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CLOSELY HELD BUSINESSES:

Entity Classification - Another Look At the Check-The-Box Regulations

By:

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CHAPTER 1

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Chapter 1

Entity Classification - - Another Look At the Check-The-Box Regulations

1.01 INTRODUCTION[1]

On December 17, 1996, Treasury issued final regulations [2] designed to simplify entity tax classification. The regulations, commonly referred to as the "Check-the-Box" regulations, successfully brought an end to much of the long existing battle between taxpayers and the Service over entity tax classification.[3] These regulations generally became effective on January 1, 1997.[4]

Historically, the battle between the Service and taxpayers over entity tax classification focused on the existence or nonexistence of numerous corporate characteristics.[5] Consequently, the battlefront was cluttered with the facts and circumstances of each case, and the battles were long and ugly.

The major corporate characteristics, which were at the forefront of these raging battles, included: (i) whether there were associates; (ii) whether an objective to carry on business and divide gains therefrom existed; (iii) whether continuity of life existed; (iv) whether centralized management existed; (v) whether liability for debts was limited to the entity's assets; and (vi) whether there was free transferability of ownership interests. Prior Treasury Regulation § 301.7701-2(a)(1) encapsulated these characteristics of corporate existence. When the Check-the-Box regulations were adopted, however, this provision of the regulations was superseded and removed as it was no longer needed. The requirement of examining the substantive differences between entity arrangements was abandoned for what appears, at first blush, to be a much simpler, more objective, more flexible and streamlined approach to entity tax classification.

The proliferation of new business entities, including the limited liability company (the "LLC") was likely a significant impetus for the government to finally steam-line entity classification for income tax purposes. LLCs, which are predominately formed by taxpayers desiring to achieve partnership income tax status and limited personal

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[1] The information contained herein is to be used solely for educational purposes. It is not intended and may not be relied upon as legal advice.
[2] TD 8697 (December 17, 1996).
[3] Unless indicated otherwise, all references herein to the Internal Revenue Code ("Code" or "IRC") are made to the Internal Revenue Code of 1986, as amended.
[4] T. Reg. § 301.7701-3(h).
[5] Throughout this paper, the use of the word "corporation" is used interchangeably with and for the word "association."

liability, are virtually indistinguishable in most characteristics from corporations. Consequently, prior to the adoption of the Check-the-Box regulations, taxpayers often found themselves battling with the Service over whether their newly formed LLC was a partnership or a corporation for income tax purposes.

These battles required a determination of whether or not corporate characteristics existed. The presence or absence of these characteristics required a thorough analysis of the facts of each case. Presumably, in order to protect the United States corporate tax base, the Service routinely casted as broad of a net as possible to capture the corporate characteristics and conclude corporate status existed. As a result, taxpayers were required to expend significant financial resources fighting the Service on this battlefront. Given the nature of the disputes (i.e., a battles based upon facts and circumstances), the outcomes were not always consistent. Thus, it was often difficult for taxpayers to navigate these turbulent waters. Certainty was virtually nonexistent.

To avoid an escalation in the entity income tax classification war between the Service and taxpayers, the Check-the-Box regulations evolved. These regulations, which have withstood judicial scrutiny,[6] significantly simplify the entity classification landscape and provide taxpayers with some objectivity and certainty. That said, despite the simplification brought into the world of entity tax classification by the Check-the-Box regulations, for which tax practitioners applauded the government, several new hazards were created. Unfortunately, not all of these hazards are obvious to taxpayers and their advisors. If taxpayers and their advisors are not extremely careful in this area, disastrous unintended tax consequences can raise their ugly head. Accordingly, a good understanding of the regulations and the consequences of making, not making or changing an entity tax classification decision is paramount. This purpose of this paper is to provide some helpful guidance in that regard.

1.02 OVERVIEW OF THE CHECK-THE-BOX REGULATIONS

[1] Basic Framework.

The Code prescribes the classification of entities for federal tax purposes. Whether an entity is separate and apart from its owners for federal tax purposes is a question of federal tax law. The determination is not dependent upon local law.[7]

A joint venture or similar contractual arrangement may create an entity that is separate and apart from its owners for federal tax purposes if the participants carry on a "trade, business, financial operation, or venture and divide profits therefrom."[8] To the contrary, a joint undertaking where expenses are merely shared or where property

[6] *Littriello v. United States*, 2005-USTC ¶50,385 (WD Ky. 2005), *aff'd*, 484 F3d 372 (6th Cir. 2007), *cert. denied*, 128 S. Ct. 1290 2008).
[7] T. Reg. § 301.7701-1(a)(1).
[8] T. Reg. § 301.7701-1(a)(2).

is merely co-owned does not necessarily give rise to a separate entity for federal tax purposes.[9]

> **Example 1.** Co-owners of an apartment complex lease units to tenants. In addition, directly or through an agent, they provide services to the tenants such as housekeeping, transportation, and grocery shopping. A separate entity exists for federal tax purposes.[10]
>
> **Example 2.** Same facts as Example 1, but no services are provided (directly or indirectly) by the co-owners. Generally, no separate entity exists for federal tax purposes.[11]
>
> **Example 3.** Two or more persons jointly construct an irrigation ditch solely to drain surface water from their respective properties. No separate entity exists for federal tax purposes.[12]

The regulations expressly provide that certain organizations that have only one owner may choose to be recognized separate and apart from the owner.[13] Alternatively, these organizations may choose to be disregarded as an entity that is separate and apart from the owner. [14]

At least two situations exist where an entity formed under local law will not be recognized as a separate entity for federal tax purposes. The first situation is where an organization is wholly owned by a State. Provided it is an integral part of the State, it will not be recognized as a separate entity from its owner (i.e., the State) for federal tax purposes.[15] For this purpose, the District of Columbia is considered to be a State.[16]

The second situation is where a tribe is incorporated under Section 17 of the Indian Reorganization Act of 1934, as amended.[17] In this situation, like the first situation, the entity will be disregarded. It will not be treated as separate and apart from its owner(s).

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[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] T. Reg. § 301.7701-1(a)(4).
[14] *Id.*
[15] T. Reg. § 301.7701-1(a)(3).
[16] T. Reg. § 301.7701-1(e).
[17] *Supra* at note 15.

Special rules exist under the Check-the-Box regulations for foreign entities. Consequently, the determination as to whether an entity is domestic or foreign is important. A detailed discussion of foreign entities is set forth later in this paper.

[2] Business Entity.

The foundation underlying the Check-the-Box regulations is the concept of "business entity." Under the regulations, a "business entity" is an entity recognized for federal income tax purposes that is **not**:

[a] Trust.

An entity classified as a trust under Treasury Regulation § 301.7701-4; **or**

[b] Special Income Tax Treatment.

An entity otherwise subject to special income tax treatment in the Code.

The Check-the-Box regulations do **not** alter the process for determining whether an entity is taxed as a trust. Trusts remain governed by Treasury Regulation §§ 301.7701-4 and 7. Further, the Check-the-Box regulations do not attempt to preempt the tax treatment of organizations which are subject to special treatment elsewhere in the Code. Examples of such organizations include: (i) real estate mortgage investment conduits (commonly known as "REMICs") under Code § 860D; and (ii) qualified settlement funds under Code § 468B. The Check-the-Box regulations solely govern business entities.

A business entity with more than one owner is either classified for federal tax purposes as a corporation or a partnership.[18] Likewise, a business entity with only one owner is either classified as a corporation or is disregarded for federal income tax purposes as being separate and apart from its owner.[19]

If a business entity is disregarded, with four notable exceptions, its activities are treated for federal tax purposes as the activities of its owner.

[c] Employment Taxes.

The first exception relates to employment taxes.[20] If the single-owner entity has employees, it will **not** be disregarded for employment tax purposes.[21]

> **Example.** X is a domestic LLC that is solely owned by A, an individual. X is disregarded as an entity separate and

[18] T. Reg. § 301.7701-2(a).
[19] *Id.*
[20] T. Reg. § 301.7701-2(a).
[21] T. Reg. § 301.7701-2(c)(2)(iv).

> apart from A. X employs 75 full time workers, all of whom are properly classified as employees and receive wages for federal tax purposes. All applicable provisions of the Code relating to the payment of wages by an employer apply to X. It is not disregarded for this purpose. Consequently, X is liable for income tax withholding, FICA taxes and FUTA taxes, and all employer reporting obligations relating thereto.[22]

In accordance with Treasury Regulation § 301.7701-2T, however, a disregarded entity is **not** the employer of the owner. Consequently, the single-owner is subject to self-employment tax on the self-employment income with respect to the entity's activities. Likewise, if a partnership is the owner of a disregarded entity, the entity is **not** treated as a corporation for purposes of employing a partner of the partnership that owns the entity. Rather, the entity is disregarded as an entity separate and apart from the partnership; it is **not** the employer of any partner of the partnership that owns the entity. Consequently, any partner that works for the disregarded entity is subject to the same self-employment tax rules as any partner of the partnership itself.

[d] Excise Taxes.

The second exception relates to certain excise taxes. Specifically, this exception broadly encompasses taxes imposed by Chapter 31 (retail), Chapter 32 (manufacturers), except for Code §4181, Chapter 33 (facilities and services), Chapter 34 (foreign insurers), Chapter 35(wagering), Chapter 36 (harbor maintenance), except for Code § 4461, Chapter 38 (environmental), and 49 (indoor tanning), and any floor stock taxes related thereto. The exception also includes collection of taxes imposed by Chapters 33 and 49 of the Code, registration under Code §§ 4101, 4222 and 4412, claims for credit, refund and payment relating to these taxes or under Code §§ 6426 or 6427, assessment and collection of amounts imposed by Code § 4980H, and any reporting required by Code § 6056.[23] If an entity is liable or responsible for any of these excise taxes or reporting responsibilities, it will **not** be disregarded with respect to such taxes and reporting obligations. In essence, for these limited purposes, it is treated as a corporation.[24]

> **Example.** X is a domestic LLC that is solely owned by A, an individual. X is disregarded as an entity separate and apart from A. X mines coal from a mine located in the United States. A tax is imposed on the sale of the coal under Chapter 32 of the Code. X is responsible for reporting and paying this tax. It is not treated as separate and apart from A for this purpose.[25] If X did not pay any of

[22] T. Reg. § 301.7701-2(c)(2)(iv)(D).
[23] T. Reg. § 301.7701-2(c)(2)(v).
[24] T. Reg. § 301.7701-2(c)(2)(v)(B).
[25] T. Reg. § 301.7701-2(c)(2)(v)(C)(i) and (ii).

the tax imposed under Chapter 32 of the Code on its sale of coal, any notice of lien the Service files will be filed against X (rather than A) as if X was a corporation.[26]

[e] Certain Federal Tax Liabilities.

