

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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subject: Split Eligible Entity Interests

This advice may not be used or cited as precedent.

ISSUE

Whether a taxpayer (Owner) who owns one-hundred percent of the membership interest in an eligible entity, which is a disregarded entity for federal tax purposes, may split his eligible entity interest into separate classes of interests and then allocate income, loss, deduction, credit, and basis among those classes.

CONCLUSION

For federal tax purposes, unless Owner elects otherwise under § 301.7701-3, a wholly owned eligible entity is a disregarded entity, and Owner may not allocate tax items or basis among its different interests.

FACTS

We recently assisted with an audit involving a taxpayer in the Coordinated Exam Program. As part of that audit, the Service discovered that the taxpayer had engaged in a transaction similar to the one described herein. We suspect that other taxpayers may have engaged in similar transactions as well. Certain Owners owning one-hundred percent interests in eligible entities split their interests into separate classes of

membership interests (Split Eligible Entity Interest Transaction), then allocate income, loss, deduction, credit, and basis among those classes for federal tax purposes according to the interests' preferences. Owner may own his various classes of interests through other disregarded entities. Owner uses this arrangement to create or manipulate an "outside basis" in parts of its disregarded entity interest for federal tax purposes. For example, Owner may attempt to control the recognition of income or loss on distributions from the eligible entity or on the disposition of a portion of its interest in that entity by manipulating the outside basis of the interests.

For example, in a Split Eligible Entity Interest Transaction, Owner creates a wholly owned state law entity, treated as a disregarded entity for federal tax purposes. The entity's governing documents state that Owner takes one-hundred percent of each class of interest in the entity. Based on the preferences contained in the governing documents, the entity allocates items of income, deduction, loss, and credit between the classes. Owner tracks and adjusts an outside basis in its various classes of interests accordingly. Owner drafts the governing documents to establish Owner's chosen class interest allocations. Thus, adjustments to Owner's bases in the various classes of interests will create disparities based on the entity's items of income, deduction, loss, or credit. Such disparities will exist in spite of the fact that the entity is a disregarded entity, and Owner should recognize all of the entity's items of income, deduction, loss, or credit directly regardless of any supposed "allocations" among artificially created classes of interests.

This artificial manipulation of the interests, if permitted, would allow Owner to control the recognition of income or loss on distributions from the entity or dispositions of its interests in the entity for federal tax purposes.

## LAW & ANALYSIS

The "check the box" regulations generally provide for three types of entities—disregarded entities, associations, and partnerships. Section 301.7701-3(b)(1)(ii) of the Procedure and Administration regulations provides that unless the entity elects otherwise, a domestic eligible entity is disregarded as an entity separate from its owner if it has a single 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) (Eligible Entity) can elect its classification for federal tax purposes. 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. An entity whose classification is determined under the default classification, however, retains that classification until the entity makes an election to change that classification under Treas. Reg. § 301.7701-3(c)(1).

Rev. Rul. 99-5 governs the taxation of an Owner who sells a portion of its interest in a disregarded entity. The revenue ruling uses an example where a state law LLC has a single owner, A, and is treated as a disregarded entity for federal tax purposes. In the first situation, B purchases 50% of A's ownership interest, and A does not contribute any part of that purchase price to the LLC. Later A and B operate the LLC as co-

owners. The revenue ruling provides that the LLC converts to a partnership when B purchases 50% of A's interest. Rev. Rul. 99-5 treats B's purchase as a purchase of a 50% interest in each of the LLC's assets, which A is treated as owning directly. The revenue ruling then treats A and B as contributing their interests in the LLC's assets to a partnership in exchange for ownership interests in the partnership. Rev. Rul. 99-5 does not ever mention a taxpayer's outside basis in his disregarded entity interest, because the owner of a disregarded entity has no outside basis in the entity for federal tax purposes. Therefore, outside basis has no relevance to a taxpayer's disposition of his interest in a disregarded entity.

Likewise, a disregarded entity cannot make distributions in a manner where the federal income tax consequences would turn on the member's nonexistent outside basis. Section 301.7701-2(a) provides that if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. For federal tax purposes, the member already owns all of the disregarded entity's property. Therefore, while a preferred interest in an eligible entity may entitle the owner of the preferred interest to preferential distribution or liquidation rights under state law, such preferences have no meaning for federal tax purposes while the same taxpayer owns one-hundred percent of all classes of interests.

In contrast, §§ 731 and 741 of the Internal Revenue Code, related to partnerships, both highlight why no authority exists allowing Owners to create or track an outside basis in a disregarded entity. Under § 731, a partner generally recognizes gain on partnership distributions to the extent money distributed exceeds the partner's outside basis in its partnership interest. Likewise, a partner that sells an interest in a partnership has sold an intangible asset that is its interest in the partnership itself—it has not sold its proportionate interest in each partnership asset. see e.g. Long v. Commissioner, 173 F.2d 471 (5th Cir. 1949) (cert. denied), Commissioner v. Smith, 173 F.2d 470 (5th Cir. 1949) (cert. denied); but see § 751(a), which in some cases overrides the principle that a partner sells its interest in the partnership and instead taxes the partner on its proportionate share of unrealized receivables and inventory items. Thus, tracking outside basis is critical to properly taxing a partner on partnership distributions or on the disposition of its partnership interest, because in both instances, the partner's federal tax consequences derive directly from its outside basis in its partnership interest. Conversely, tracking outside basis in its disregarded entity is irrelevant to Owner's taxation, and therefore, no authority provides for such tracking.

While state law may or may not allow for different classes of interests in eligible entities for federal tax purposes, such interests have no effect for federal tax purposes because a wholly owned eligible entity is a disregarded entity unless it elects otherwise. Therefore, for federal tax purposes Owner may not split its interest into separate classes of interests and may not allocate items of income, loss, deduction, credit, and basis among those classes.

The Service may disallow any tax benefit attributable to a Split Eligible Entity Interest Transaction, by asserting one or more arguments that may include, but are not limited to:

1) Rev. Rul. 99-5, 1999-6 C.B. 434, provides that a taxpayer who sells a portion of its interest in a disregarded entity is treated as selling a pro-rata share of each asset owned by the disregarded entity; and

2) a disregarded entity cannot make distributions, the taxation of which would affect outside basis because Treas. Reg. § 301.7701-2(a) treats a disregarded entity as a sole proprietorship, branch, or division of the owner.

Additionally, we do not believe that the federal tax laws provide any support for the Split Eligible Entity Interest Transaction, so the Service should consider the applicability of accuracy related penalties in these cases. Please contact Ari S. Berk at (202) 622-3070 if you have any further questions.

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