

# Disregarded Entities and Partnerships

TAX SECTION



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Single-member LLCs and grantor trusts are both entities that exist for state law purposes but are disregarded for federal income tax purposes. These entities are commonly known as disregarded entities or DREs. The ownership of partnership interests by a disregarded entity creates the question of who the partner really is.

A limited liability company has great flexibility in federal and state tax treatment under Treas. Reg. § 1.7701-3. The default treatment of an LLC that has a single owner is for the LLC to be disregarded as an entity separate from its owner. So, who is the partner if a disregarded LLC owns a partnership interest? The IRS answered that in Rev. Rul. 2004-77, which confirms an entity disregarded under federal tax law is ignored under federal partnership law. Thus, the disregarded entity's owner is treated as the partner.

In Rev. Rul. 2004-77, a taxpayer created a wholly-owned LLC that was disregarded as an entity separate from taxpayer. The taxpayer and his LLC attempted to form a partnership together. The IRS ruled because the LLC is a disregarded entity, the taxpayer was the only partner, and thus a partnership did not exist.

The same principle is also applied to grantor trusts, which are governed by Subpart E of Subchapter J of the Code. A grantor trust is a trust whose assets, because of the powers of the grantor, are treated as owned by the grantor. As a result, the income of the trust is taxed to the grantor. Another consequence of grantor trust status, as with single-member LLCs, is any partnership interest owned by a grantor trust is treated as owned by the grantor.

The use of disregarded entities as owners of partnership interests can create more complicated questions when the disregarded entities are guarantors of debt. The guarantor of partnership debt generally receives basis credit for being liable to pay the debt under Section 752. But does that rule apply when the guarantor is a disregarded entity that is not treated as the partner under partnership tax law? This issue is addressed in Treas. Reg. § 1.752-2(k)(1) through the "no reasonable expectation of payment test." To avoid abuse by taxpayers, this test provides a guarantee by a disregarded entity (including a grantor trust) is respected so long as there is "a commercially

reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable." Thus, where a disregarded entity guarantees a partnership debt, the partner who is the owner for tax purposes may receive a basis credit if the disregarded entity has the means to pay that debt should it be required to.

Because of these nuances, important tax consequences turn on whether disregarded entities that guarantee debt have the means to pay those obligations.

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