The third exception relates to federal taxes. A single-owner entity will **not** be disregarded as separate and apart from its owner in the case of:

[i] Federal tax liabilities of the entity that relate to any period for which the entity was **not** disregarded[27];

[ii] Federal tax liabilities of any other entity for which the entity is liable;[28] **and**

[iii] Refunds or credits of federal tax. [29]

Example. X is a domestic LLC that is disregarded for income tax purposes as separate and apart from its sole owner, A, an individual. X acquires 100% of the membership interests of Z from B and C, individuals. Immediately prior to the acquisition, Z was treated as a corporation for entity tax classification purposes. After thoroughly reviewing the tax implications, X properly and timely causes an entity classification election to be filed on behalf of Z, whereby Z will be treated as a disregarded entity from the date of acquisition. After the acquisition, the Services assesses income taxes for a tax period when Z was owned by B and C, and was treated as a corporation taxed under Subchapter C of the Code. The Service's assessment is against Z; not X, its new owner. In the event Z fails to pay the assessment, the Service's collection efforts will be aimed at Z's assets rather than its sole owner, X, or X's sole owner, A. Z is **not** disregarded as an entity separate and apart from its owner for purposes of the prior period income tax liability. Hopefully, X has claims against B and C under the acquisition agreement for a breach of the tax representations and warranties.[30]

[26] T. Reg. § 301.7701-2(c)(2)(v)(C)(iv).
[27] T. Reg. § 301.7701-2(c)(2)(iii)(A)(1).
[28] T. Reg. § 301.7701-2(c)(2)(iii)(A)(2).
[29] T. Reg. § 301.7701-2(c)(2)(iii)(A)(3).
[30] T. Reg. § 301.7701-2(c)(2)(iii)(B), Examples 1 and 2.

[f] Banks.

The fourth exception relates to banks. If the single-owner is a bank, as defined under Code §§ 581 (domestic banks) or 585(a)(2)(B) (foreign banks) without regard to the second sentence, the special provisions of the Code applicable to banks will continue to apply to the single-owner as if the entity were a separate entity.[31]

[3] Per Se Corporations.

Certain business entities under the Check-the-Box regulations are treated as per se corporations for federal tax purposes.[32] These entities include:

[a] An association (as determined under Treasury Regulation § 301.7701-3);

[b] A business entity organized under a federal or State statute as a corporation;

[c] A business entity organized under a State statute as a joint stock company or association;

[d] An insurance company;

[e] A state organized bank with deposits insured under the Federal Deposit Insurance Act or a similar federal law;

[f] A business entity solely owned by a state or local government;

[g] A business entity that is taxable as a corporation under the Code other than Code § 7701(a)(3); **and**

[h] Subject to limited exceptions, certain business entities formed in 1 of 87 foreign jurisdictions specified in Treasury Regulation § 301.7701-2(b)(8).[33]

> **PRACTICE ALERT.** Per se corporations are taxed as corporations for income tax purposes. No election for an alternative tax classification exists for these entities under the Check-the-Box regulations.

[31] T. Reg. §§ 301.7701-2(c)(2)(ii).
[32] T. Reg. §§301.7701-2(b) and 301.7701-3(a).
[33] *See* Appendix A for a list of the applicable foreign entities.

[4] Eligible Entities.

A business entity which is **not** a per se corporation is referred to as an "eligible entity" under the Check-the-Box regulations.[34]

If an eligible entity has two or more owners, it may elect to be classified as either a corporation or a partnership for federal income tax purposes.[35] If an eligible entity has only one owner, however, it may elect to be classified as either a corporation or an entity which is disregarded as an entity separate and apart from its owner.[36]

[5] Default Provisions.

Unless an eligible entity makes an election, it will be subject to the following default rules:

[a] Domestic Eligible Entities.

Without a valid election, a "domestic"[37] eligible entity is:

[i] a partnership if it has two or more owners;[38] **or**

[ii] disregarded as an entity separate and apart from its owner it if has only one owner.[39]

[b] Foreign Eligible Entities.

Without a valid election, a "foreign"[40] eligible entity is:

[i] a partnership if it has two or more owners **and** at least one owner does **not** have limited liability;

[ii] a corporation if all of its owners have limited liability; **or**

[iii] an entity that is disregarded as separate and apart from its owner if it only has one owner and the owner does **not** have limited liability.[41]

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[34] T. Reg. §301.7701-3(a).
[35] *Id.*
[36] *Id.*
[37] A "domestic" entity is an entity created or organized in the United States or under the laws of the United States or any state therein. T. Reg. § 301.7701-1(d).
[38] T. Reg. § 301.7701-3(c)(1)(i)
[39] T. Reg. § 301.7701-3(c)(1)(ii).
[40] An entity is a "foreign" entity if it is not a "domestic" entity. T. Reg. § 301.7701-1(d).
[41] T. Reg. § 301.7701-3(b)(1) and (2).

For this purpose, an owner of a foreign eligible entity has limited liability if the owner has **no** personal liability for the debts of or claims against the entity by reason of being an owner. An inquiry into applicable local law and the entity's organizational documents is required. Agreements whereby other owners or third parties agree to indemnify and hold the owner harmless from debts of the entity or claims of others relating to the entity are not relevant to the inquiry.[42]

1.03 DOMESTIC AND FOREIGN ENTITIES

A business entity is domestic, for purposes of the Check-the-Box regulations, if it was created or organized in the United States or created or organized under the laws of the United States or any State thereof, including the District of Columbia.[43] In addition, a business entity created or organized in or under the laws of both the United States and a foreign jurisdiction will, for purposes of the Check-the-Box regulations, be treated as a domestic entity.[44]

> **Example 1.** Y is an entity that was created or organized under the laws of Country A as a public limited company. Y was also organized as a limited liability company under California laws. Y is classified as a corporation for federal tax purposes under Treasury Regulation § 301.7701-2 and Treasury Regulation § 301.7701-3. Y is a domestic entity for purposes of applying the Check-the-Box regulations because it is an entity organized under California laws.[45]

> **Example 2.** X is an entity with more than one owner. It was organized under the laws of Country A as an unlimited company. X was also organized as a general partnership under California laws. X is classified as a partnership for federal tax purposes under Treasury Regulation § 301.7701-2 and Treasury Regulation § 301.7701-3. X is a domestic entity for purposes of applying the Check-the-Box regulations because it is an entity organized under California laws.[46]

[42] T. Reg. § 301.7701-3(b)(2)(ii).
[43] T. Reg. § 301.7701-5(a).
[44] *Id.*
[45] T. Reg. § 301.7701-5(b), Example 1.
[46] T. Reg. § 301.7701-5(b), Example 2.

1.04 ELECTIONS FOR ELIGIBLE ENTITIES

[1] Basics.

An eligible entity may avoid application of the default provisions by properly preparing and timely filing a written election with the Service. Also, an eligible entity may, in certain circumstances, properly prepare and timely file a written election with the Service in order to change its current income tax classification. In addition, eligible entities uncertain as to their default classification (e.g., not clear whether an entity is a "foreign" or a "domestic" entity) may prepare and file a protective written election with the Service.

Aside from a protective election, an entity classification election is generally only required in two situations, namely:

[a] Initial Classification.

When an eligible entity chooses to be classified initially as other than its default classification (commonly referred to as "electing out" of the default classification); and

[b] Change of Classification.

When an eligible entity chooses to change its entity classification.

An entity tax classification election is made by completing and filing IRS Form 8832 with the Service Center designated thereon. Depending upon where an eligible entity's principal place of business is located, it currently is required to file IRS Form 8832 with either the Service Center in Ogden, Utah or Cincinnati, Ohio.

> **Practice Alert.** Unless all information required by the form and its instructions is provided, an election may not be valid.

A copy of IRS Form 8832 must be attached to the tax return of the entity for the taxable year in which the election is made.[47]

Where an entity is **not** required to file a tax return for the year in which an election is made, a copy of IRS Form 8832 must be attached to the returns of all owners (direct and indirect) of the entity for the taxable year of the owners that includes the effective date of the election. An indirect owner of an eligible entity does **not** have to attach a copy of IRS Form 8832 to its return, however, if the entity in which it has an interest is filing a copy of IRS Form 8832 with its return.[48]

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[47] T. Reg. § 301.7701-3(c)(1)(ii).
[48] *Id.*

Failure of an entity or its owners (direct or indirect) to attach a copy of IRS Form 8832 to their return, in and of itself, will **not** invalidate an otherwise valid entity classification election. The non-filer may, however, be subject to an assessment of penalties if the federal tax or informational returns are inconsistent with the election being in effect.[49]

> **Practice Alert.** Interestingly, beginning in 2003, the copy of IRS Form 8832 to be attached to a return of any owner (direct or indirect) does **not** have to be a signed copy of the election form.

[2] Effective Dates.

The effective date of an election is generally the date specified on the IRS Form 8832 or, if no date is specified, the filing date.[50] The effective date specified on IRS Form 8832 cannot be more than 75 days before or more than twelve months after the filing date.[51] If the election specifies an effective date that is more than 75 days before the filing date, it will be effective 75 days before the filing date.[52] Likewise, if the election specifies an effective date that is more than twelve months after the filing date, it will be effective twelve months after the filing date.[53]

> **Example 1.** On January 1, 2017, Corporation X properly completes and files IRS Form 8832 with the designated Service Center. No effective date is specified on the election. Consequently, the effective date of the entity tax classification election is January 1, 2017.

> **Example 2.** Same facts as Example 1, except that that an effective date of December 1, 2016 was set forth on IRS Form 8832. Since December 1, 2016 is not more than 75 days prior to the filing date of January 1, 2017, the effective date of the entity tax classification election is December 1, 2016 (i.e., the effective date specified on the entity tax classification election).

