, disregarded as an entity separate from the other owner of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation.

### ISSUE

How is an eligible entity (as defined in § 301.7701-3(a) of the Procedure and Administration Regulations) classified for federal tax purposes if the entity has two members under local law, but one of the members of the eligible entity is disregarded as an entity separate from the other member of the eligible entity for federal tax purposes?

### FACTS

*Situation 1.* *X*, a domestic corporation, is the sole owner of *L*, a domestic limited liability company (LLC). Under § 301.7701-3(b)(1), *L* is disregarded as an entity separate from its owner, *X*. *L* and *X* are the only members under local law of *P*, a state law limited partnership or LLC. There are no other constructive or beneficial owners of *P* other than *L* and *X*. *L* and *P* are eligible entities that do not elect under § 301.7701-3(c) to be treated as associations for federal tax purposes.

*Situation 2.* *X* is an entity that is classified as a corporation under § 301.7701-2(b). *X* is the sole owner of *L*, a foreign eligible entity. Under § 301.7701-3(c), *L* has elected to be disregarded as an entity separate from its owner. *L* and *X* are the only members under local law of *P*, a foreign eligible entity. There are no other constructive or beneficial owners of *P* other than *L* and *X*.

### LAW AND ANALYSIS

Section 7701(a)(2) of the Internal Revenue Code provides that the term partnership includes 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 trust, estate, or corporation.

Section 301.7701-1(a)(1) provides that whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Section 301.7701-2(a) provides that a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code. A business entity with two or more owners is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; 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(c)(1) provides that, for federal tax purposes, the term “partnership” means a business entity that is not a corporation under § 301.7701-2(b) and that has at least two owners.

Section 301.7701-2(c)(2)(i) provides, in general, that a business entity that has a single owner and is not a corporation under § 301.7701-2(b) is disregarded as an entity separate from its owner.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes. An eligible entity with at least two owners can elect to be classified as either an association (and thus a corporation under § 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.

Section 301.7701-3(b)(1) provides generally that in the absence of an election otherwise, a domestic eligible entity is (a) a partnership if it has at least two members, or (b) disregarded as an entity separate from its owner if it has a single owner.

Section 301.7701-3(b)(2) provides generally that, in the absence of an election otherwise, a foreign eligible entity is (a) a partnership if it has two or more owners and at least one owner does not have limited liability, (b) an association if all its owners have limited liability, or (c) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

*Situation 1.* Under § 301.7701-2(c)(2), *L* is disregarded as an entity separate from its owner, *X*, and its activities are treated in the same manner as a branch or division of *X*. Because *L* is disregarded as an entity separate from *X*, *X* is treated as owning all of the interests in *P*. *P* is a domestic entity, with only one owner for federal tax purposes, that has not made an election to be classified as an association taxable as a corporation. Because *P* has only one owner for federal tax purposes, *P* cannot be classified as a partnership under § 7701(a)(2). For federal tax purposes, *P* is disregarded as an entity separate from its owner.

*Situation 2.* Under § 301.7701-3(c), *L* is disregarded as an entity separate from its owner, *X*, and its activities are treated in the same manner as a branch or division of *X*. Because *L* is disregarded as an entity separate from *X*, *X* is treated as owning all of the interests in *P*. Because *P* has only one owner for federal tax purposes, *P* cannot be classified as a partnership under § 7701(a)(2). For federal tax purposes, *P* is either disregarded as an entity separate from its owner or an association taxable as a corporation.

## **HOLDING**

If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation.

## **DRAFTING INFORMATION**

The principal author of this revenue ruling is Jason T. Smyczek of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Smyczek at (202) 622-3050 (not a toll-free call).