> **Example 3.** Same facts as Example 1, except that that an effective date of October 1, 2016 was set forth on IRS Form 8832. Since October 1, 2016 is more than 75 days prior to the filing date of January 1, 2017, the effective date of the entity tax classification election is October 18, 2016

[49] *Id.*
[50] For filings made within the United States, the United States postmark date is considered the filing date. Code § 7502.
[51] T. Reg. § 301.7701-3(c)(1)(iii).
[52] *Id.*
[53] *Id.*

(i.e., the date that is exactly 75 days prior to the date of filing the entity tax classification election).

Example 4. Same facts as Example 1, except that that an effective date of June 1, 2017 was set forth on IRS Form 8832. Since June 1, 2017 is not more than 12 months after the filing date of January 1, 2017, the effective date of the entity tax classification election is June 1, 2017 (i.e., the effective date specified on the entity tax classification election).

Example 5. Same facts as Example 1, except that that an effective date of February 1, 2018 was set forth on IRS Form 8832. Since February 1, 2018 is more than 12 months after the filing date of January 1, 2017, the effective date of the entity tax classification election is January 1, 2018 (i.e., the date that is exactly 12 months after the date of filing the entity tax classification election).

In the case of a purchasing corporation making an election under Code § 338 relative to the acquisition of a subsidiary, an election can be effective no earlier than the day after the acquisition date within the meaning of Code § 338(h)(2).[54]

Example. On December 31, 2017, X corporation acquires all of the stock of Y corporation. An election under Code § 338 was properly and timely filed by the parties. An entity tax classification election using IRS Form 8832 with respect to Y could be made, effective January 1, 2017 or later.

[3] Who Must Sign The Election.

An entity tax classification election must be signed by either an authorized representative of the entity for which the election is being made, or by all persons who were owners of the entity at the time of filing.[55] Whether a person is an authorized representative is a question of state law.

For elections with a retroactive effective date, each person who was an owner of the entity for which the election is being made between the effective date and the date of filing, but who was not an owner when the election was filed, must also sign the election.[56]

Practice Alert. In the case of a prospective entity tax classification election, any person who becomes an owner of the target entity after the filing of the election but before

[54] *Id.*
[55] T. Reg. § 301.7701-3(c)(2)(i).
[56] T. Reg. § 301.7701-3(c)(2)(ii).

the effective date, is not required to approve the election or sign an addendum to the election before the effective date. Consequently, tax and legal advisors representing a client who is acquiring an interest in an entity should make due inquiry as to the existence or nonexistence of a prospective entity tax classification election. A prospective entity tax classification election that is effective after an acquisition of an interest in an entity could sour an otherwise good acquisition. **Caution is advised.**

For any elective changes in entity tax classification (discussed in Treasury Regulation § 301.7701-3(g)), the election must also be signed (in addition to all persons who were owners of the entity at the time of filing) by each person who was an owner of the entity on the date of the "deemed transaction" resulting from the elective change even though the person(s) was not an owner when the election was actually filed.[57]

As discussed below, these elective **changes** come in four flavors, namely:

- An eligible entity which properly elected partnership tax status later elects to be classified for federal tax purposes as a corporation;

- An eligible entity which properly elected corporation tax status later elects to be classified for federal tax purposes as a partnership;

- An eligible entity which properly elected corporation tax status later elects to be classified for federal tax purposes as an entity that is disregarded as separate and apart from its owner; **and**

- An eligible entity which properly elected to be disregarded from its owner later elects to be classified for federal tax purposes as a corporation.

[4] Permanency/Change.

An eligible entity's tax classification is generally **not** permanent. In most cases, an eligible entity may elect to change its tax classification. Once an eligible entity elects to change its tax classification, however, it cannot again change its tax classification for 60 months following the effective date of the election effectuating a change of tax classification.

[57] T. Reg. § 301.7701-3(c)(2)(iii).

The 60-month restriction is inapplicable to eligible entities whose only prior change was an election out of its default classification. In other words, an election of a newly formed eligible entity that was effective upon the date of formation will be ignored for purposes of applying the 60-month rule.[58] In addition, the Commissioner may waive the 60-month restriction if more than 50% of the ownership interests in the eligible entity as of the effective date of a subsequent election are owned by persons who did not own any interests in the entity on the filing date or the effective date of the prior election.[59]

The income tax classification of an eligible entity may be altered by a change in the number of its owners. In such instances, the following rules apply:

[a] Corporation Change In Number of Owners.

A corporation is **not** affected by any change in the number of owners.[60]

[b] Partnership Reduction To One Owner.

An eligible entity classified as a partnership becomes disregarded as an entity separate and apart from its owner when the entity's ownership is reduced to one owner.[61]

[c] Disregarded Entity Increase To More Than One Owner.

A single owner eligible entity disregarded as an entity separate and apart from its owner is classified as a partnership when the entity has more than one owner.[62]

[d] Sixty-Month Rule.

A change in the number of owners of an eligible entity does not, in and of itself, trigger the application of the 60-month rule.[63] Consequently, an eligible entity, whose default entity income tax classification is altered by a change in the number of its owners, is not required to wait 60 months from the change in classification created by the change in ownership before it may prepare and file a written election to change its entity income tax classification.

> **Example 1.** A, a U.S. person, owns a domestic eligible entity that is disregarded as an entity separate and apart from its owner. On January 1, 2017, B, who is also a U.S.

[58] T. Reg. § 301.7701-3(c)(1)(iv).
[59] *Id.*
[60] T. Reg. § 301.7701-3(f)(1).
[61] T. Reg. § 301.7701-3(f)(2).
[62] *Id.*
[63] T. Reg. § 301.7701-3(f)(3).

person, acquires a 50 percent interest in the entity from A. Under Treasury Regulation § 301.7701-3(f), the entity is classified as a partnership when B acquires an interest in the entity from A. A and B, however, elect to have the entity classified as a corporation effective January 1, 2017. Thus, for federal tax purposes, B is treated as buying shares of stock on January 1, 2017. Under Treasury Regulation § 301.7701-3(c)(1)(iv), the election is treated as a change in classification so that the entity generally cannot change its classification by election again during the 60 months following the effective date of the election. Under Treasury Regulation § 301.7701-3(g)(1), A is treated as contributing the assets and liabilities of the entity to the newly formed corporation immediately before the close of December 31, 2016. Because A does not retain control of the corporation as required by Code§ 351, A's contribution will be a taxable event. Therefore, under Code § 1012, the corporation will have a fair market value basis in the assets contributed by A, and A will have a fair market value basis in the stock received in the deemed incorporation. A will have no additional gain upon the sale of stock to B, and B will have a cost basis in the stock purchased from A.[64]

Example 2. On April 1, 2018, A and B, both U.S. persons, form X, a foreign eligible entity. X is treated as a corporation under the default provisions of Treasury Regulation § 301.7701-3(b)(2)(i)(B) because both A and B have limited liability. X does **not** make an election to be classified as a partnership. On June 1, 2019, A purchases all of B's interest in X. Under Treasury Regulation § 301.7701-3(f)(1), X continues to be classified as a corporation. X, however, can subsequently elect to be disregarded as an entity separate and apart from its owner, A. The 60-month limitation of does not prevent X from making an entity classification election because X has not made a prior election under paragraph Treasury Regulation § 301.7701-3(c)(1)(i).[65]

Example 3. On April 1, 2018, A and B, both U.S. persons, form X, a foreign eligible entity. X is treated as a corporation under the default provisions of Treasury Regulation § 301.7701-3(b)(2)(i)(B) because both A and B have limited liability. X does not make an election to be classified as a partnership. On January 1, 2019, X elects to

[64] T. Reg. § 301.7701-3(f)(4), Example 1.
[65] T. Reg. § 301.7701-3(f)(4), Example 2.

be classified as a partnership effective on that date. Under the 60-month limitation of Treasury Regulation § 301.7701-3(c)(1)(iv), X **cannot** elect to be classified as a corporation until January 1, 2024 (i.e., 60 months after the effective date of the election to be classified as a partnership). On June 1, 2019, A purchases all of B's interest in X. After A's purchase of B's interest, X can no longer be classified as a partnership because X has only one member. Under Treasury Regulation § 301.7701-3(f)(2), X is disregarded as an entity separate and apart from A when A becomes the only member of X. X, however, is not treated as a new entity for purposes of Treasury Regulation § 301.7701-3(c)(1). Consequently, the 60-month limitation continues to apply to X, and X cannot elect to be classified as a corporation until January 1, 2024 (i.e., sixty months after January 1, 2019, the effective date of the election by X to be classified as a partnership).[66]

[e] Tax Implications.

As explained above, under the Check-the-Box regulations, if an eligible entity that is not taxable as a corporation, goes from having a single owner to multiple owners, its entity tax classification will change from a disregarded entity to a partnership. Likewise, if an eligible entity that is not taxable as a corporation, goes from having multiple owners to only one owner, its entity tax classification will change from a partnership to a disregarded entity.

> **Practice Alert.** Unfortunately, the Check-the-Box regulations do **not** address the tax implications of these transformations. This is a huge shortcoming of the regulations.

In 1999, the Service attempted to address this shortcoming when it issued Revenue Rulings 99-5[67] and 99-6.[68]

> **Practice Alert.** Revenue Rulings 99-5 and 99-6 only address some of the tax implications taxpayers' face when these entity tax classification changes occur. For one, these rulings fail to address the tax implications to foreign eligible entities. Rather, they only focus on domestic eligible entities. Also, these rulings fail to consider the potential tax implications when there exists debt at the entity level. Last, they fail to address possible tax

[66] T. Reg. § 301.7701-3(f)(4), Example 3.
[67] Rev. Rul. 99-5, 1999-1 C.B. 434.
[68] Rev. Rul. 99-6, 1999-1 C.B. 432.

implications when there are multiple owner changes rather than single owner changes. **Caution is advised.**

[f] Revenue Ruling 99-5.

In Revenue Ruling 99-5, the Service addresses some of the basic tax consequences of a domestic single member limited liability company that is disregarded as an entity separate and apart from its owner for federal tax purposes when it is converted to an entity classified as a partnership for federal tax purposes due to the addition of an additional owner. The ruling discusses two situations, namely:

[i] Situation 1. A is the sole owner of LLC, a disregarded entity. LLC is not an investment company within the meaning of Code § 351 if it were incorporated. All of A's assets are capital assets or Code § 1231 property. A has no debt. A sells 50% of its ownership interest in LLC to B, an unrelated person, for $5,000 of cash. A does not contribute the $5,000 to LLC. After the sale and purchase, A and B operate LLC as co-owners and no entity classification election is made to treat LLC as a corporation. The result of the transaction is that LLC is converted to a partnership for federal tax purposes when B acquires a 50% ownership interest from A. We get to this result in two steps. First, B's purchase of the 50% ownership interest in LLC is treated as a purchase of 50% of each of the assets of LLC, which for tax purposes are treated as held directly by A. Immediately thereafter, A and B are treated as contributing their interests in the assets to a newly formed partnership in exchange for the ownership interests in the partnership.

Under Code § 1001, A recognizes gain or loss from the deemed sale of 50% of each asset of LLC to B.

Under Code § 721(a), no gain or loss is recognized by A or B as a result of their deemed contribution of the assets to the partnership.

Under Code § 722, B's basis in the partnership interest is $5,000. A's basis in the partnership interest is the same as his or her basis was in 50% of LLC's assets.

Under Code § 723, LLC's basis in the assets is the adjusted basis of that property in A's and B's hands immediately after the deemed sale (i.e., the aggregate bases A and B have in their ownership interests).

Under Code § 1223(1), A's holding period in his or her ownership interest in LLC includes his or her holding period in the assets held by LLC when it ceased to be a disregarded entity and became a partnership for federal tax purposes. B's holding period in his or her ownership interest begins on the day following the purchase of the ownership interest from A.[69]

[69] Rev. Rul. 66-7, 1966-1 C.B. 188.

Under Code § 1223(2), LLC's holding period for each of the assets deemed transferred to it by A and B is bifurcated and includes A's and B's holding periods as determined under Code § 1223(1).

[ii] Situation 2. A is the sole owner of LLC, a disregarded entity. LLC is not an investment company within the meaning of Code § 351 if it were incorporated. All of A's assets are capital assets or Code § 1231 property. A has no debt. B, an unrelated person, contributes $10,000 of cash to LLC in exchange for a 50% ownership interest. The cash contributed to LLC is used for business operations. After the capital contribution, A and B operate LLC as co-owners and no entity classification election is made to treat LLC as a corporation. The result is that LLC is converted from an entity that is disregarded as separate and apart from its owner to a partnership for federal tax purposes when B contributes cash to LLC. We get to this result in two simultaneous steps. First, B's contribution is treated as a contribution to the capital of a newly formed partnership, in exchange for an ownership interest in the partnership. Second, A is treated as contributing all of the assets of LLC to the newly formed partnership in exchange for an ownership interest in the partnership.

Under Code § 721(a), no gain or loss is recognized by A or B as a result of their deemed contribution of the assets to the partnership.

Under Code § 722, B's basis in the partnership interest is $10,000 (the amount of cash B contributed to the partnership). A's basis in the partnership interest is the same as his or her basis was in LLC's assets when it was a disregarded entity.

Under Code § 723, LLC's basis in the assets contributed to the newly formed partnership is the adjusted basis of that property in A's hands immediately prior to the contribution. Obviously, LLC has a basis of $10,000 in the cash (its face value).

Under Code § 1223(1), A's holding period in his or her ownership interest includes his or her holding period in the assets held by LLC when it ceased to be a disregarded entity and became a partnership for federal tax purposes. B's holding period in his or her ownership interest begins on the day following his or her contribution of money to LLC.[70]

Under Code § 1223(2), LLC's holding period for each of the assets deemed contributed to it by A includes A's holding period as determined under Code § 1223(1). No bifurcation occurs because B is deemed to only contribute cash.

[g] Revenue Ruling 99-6.

In Revenue Ruling 99-6, the Service addresses some of the basic tax consequences of a domestic two member limited liability company that is a partnership for federal tax

[70] *Id.*

purposes when it is converted to an entity classified as disregarded as separate and apart from its owner for federal tax purposes due to the reduction to one owner. The ruling discusses two situations, namely:

[i] Situation 1. A and B are equal partners in AB, an LLC under state law which is taxed as a partnership for federal tax purposes. AB does not hold any unrealized receivables or substantially appreciated inventory under Code § 751(b). All of AB's assets are capital assets or Code § 1231 property. AB has no debt. A sells his entire 50% ownership interest in AB to B for $10,000 of cash. A and B are unrelated. After the sale and purchase, the business of AB is continued by B as the sole owner. The result is that AB's partnership existence is terminated for federal tax purposes under Code § 708 when B purchases A's entire interest in AB.

Consequently, A is must treat the transaction as a sale of a partnership interest under Treasury Regulation § 1.741-1(b), and must report gain or loss, if any, resulting from the sale under Code § 741. So, A's gain is the excess of $10,000 (amount realized) over his or her adjusted basis in the ownership interest of AB. Generally, the gain or loss will be capital gain or loss. While the ruling assumes that AB owned no unrealized receivables or substantially appreciated inventory, be aware, if such assets had existed, a portion of any gain or loss would be re-characterized as ordinary income or loss.

On the other hand, the tax consequences to B are a bit more complicated. They are determined from viewing the transaction as a deemed liquidating distribution of all of the assets of AB to A and B, and thereafter, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest. In other words, B acquires 50% of the assets in a liquidating distribution from AB and 50% of the assets from a deemed purchase from A.

Under Code § 1012, B's basis in the assets acquired in the deemed purchase is $10,000, the purchase price paid to A for the assets (allocated to each asset in proportion to the asset's relative fair market value). Under Revenue Ruling 66-7,[71] B's holding period in these assets begins the day following the purchase.

B received a distribution of assets in a deemed liquidation. To the extent required under Code § 731(a), B recognizes gain or loss on the deemed liquidation. In this case, because there was no debt and the assets were distributed proportionality to A and B, assuming B's capital account was not negative, there should be no gain or loss recognition by B on the deemed liquidation.

B's basis in the assets acquired in the deemed liquidation is determined under Code § 732(b). Accordingly, since there are no unrealized receivables, B's basis in the partnership interest is allocated to each asset received in the deemed distribution.

[71] *Supra* at note 69.

B's holding period in these assets is essentially includes the partnership's holding period of that portion of the assets.

In essence, B's basis and holding period in the assets is bifurcated into two components. So, there are two components to basis of each asset (i.e., one-half of each asset has a separate basis) and two separate holding periods for each asset (i.e., one-half of each asset has a separate holding period).

[ii] Situation 2. C and D are equal partners in CD, an LLC under state law which is taxed as a partnership for federal tax purposes. CD does not hold any unrealized receivables or substantially appreciated inventory under Code § 751(b). All of CD's assets are capital assets or Code § 1231 property. CD has no debt. C and D sell their entire ownership interests in CD to E, an unrelated party, for $10,000 of cash each. After the sale and purchase, the business of CD is continued with E as the sole owner. The result is that CD's partnership existence is terminated for federal tax purposes under Code § 708 when E purchases the entire ownership interests of C and D as only one owner remains.

C and D must report gain or loss, if any, from the sale of their partnership interests under Code § 741. So, if the $10,000 of cash that each C and D received is greater than their respective adjusted bases in their partnership interests, they will have a gain to report. Conversely, if the $10,000of cash that each C and D received is less than their respective adjusted bases in their partnership interests, they will have a loss to report. Generally, any gain or loss will be capital gain or loss. While the ruling assumes that CD owned no unrealized receivables or substantially appreciated inventory, be aware, if such assets had existed, a portion of any gain or loss would be re-characterized as ordinary income or loss.

From E's perspective, the tax implications are a bit more complicated. CD is deemed to have made a liquidating distribution of its assets to C and D. Immediately thereafter, E is deemed to have acquired, by purchase, all of the assets of the former partnership.

E's basis in the assets is $20,000 (i.e., the purchase price) under Code § 1012.

E's holding period for the assets begins on the day immediately following the purchase.

Revenue Rulings 99-5 and 99-6 are excellent for illustrating very basic fact patterns. If the fact patterns vary from those discussed in the rulings, doom and gloom may be lurking. **Caution is required.**

A variety of additional facts could exist that will materially impact the tax analysis.

Examples of additional facts that could have a material impact on the tax results include:

- When debt exists;
- Where the eligible entity is not taxed as a partnership (i.e., it is taxed as a corporation);
- When the eligible entity is not a domestic entity;
- Where the ownership changes are greater than one (e.g., an ownership change from four persons to one person);
- When the selling partners have negative capital accounts; or
- When the entity owns substantially appreciated inventory or unrealized receivables.

Again, extreme caution is advised. A much more detailed analysis of each situation is required if the facts vary to any degree from the basic fact patterns considered in Revenue Rulings 99-5 and 99-6.

1.05 LATE ELECTIONS

[1] Service's Statutory Authority.

The Service generally has authority to grant a reasonable extension of time to make a regulatory or a statutory election under all subtitles of the Code except subtitles E, G, H and I.[72]

A regulatory election generally is an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice, or announcement published in the Internal Revenue Bulletin.[73] An entity classification election is a regulatory election. Consequently, the Service may permit a late entity classification election under the rules set forth in regulations.

The regulations set forth certain requirements and standards that the Service uses to determine whether to grant an extension of time for a taxpayer to make an election.[74] In limited situations set forth in the regulations, automatic extensions will be

[72] T. Reg. §§ 301.9100-1(c), 301.9100-2 and 301.9100-3.
[73] T. Reg. § 301.9100-1(b).
[74] T. Reg. §§ 301.9100-1 through 301.9100-3.

granted.[75] Unfortunately, entity classification elections are not one of these enumerated situations.

Nevertheless, the regulations provide for extensions of time for making elections that do not meet the requirements for an automatic extension.[76] In general, to qualify for this relief, the taxpayer must establish to the satisfaction of the Service that it acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government.[77]

A taxpayer is deemed to have acted in reasonably and in good faith for this purpose if:

[a] Prior To Service Discovering.

The request for relief is made prior to the Service discovering the failed election;

[b] Intervening Events.

The taxpayer failed to make the election because of intervening events beyond the taxpayer's control;

[c] Unaware.

The taxpayer failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election;

[d] Written Advice of the Service.

The taxpayer reasonably relied on the written advice of the Service; **or**

[e] Reliance on Qualified Tax Professional.

The taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make, or advise the taxpayer to make, the election. A taxpayer will **not** be deemed to have reasonably relied on a qualified tax professional if the taxpayer knew or should have known that the professional was not competent to render advice on the regulatory election or was not aware of all relevant facts.[78]

A taxpayer is deemed to have **not** acted reasonably and in good faith if:

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[75] T. Reg. § 301.9100-2.
[76] T. Reg. § 301.9100-3.
[77] *Id.*
[78] T. Reg. § 301.9100-3(b)(1).

[f] Alter a Return Position.

The taxpayer seeks to alter a return position for which an accuracy-related penalty has been or could be imposed under Code § 6662 at the time the taxpayer requests relief (taking into account any qualified amended return filed within the meaning of Treasury Regulation § 1.6664-2(c)(3)) and the new position requires or permits a regulatory election for which relief is requested;

[g] Informed.

The taxpayer was informed in all material respects of the required election and related tax consequences, but chose not to file the election; **or**

[h] Hindsight.

The taxpayer used hindsight in requesting relief. If specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.[79]

The interests of the government will be deemed prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made (taking into account the time value of money).[80] Likewise, the interests of the government will likely be prejudiced if the taxable year in which the election should have been made or any taxable years that would have been affected by the election had it been timely made are closed by the period of limitations on assessment under Code § 6501(a) before the taxpayer obtains relief.[81]

The bad news is that relief under the regulations requires that the taxpayer file a formal ruling request.[82]

[2] Revenue Procedure 2009-41.[83]

Revenue Procedure 2009-41 provides automatic relief with respect to late entity classification elections for: (i) an eligible entity's initial classification election; or (ii) a change in classification election.

Eligible entities meeting the requirements under the revenue procedure, however, must request relief within three years and 75 days of the requested effective date of

[79] T. Reg. § 301.9100-3(b)(2).
[80] T. Reg. § 301.9100-3(c)(1).
[81] *Id.*
[82] T. Reg. § 301.9100-3(e).
[83] Rev. Proc. 2009-41, 2009-2 C.B. 439.

the eligible entity's classification election. This is a huge shortcoming of the revenue procedure.

To be eligible for automatic relief under Revenue Procedure 2009-41, the following four requirements must be met:

[a] Non-filing of Election.

The eligible entity failed to obtain the election solely because the IRS Form 8832 was not timely filed;

[b] Has Not Filed a Return.

The eligible entity has not filed a federal tax or information return for the first year in which the election was to be effective because the due date has not passed or it must have filed all of its federal returns since the intended election effective date consistent with the intended classification;

[c] Reasonable Cause.

The eligible entity has reasonable cause for its failure to timely file the election; **and**

[d] Three years and 75 days have not elapsed.

Three years and 75 days from the requested effective date of the election have not passed.

To obtain relief under the revenue procedure, the taxpayer must file the fully completed IRS Form 8832 with the Service Center where it would have filed the timely election, including a statement that it meets the above requirements. If these requirements are not satisfied, however, the taxpayer's only relief is to file a formal ruling request.

[3] Revenue Procedure 2013-30.

Keep in mind, Revenue Procedure 2009-41 only provides relief in two situations with respect to late entity tax classification elections, namely: (i) for an eligible entity's initial tax classification election; and (ii) for a change in an eligible entity's tax classification election. Revenue Procedure 2013-30,[84] however, provides relief for a late entity tax classification election intended to be effective the same date as the entity's S election.

[84] Rev. Proc. 2013-30, 2013-36 IRB 173.

To obtain relief under Revenue Procedure 2013-30, the following requirements must be met:

[a] Eligible Entity.

The requesting entity is an eligible entity;

[b] Intent To Be An S Corporation.

The requesting entity intended to be classified as an S corporation as of the effective date of the tax classification election;

[c] Less Than Three Years And 75 Days Has Passed.

Less than **three years and 75** days have passed since the intended effective date of the election;

[d] Only Failure Is Timeliness.

The only reason the requesting entity failed to qualify as a corporation is the untimely filing of the election or the election was deemed not to be filed under Treasury Regulation § 301.7701-3(c)(1)(v)(C);

[e] S Election Not Filed.

The requesting entity solely failed to qualify as an S corporation because the S election was not timely filed;

[f] Filed Returns Consistent With S Status.

The requesting entity filed all federal returns consistent with it being an S corporation or the due date for its first return as an S corporation has not yet passed;

[g] Reasonable Cause Exists.

The requesting entity has reasonable cause for its failure to timely file the S election and has acted with reasonable diligence to correct the error since discovery; **and**

[h] Statements of Shareholders.

The requesting entity can provide statements of all shareholders during the time from of the S election effective date to the date the election was actually filed that they have reported income consistent with the S election having been in effect from the intended effective date forward.

While most of the requirements are objective in nature, the requesting entity must demonstrate reasonable cause as to why a timely election was not filed. This is a subjective inquiry.

Historically, the IRS has placed a fairly low threshold on the reasonable cause requirement. Examples of situations where the IRS has found reasonable cause include: (i) the corporation's responsible person failed to file the election; (ii) the corporation's tax professional failed to file the election; and (iii) the corporation did not know it needed to affirmatively file an election. Consequently, it appears most reasonable explanations for a late filing will suffice.

To apply for relief under Revenue Procedure 2013-30, the requesting entity is required to complete IRS Form 2553 (with Part IV - late entity classification), and attach a statement that the above requirements are satisfied. The IRS Form 2553 should be marked at the top: **"FILED PURSUANT TO REVENUE PROCEDUE 2013-30."** It is filed with the Service Center where the election would have been filed if it had been filed on a timely basis.

If the requirements for simplified relief under Revenue Procedures 2009-41 or 2013-30 are not met, a formal ruling request will be necessary to obtain relief.

1.06 DEEMED ELECTIONS

In three situations, a deemed entity election occurs.

[1] Exempt Organizations.

An eligible entity that has been determined to be or claims to be exempt from taxation under Code § 501(a) is deemed to have made an election to be treated as a corporation for federal tax purposes.[85] The deemed election is effective as of the day for which tax exemption is claimed or determined to apply, regardless of when the claim or determination is made.[86] It remains in effect until an entity classification election is made after the date the exempt status claim is withdrawn or rejected, or the exempt status is revoked.[87]

[2] Real Estate Investment Trusts.

An eligible entity that files an election under Code § 856(c)(1) to be treated as a real estate investment trust is deemed to have made an election to be treated as a corporation for federal tax purposes.[88] The deemed election is effective as of the first day the entity is treated as a real estate investment trust.[89]

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[85] T. Reg. § 301.7701-3(c)(v)(A).
[86] *Id.*
[87] *Id.*
[88] T. Reg. § 301.7701-3(c)(v)(B).
[89] *Id.*

[3] S Corporations.

An eligible entity that timely and properly elects to be treated as an S corporation under Code § 1362(a)(1) is deemed to have made an election to be treated as a corporation for federal tax purposes.[90] The deemed election is only effective provided (as of the effective date of the S election) the S corporation requirements contained in Code § 1362(b) were met.[91] The deemed election is effective as of the effective date of the S election.[92] It will continue in effect until the entity makes an election to be treated as other than a corporation.[93]

1.07 SPECIAL RULES FOR FOREIGN ELIGIBLE ENTITIES

[1] General Rule.

As a general rule, any foreign entity listed in the Check-the-Box regulations (i.e., a specific entity formed in one of 87 different foreign jurisdictions)[94] may not elect classification status for federal tax purposes. Rather, these entities are corporations per se for federal tax purposes. In the preamble to the regulations, Treasury expressly states that treating these foreign entities as corporations is consistent with its goal of simplifying entity classification.

[2] Grandfather Status.

Notwithstanding this general rule, the regulations permit certain foreign entities that existed on May 8, 1996 and which were classified as a partnership prior to that date to retain such classification.[95] In order to qualify for this grandfather exception to the general rule, certain requirements must be met:

- The foreign entity was in existence on May 8, 1996;
- The foreign entity's classification was "relevant" on May 8, 1996;
- No person (including the entity) for whom the classification was "relevant" on May 8, 1996 has treated the entity as a corporation;
- Any change in the foreign entity's claimed entity classification within 60 months prior to May 8, 1996

[90] T. Reg. § 301.7701-3(c)(v)(C).
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Supra* note 33.
[95] T. Reg. § 301.7701-2(d).

occurred solely as a change in the organizational documents of the entity and the owners of the entity recognized any federal tax consequences of the change;

- A reasonable basis (within the meaning of Code § 6662) existed on May 8, 1996 for treating the entity as other than a corporation for federal tax purposes; **and**

- Neither the foreign entity or of any of its owners received written notice on or before May 8, 1996 that the entity's classification was under examination by the IRS.[96]

Under what is commonly called the "binding contract" rule, if the foreign entity was actually formed after May 8, 1996, but pursuant to a "written binding contract in effect on May 8, 1996 and at all times thereafter, the parties agreed to directly or indirectly engage in an active and substantial business operation in the jurisdiction in which it was formed, the entity's date of formation will be ignored for purposes of applying the grandfather rule.[97]

The grandfather status of a foreign entity will terminate, however, upon the earlier of:

- The effective date of the foreign entity's election to be treated as a corporation;

- The termination of the foreign entity as a partnership under Code § 704(b)(1)(B) (a sale or exchange of 50% or more of the total capital and profits interests of the partnership within a 12-month period);

- A division of the foreign entity under Code § 704(b)(2)(B); **or**

- The date any person(s), who were not owner(s) of the foreign entity as of November 29, 1999 own, in the aggregate, 50% or more of the foreign entity (capital interests and/or profits interests).[98]

Caveat: A termination of the foreign entity as a partnership under Code § 704(b)(1)(B) will be ignored for purposes of applying the grandfather rule if the sale or exchange is among related parties within the meaning of

[96] *Id.*
[97] T. Reg. § 301.7701-2(d)(2).
[98] T. Reg. § 301.7701-2(d)(3).

> Code § 707(b) or Code § 267(b) and such sale or exchange occurred within 12 months of the entity's formation.[99]
>
> **Practice Alert.** A merger of two or more partnerships will not cause a loss of grandfather status for the partnership that is treated as continuing under Treasury Regulation § 1.708-1(b)(2)(i).[100]

A foreign eligible entity's classification is "relevant" when its classification affects the liability of any person for federal tax or informational purposes.

> **Example.** The withholding amount relative to the US sourced income of Corporation X and the corresponding withholding agent's obligation under Chapter 3 of the Code varies, depending upon whether the entity (i.e., Corporation X) is classified as a partnership or a corporation. Consequently, the entity classification of Corporation X impacts the documentation that the withholding agent must obtain from Corporation X, the amount it must withhold, and the type of tax or informational return it must file.[101]

The date that the classification of a foreign eligible entity becomes "relevant' is the date an event occurs that creates an obligation to file a federal tax return, informational return or a statement for which the classification of the foreign entity must be determined.[102]

> **Example.** A U.S. person acquires by purchase an interest in an eligible foreign entity on January 1, 2016, requiring the U.S. person to file an informational return on IRS Form 5471. The classification of the eligible foreign entity became "relevant" on January 1, 2016.[103]

Unless an eligible foreign entity's classification is "relevant" under the general rule, its classification will be deemed "relevant" on the effective date of the filing of an IRS Form 8832.[104]

The Check-the-Box regulations contain detailed effective dates that relate to foreign entities and the grandfather rule. A thorough review of Treasury Regulation §

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[99] T. Reg. § 301.7701-2(d)(3)(ii).
[100] *Id.*
[101] T. Reg. § 301.7701-3(d).
[102] T. Reg. § 301.7701-3(d)(1)(i).
[103] *Id.*
[104] T. Reg. § 301.7701-3(d)(1)(ii).

301.7701-2(e) is absolutely necessary if you are presented with a foreign entity's classification.

1.08 ELECTIVE CHANGES IN CLASSIFICATION

The deemed treatment of elective changes in entity classification vary depending upon the actual change.

[1] Partnership to Corporation.

If an eligible entity classified as a partnership later properly elects to be classified as a corporation, the partnership is deemed for federal tax purposes as having contributed all of its assets and liabilities to a newly formed corporation in exchange for the shares of the corporation, and immediately thereafter, the partnership liquidates by distributing the shares to the partners.[105] These deemed transactions occur the day before the election.[106]

[2] Corporation to Partnership.

If an eligible entity classified as a corporation later properly elects to be classified as a partnership, the corporation is deemed to have distributed all of its assets and liabilities to its shareholders in liquidation of the corporation. Immediately after the liquidation, the shareholders of the corporation are deemed to have contributed all of the assets and liabilities received in the liquidation to a newly formed partnership.[107] These deemed transactions occur the day before the election.[108]

[3] Corporation to Disregarded Entity.

If an eligible entity classified as a corporation later properly elects to be classified as a disregarded entity, the corporation is deemed to have distributed all of its assets and liabilities to its shareholder (single-owner) in a complete liquidation of the corporation the day prior to the election.[109]

[4] Disregarded Entity to a Corporation.

If an eligible entity classified as a disregarded entity later properly elects to be classified as a corporation, the single-owner of the disregarded entity is deemed to have contributed all of the assets and liabilities of the entity to a newly formed corporation in exchange for its shares the day prior to the election.[110]

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[105] T. Reg. § 301.7701-3(g)(1)(i).
[106] T. Reg. § 301.7701-3(g)(3).
[107] T. Reg. § 301.7701-3(g)(1)(ii).
[108] T. Reg. § 301.7701-3(g)(3).
[109] T. Reg. § 301.7701-3(g)(1)(iii).
[110] T. Reg. § 301.7701-3(g)(1)(iv).

1.09 REVENUE PROCEDURE 2002-69

In accordance with the Check-the-Box regulations, an eligible entity with two or more owners may be classified as either a corporation or a partnership. In addition, an eligible entity with one owner may be classified as a corporation or be generally disregarded as an entity separate from its owner.

Historically, taxpayers debated over whether an eligible entity wholly owned by spouses was an entity with one or two owners for purposes of applying the Check-the-Box regulations. The preferred taxpayer resolution of the issue was obviously that spouses be treated as one owner. Consequently, in those instances where the default provision under the Check-the-Box regulations was chosen, the entity would be disregarded for income tax purposes and no separate income tax return would be required for the entity itself.

On October 9, 2002, the Service put an end to the debate when it issued Revenue Procedure 2002-69.[111] Unfortunately, the Service only favored a subset of taxpayers in its pronouncement.

If an entity meets the following requirements, it is a "qualified entity" for purposes of applying the Revenue Procedure:

- It is an eligible entity (not a per se corporation) under Treasury Regulation §301.7701-2;

- It is solely owned by spouses (as community property) under the laws of a state, foreign country or possession of the United States; **and**

- No persons, other than the two spouses, are considered owners for federal income tax purposes.

If a "qualified entity" is wholly owned by spouses under community property laws and they treat the entity as a disregarded entity, the Service will accept that classification. Likewise, if a "qualified entity" is wholly owned by spouses under community property laws and they treat the entity as a partnership, the Service will accept that classification.

> **Practice Alert:** Any subsequent change in such an entity's reporting position will be treated as a conversion of the entity. A conversion of a "qualified entity" may be a taxable event.

[111] Rev. Proc. 2002-69, 2002-45 IRB 831.

If an eligible entity is treated by the owners as a partnership, and it is subsequently treated by owners as a disregarded entity, the change in entity status will be treated as a liquidation of the partnership. If the owners had negative capital accounts upon the deemed liquidation or there is a reallocation of debt upon the deemed liquidation, they made find themselves being subject to unwanted tax consequences. **Caution is advised.**

If an eligible entity is treated by the owners as a disregarded entity, and it is subsequently treated by the owners as a partnership, the change in entity status will be treated as a contribution of the assets of the disregarded entity to a newly formed partnership.

If an eligible entity is treated by the owners as a corporation, and it is subsequently treated by the owners as a partnership, the change in entity status will be treated as a liquidation of the corporation. It is clearly a taxable event.

Revenue Procedure 2002-69 does not favorably resolve the debate for eligible entities wholly owned by spouses **not** subject to community property laws. In such cases, the Service's position is that spouses constitute two separate owners. Consequently, under the Check-the-Box regulations, an eligible entity owned wholly by spouses not subject to community property laws may be classified as either a corporation or a partnership. Under the default provisions, without an election to be treated as a corporation, such an eligible entity will be classified as a partnership for income tax purposes.

When an entity is wholly owned by spouses, most tax practitioners desire to avoid both the corporate and partnership income tax classifications. The clearly preferred income tax classification in these situations is the disregarded entity classification.

There are at least two alternatives by which taxpayers may attain disregarded entity status for entities wholly owned by spouses **not** subject to community property laws. First, they could limit ownership of the eligible entity to one spouse. Alternatively, provided they meet the eligibility requirements, they could make an election under Code §761 to be excluded from Subchapter K.

In general, a Code § 761 election may only be made by all owners of unincorporated organizations which are:

- Used for investment purposes only and not the active conduct of a trade or business;

- Used for joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted; **or**

- Used for dealers in securities.

The owners of organizations eligible for a Code § 761 election must be able to compute their income without the need to compute the taxable income of the organization. This is an extremely complex area of tax law and several traps exist for the unwary. Before a Code § 761 election is entertained, it should be thoroughly vetted.

Both of the above alternatives allow taxpayers to obtain disregarded entity status. If these approaches are not available, however, entities wholly owned by spouses not subject to community property laws will **not** be eligible to obtain disregarded entity status under the Check-the-Box regulations.

Revenue Procedure 2002-69 provides tax practitioners with nothing more than the obvious. It does, however, make it clear that an eligible entity wholly owned by spouses as community property may be treated as a disregarded entity under the Check-the-Box regulations. Be aware -- an eligible entity wholly owned by spouses as **separate property** in a community property state or wholly owned by spouses **not** subject to community property laws may not be treated as a disregarded entity under the Check-the-Box regulations. The only method by which taxpayers in this situation may attain such status would be by having only one spouse own the entity or by qualifying and making a valid Code § 761 election.

1.10 EMPLOYER IDENTIFICATION NUMBERS

IRS Form 8832 requires the employer identification number ("EIN") for the electing eligible entity be used.

A few general rules come into play:

[1] Change of Classification.

An eligible entity retains and uses its prior EIN if it had one and it elects to change entity classification;[112]

[2] Eligible Foreign Entity.

An eligible foreign entity that makes an entity tax classification election is required to obtain an EIN at the time of the election and use it;[113] **and**

[112] T. Reg. § 301.6109-1(h)(1).
[113] T. Reg. § 301.6109-1(b)(2)(v).

[3] Disregarded Entity.

A disregarded entity is generally allowed to use its owner's EIN except in two cases; namely, when it changed its entity classification and had an EIN prior thereto, and when it has employees and reports payroll.[114]

Interestingly, the Chief Counsel's Office recently concluded that the IRS has the authority to modify tax return forms and instructions under Code § 6011(a) and Treasury Regulation § 1.6011-1(a) to require the sole owner of a disregarded entity to provide the entity's EIN (should it have its own EIN) on the owner's tax return.[115] Chief Counsel's Office also suggests potential revisions should be made to the relevant forms and instructions in order to promote effective tax administration. However, the Chief Counsel's Office finds that a return filed without the additional EIN would still be a valid return for purposes of both the statute of limitations and the failure-to-file penalties.

1.11 CORRECTIONS TO OTHERWISE VALID ELECTIONS

In accordance with guidance provided in Revenue Procedure 2010-32,[116] an otherwise valid entity classification election may be corrected when the IRS Form 8832 misstates the actual number of owners.

> **Example 1.** An otherwise valid entity classification election is made for a foreign eligible entity called Z to be treated as a disregarded entity. The IRS Form 8832 filed with the Service misstates the actual number of owners of Z as one. It is later determined that Z actually has two owners. The entity election of Z remains valid, but Z will be treated as having made an election to be classified as a partnership, provided it files a corrected IRS Form 8832, and its owners file amended federal returns, attaching a copy of the corrected IRS Form 8832 to the returns.
>
> **Practice Alert.** If Z does not want partnership classification status, it should not file a corrected IRS Form 8832. In which case, it will be treated as a corporation.
>
> **Example 2.** Same facts as Example 1, except the original entity election of Z was for the entity to be classified as a partnership, but it was later determined that Z only had one owner (rather than two owners). Z's entity classification election will remain valid, but it will be treated as having made an election to be classified as a disregarded entity,

[114] TD 9356, August 15, 2007.
[115] PMTA 2016-008 (2016).
[116] Rev. Proc. 2010-32, 2010-36 IRB 320.

provided it files a corrected IRS Form 8832 and its owner files an amended federal return, attaching a copy of the corrected IRS Form 8832 to the return.

Practice Alert. If Z does not want disregarded entity tax classification status, it should not file a corrected IRS Form 8832. In which case, it will be treated as a corporation.

1.12 TRUSTS

The Check-the-Box regulations contain specific provisions that focus on trusts.[117] In general, an arrangement will be treated as a trust for federal tax purposes if the purpose of the arrangement is to vest in one or more trustees the responsibility for protecting and conserving property for beneficiaries who cannot share in the discharging of these responsibilities – so that the beneficiaries are not associates in a joint enterprise conducting a business for profit.[118] Unfortunately, it is not always a simple exercise to determine whether an arrangement meets these criteria. Many arrangements, despite being labelled as "trusts," actually constitute organizations more properly classified as business entities under Treasury Regulation § 301.7701-2.

The Check-the-Box regulations specifically address the classification of certain types of trusts, including: business or commercial trusts,[119] investment trusts,[120] liquidating trusts,[121] and environmental remediation trusts.[122] In addition, the regulations, in significant detail, provide guidance as to whether a trust is a "domestic" or a "foreign" trust for purposes of entity classification.[123]

While the entity classification of arrangements labelled as "trusts" is beyond the scope of this paper, it is important to at least note that these provisions of the Check-the-Box regulations exist. Just because an arrangement is labelled as a "trust" it does not necessarily mean that it will be treated for federal tax purposes as a "trust." If it is more properly classified as a business entity, the entity classification rules contained in the Check-the-Box regulations will apply.

[117] T. Reg. § 301.7701- 4 and T. Reg. § 301.7701-7.
[118] T. Reg. § 301.7701- 4(a).
[119] T. Reg. § 301.7701- 4(b).
[120] T. Reg. § 301.7701- 4(c).
[121] T. Reg. § 301.7701- 4(d).
[122] T. Reg. § 301.7701- 4(e).
[123] T. Reg. § 301.7701- 7.

1.13 SOME NOT SO OBVIOUS ISSUES

[1] Making A Corporate Classification Election and S Election For An LLC Taxed As A Partnership.

By default, a LLC with two or more owners will generally be taxed as a partnership. By properly making an entity classification election, as discussed above, however, such a business entity could (assuming the entity and its shareholders meet the eligibility requirements)[124] be treated for federal tax purposes as an S corporation. Whether having a state law LLC treated for federal tax purposes as an S corporation is a good idea is likely the subject of debate. For many reasons, taking this approach may not be a good idea. **Careful thought and consideration is required.**

[2] Payroll Taxes.

In general, all income that passes through a partnership to a partner from trade or business activities (other than to a limited partner) is self-employment income, subject to payroll taxes. For an S corporation, however, amounts properly characterized as distributions escape payroll taxes because they do not constitute self-employment income.[125] This later conclusion assumes the shareholder employees of the S corporation receive reasonable compensation for actual services rendered.

The potential payroll tax savings under current law for S corporation shareholders may very well point in the direction of electing corporation tax classification status (with an S election) for current LLCs. As discussed below, other viable options may exist that are better suited for the entity and its owners. These options, after careful analysis and consideration may include forming the entity as a corporation at the outset, or converting the entity under state law conversion statutes to a corporation followed by the making of an S election.[126]

[3] Tax Free Reorganizations.

Business entities classified as partnerships are not eligible to utilize the tax free treatment offered entities classified as corporations under Code § 368(a). The potential to utilize the time tested tax free corporate reorganization provisions of the Code may, in some circumstances welcome electing corporation classification status (with an S election) for current LLCs. As discussed below, better options may exist for the entity and its owners. Again, these options, after careful analysis and

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[124] Code § 1362(a) requires that there are 100 or fewer shareholders; all shareholders are individuals, specified types of trusts or estates and are US citizens or resident aliens; and the corporation has a single class of stock.

[125] Code § 1402(a)(2).

[126] A conversion will treated as either a liquidation followed by a contribution of assets to a newly formed corporation in exchange for stock, or a contribution of membership interests to a newly formed corporation in exchange for stock, followed by the termination of the partnership. A careful review and analysis of the conversion is required to ensure unforeseen tax consequences do not occur.

consideration may include forming the entity as a corporation at the outset, or converting the entity under state law conversion statutes to a corporation followed by the making of an S election.[127]

[4] Formalities.

In general, most state LLC statutes impose fewer formalities on the entities and their members. Most corporate statutes, on the other hand, impose several formalities on corporations and their shareholders, including the following requirements:

- Must have a board of directors.
- Must have officers (typically a president and a secretary).
- Must formally approve acts of the board of directors at a meeting that is convened following specific notice requirements, or in consent action minutes signed by the board members.
- Must formally approve acts of the shareholders at a meeting that is convened following specific notice requirements, or in consent action minutes signed by the shareholders.

On the other hand, LLCs are generally required to follow fewer formalities. Annual meetings, meeting minutes or consent actions are not required under most state LLC statutes. Members or Managers are generally responsible for managing the business enterprise. A separate board of directors and a slate of officers are not required.

Consequently, given the potential for payroll tax savings in the S corporation tax classification, the ability to utilize the tax free corporate reorganization provisions of the Code, and the lack of formalities that exist with state law LLC status, there appears to be an overwhelmingly strong argument that a state law LLC taxed as an S corporation is the best of both worlds. At first blush, it is difficult to debate that conclusion. After considering the following nuances and traps that exist for the unwary, the proper conclusion, however, is that an LLC should rarely, if ever, elect corporate tax classification status.

[5] Confusion.

Most business enterprises deal with third parties, including banks/lenders, government regulators, customers, suppliers and vendors. If may be difficult to explain to these parties (or show them) that the entity is a LLC for state law purposes

[127] *Id.*

and an S corporation for federal tax purposes. Many rigid organizations such as lenders and regulatory bodies may not readily understand and accept the fact that a LLC is filing IRS Form 1120S and yet does not have officers, directors, articles of incorporation, or bylaws, and does not conduct formal board and/or shareholder meetings, or maintain corporate minutes. The potential payroll tax savings under current law for S corporation shareholders may very well point in the direction of electing corporation classification status (with an S election) for current LLCs. As discussed below, other viable options may exist that are better suited for the entity and its owners. Once again, these options, after careful analysis and consideration may include forming the entity as a corporation at the outset, or converting the entity under state law conversion statutes to a corporation followed by the making of an S election.

[6] Capital Accounts.

What happens to the capital accounts of the LLC upon electing S corporation status? This author does not have a precise answer to this question.

What happens to the LLC members that have negative capital accounts upon conversion to S status for federal tax purposes? The answer to this question is likely easier to answer than the question about capital accounts. The members in this situation clearly have generated a tax liability to the extent of their capital account deficit.

[7] Retroactive Entity Classification Elections.

A LLC taxed as a partnership can make a retroactive entity classification elected to be treated as a corporation.[128] The election can be retroactive up to 75 days. Sounds good! Nevertheless, unforeseen consequences may be looming.

One obvious issue that needs careful consideration if a retroactive entity classification election is being considered is S corporation eligibility. It must exist on the day the retroactive election becomes effective and for each day thereafter. If not, the election will result in the entity being classified as a C corporation. This is likely **not** an intended result.

Other issues that need consideration if a retroactive entity classification election is being considered are not so obvious. These issues include payroll tax withholding, reporting and payment obligations.

If the LLC had been making significant payments to its members during the 75 days before the entity classification election is filed for services rendered, the stage is set for possible disaster.

[128] T. Reg. § 301.7701-3(c)(1)(iii).

During the entity's life as a LLC taxed as a partnership, the payments would likely have been characterized as guaranteed payments under Code § 707(c). Consequently, the LLC would not have withheld taxes as an employer from the payments. Likewise, the LLC would not have paid (with its payroll tax deposits for its employees) the employer portion of the payroll taxes on these payments. Rather, the members would have been subject to self-employment taxes on the payments under Code § 1402(a).

Assume a LLC elected to be classified for federal tax purposes as a corporation. The election was made retroactively 75 days prior to the filing of the IRS Form 8832. The compensatory payments made to the members during this 75-day period cannot be characterized as guaranteed payments since Code § 707(c) is inapplicable to corporations. These payments likely constitute wages paid by the corporation to an employee. **Oops!** The corporation did not withhold and/or remit income or payroll taxes to the government for the payments made to the members during the 75-day period for services rendered. Presumably, an assessment of penalties for the late payments and interest are lurking. **Caution is advised.**

> **Example.** ABC, LLC is formed, effective January 1, 2017, under State X's limited liability act. ABC has multiple members. No election for an entity tax classification out of the default classification was filed. Accordingly, pursuant to Treasury Regulation § 301.7701-3(b)(1)(i), ABC is treated as a partnership for federal tax purposes. Member A of ABC performs substantial services for the company. As a consequence, the company pays him $40,000 per month (a guaranteed payment under Code § 707(c)). No employer withholding or payroll taxes are paid since A is a partner of ABC for federal income tax purposes.[129] The payments are likely self-employment income to A under Code § 1402(a). On March 15, 2017, after A received total guaranteed payments of $100,000, ABC properly elects, effective January 1, 2017, to be classified as a corporation taxed under Subchapter S of the Code. Since the election was made within 75 days of its intended effective date, the retroactive effective date of January 1, 2017 will be honored. Since ABC was **not** a partnership for federal income tax purposes when the payments to A were made (as a result of the retroactive entity tax classification election), the payments cannot constitute guaranteed payments under Code § 707(c). Instead, the likely correct answer is that the payments, as a result of the retroactive entity tax classification election, constitute wages, subject to employee withholding and reporting, and payroll taxes.

[129] *See, e.g.*, Rev. Rul. 69-184, 1969-1 C.B. 115.

[8] Unwanted Tax Consequences.

As stated earlier, if an eligible entity classified as a partnership properly elects to be classified as a corporation, the partnership is deemed for federal tax purposes as having contributed all of its assets and liabilities to a newly formed corporation in exchange for the shares of the corporation, and immediately thereafter, the partnership liquidates by distributing the shares to the partners.[130] These deemed transactions occur the day before the election.[131] That sounds so simple in concept. It seems nothing could go wrong.

[a] Code § 351.

For starters, compliance with Code § 351 is paramount. The control requirement should not be taken for granted. If other shareholders are coming into the picture as part of a prearranged series of transactions, care needs to be implemented to ensure Code § 351 tax free treatment is attained.

[b] Code § 357.

Code § 357 cannot be forgotten. If the aggregate adjusted basis of the assets being contributed to the newly created corporation are less than the aggregate liabilities being contributed in the deemed incorporation, the entity tax classification election will end up being taxable. This is likely an unexpected and unwanted result.

[9] Jeopardizing S Status.

Code § 1362 imposes certain rigid requirements on S corporations, including the requirement that an S corporation may only have one class of stock. Having differences in the voting rights of shares alone will not cause an S corporation to have more than one class of stock.[132] All shares of an S corporation, however, must have identical rights to liquidation and distribution proceeds. Here is where a potential time bomb could be lurking.

Most LLC operating agreements typically contain provisions that could violate the single class of stock requirement. These provisions may include, but are certainly not limited to, maintenance of capital accounts, regulatory allocation provisions, special allocation provisions, and non-pro rata distribution and liquidation provisions. In addition, most LLC operating agreements are not concerned with provisions that limit a member's ability to transfer the member's interest to a non-qualified S corporation shareholder. So, post S status transfers that could terminate an S election may be permitted. An example may include a transfer to a non-qualifying trust that was innocent in nature (i.e., a trust established for estate planning purposes).

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[130] T. Reg. § 301.7701-3(g)(1)(i).
[131] T. Reg. § 301.7701-3(g)(3).
[132] Code § 1361(c)(4).

An obvious solution may be to terminate any existing LLC operating agreement, effective immediately before the S election is effective. While that appears to be an effective solution, it may very well turn out to be ineffective.

> **Practice Alert.** Most state LLC statutes expressly provide, to the extent not specifically overridden by written agreement, the statutory provisions shall govern.[133] These statutory provisions may create more than one class of stock. So, it is important that a carefully and thoughtfully drafted agreement is put in place at the effective date of the entity tax classification election. Specifically, such an agreement needs to supersede and replace the old operating agreement and override any provision of the applicable state law LLC statutory scheme that could jeopardize the S election. Again, the loss of the S election does not invalidate an otherwise valid entity tax classification election. The result is that the entity is a C corporation for federal tax purposes – likely an unintended result.

[10] Outstanding Profits Interests.

It is not uncommon for LLCs taxed as partnerships to issue profits interests to key executives. Since partnerships cannot issue incentive stock options,[134] the issuance of profit interests in the world of entities taxed as partnerships is likely more common today than ever before.

In accordance with Revenue Procedure 93-27,[135] as clarified by Revenue Procedure 2001-43,[136] the recipient of a profits interest does not generally have a taxable event upon grant. This is another reason why the use of these types of compensatory devices are commonplace in entities taxed as partnerships.

Three exceptions to the general rule on taxation of profits interests exist:

[a] Substantial Certainty.

When the profits interest relates to a substantially certain and predictable stream of income from partnership assets such as high quality debt securities or net lease(s) it is taxable upon grant.

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[133] An example is found in the Oregon Limited Liability Act. ORS 63.195.
[134] Code § 422 only allows corporations to issue incentive stock options.
[135] Rev. Proc. 93-27, 1993-2 C.B. 343.
[136] Rev. Proc. 2001-43, 2001-2 C.B. 191.

[b] Disposition within Two Years.

When, within two years of the receipt of the profits interest, the recipient disposes of the partnership interest, it is taxable upon grant.

[c] Publicly Traded Limited Partnership Interest.

When the profits interest is a limited partnership interest in a publically traded partnership, within the meaning of Code § 704(b), it is taxable upon grant.

A profits interest is generally similar to a stock appreciation right. It gives the recipient only a share of future profits and appreciation of the company. The recipient has no rights to current capital in the company. So, if the company were to be liquidated at the end of the very day on which the recipient was awarded a ten percent profits interest in the company, assuming the company did not appreciate during that one day, the recipient (despite the ten percent interest) would receive none of the liquidation proceeds. Likewise, if the company was properly valued at $5 million upon grant of the profits interest, and it was liquidated a short time later, at which time the company had appreciated by $1 million, the recipient of the profits interest would receive $100,000 (ten percent of the appreciation) rather than $600,000 (ten percent of the company's value at liquidation). Since all of the shares of the company do **not** confer identical rights to distribution and liquidation proceeds, an outstanding profits interest would invalidate the S election.

> **Practice Alert.** Before considering making an entity tax classification election, a review of outstanding interests in the entity is absolutely necessary.

All in all, after weighing the pros and the cons, making an entity tax classification election under the Check-the-Box regulations so that a LLC currently taxed as a partnership will be taxed as an S corporation is fraught with problems. Granted, such a strategy brings with it the potential for payroll tax savings (as well as net investment tax savings under Code § 1411 assuming the owner is an active participant in the business), the ability to utilize Code § 368 (tax free reorganizations), and minimization of entity formalities. Nevertheless, the strategy is fraught with problems, including confusion among regulators, customers, lenders/bankers, vendors and suppliers, disappearing capital accounts, retroactive entity tax classification unanticipated issues, unwanted tax consequences, and the potential loss of S status. Consequently, making an entity tax classification election for a LLC taxed as a partnership to become a LLC taxed as an S corporation is **not** generally recommended.

> **Practice Alert.** When forming a new eligible entity that intends to immediately elect out of its default status as a partnership or disregarded entity to corporate status for federal tax purposes, consider making the election before the owner(s) contribute any assets to the entity. Arguably,

this approach avoids any adverse tax consequences resulting from the deemed entity tax classification transactions because the post-election contributions to capital occurred directly to the corporate entity (which began its existence under its elected status without beginning under the default classification status and then moving to the elected status).

[11] State Law.

Even though the emphasis of this paper is federal income taxes, we cannot ignore the state tax law implications of making or changing an entity classification election.

Several states, including New Hampshire, Tennessee, Texas, Louisiana, and the District of Columbia do **not** recognize S corporations. In these states, the entity will be taxed as a C corporation. Some states, including Arkansas, New Jersey, New York, and Pennsylvania recognize a valid S election, but they require a separate state law S election. So, when electing a corporate entity classification with an S election, state law needs to be considered.

State and local taxing authorities may require disregarded entities to register, report and pay taxes even though they are disregarded for federal income tax purposes. These taxes may include income, sales and use, workers compensation, employment, unemployment insurance, and other excise taxes. For example, both Virginia[137] and Connecticut[138] treat single member LLCs, otherwise taxed as disregarded entities for federal tax purposes, as separate entities for purposes of their sales and use tax regimes.

1.14 CONCLUSION

Entity tax classification for income tax purposes was greatly simplified by the Check-the-Box regulations. The regulations are generally friendly and offer taxpayers significant flexibility relative to entity tax classification. Revenue Procedure 2002-69 expands this flexibility for eligible entities wholly owned by spouses subject to community property laws. The historic entity tax classification war between the Service and taxpayers appears to be over. Nevertheless, due to the subtle nuances that exist in the Check-the-Box regulations, a keen understanding of the regulations and the possible tax traps that exist for the unwary is absolutely necessary.

A careful analysis of each situation is required. A multi-step approach may be warranted. The approach should include, but not necessarily be limited to:

[137] Ruling of Virginia Commissioner, PD 98-157 (October 20, 1998).
[138] Information Notice of Connecticut of Labor (March 2009).

- A determination of whether the arrangement at issue qualifies as an entity is the likely starting point for any analysis under the Check-the-Box regulations.

- A determination as to whether the entity is a trust or business entity is required.

- If the entity is a business entity, a determination as to whether it is a foreign entity or a domestic entity is required.

- If the entity is a business entity, a determination of who are the owner(s) is required.

- If the entity is a business entity, a determination as to whether the entity is corporation per se or an eligible entity is required.

- Eligible entities with two or more owners have the choice to be classified as a corporation or a partnership. An analysis of whether such an eligible entity should be classified as a partnership or a corporation is clearly required.

- Eligible entities with one owner have the choice to be classified as a corporation or a disregarded entity. An analysis of whether such an eligible entity should be classified as a corporation or disregarded entity is clearly required.

- A determination as to whether an eligible entity should accept its applicable default classification status or elect to change that status is required. The tax impact of an election or deemed election is critical.

- All classification election requirements should be closely reviewed, including eligibility, timing of filing, allowable effective dates, and required consents.

- An eligible entity may be able to change its classification status. Changes in the entity itself, including its tax attributes and the ownership, and/or changes in applicable law, may warrant a change in entity classification for federal tax purposes. Before any change is attempted, however, the timing of the change must be scrutinized to determine if a change is allowable.

Additionally, the tax impact of the change should be thoroughly reviewed be avoid unwanted consequences.

It is critical that, once an entity classification election is made, it is periodically reviewed and revisited to ensure it remains appropriate or to determine if the facts have caused a change in tax classification status (e.g., where the ownership of an entity taxed as a partnership is reduced to one). Consequently, a good understanding of the entity tax classification rules continues after an election is made. Ignoring the potential issues arising from entity tax classification decisions or non-decisions could be disastrous.

Appendix A

American Samoa, Corporation

Argentina, Sociedad Anonima

Australia, Public Limited Company

Austria, Aktiengesellschaft

Barbados, Limited Company

Belgium, Societe Anonyme

Belize, Public Limited Company

Bolivia, Sociedad Anonima

Brazil, Sociedade Anonima

Bulgaria, Aktsionerno Druzhestvo.

Canada, Corporation and Company

Chile, Sociedad Anonima

People's Republic of China, Gufen Youxian Gongsi

Republic of China (Taiwan), Ku-fen Yu-hsien Kung-szu

Colombia, Sociedad Anonima

Costa Rica, Sociedad Anonima

Cyprus, Public Limited Company

Czech Republic, Akciova Spolecnost

Denmark, Aktieselskab

Ecuador, Sociedad Anonima or Compania Anonima

Egypt, Sharikat Al-Mossahamah

El Salvador, Sociedad Anonima

Estonia, Aktsiaselts

European Economic Area/European Union, Societas Europaea

Finland, Julkinen Osakeyhtio/Publikt Aktiebolag

France, Societe Anonyme

Germany, Aktiengesellschaft

Greece, Anonymos Etairia

Guam, Corporation

Guatemala, Sociedad Anonima

Guyana, Public Limited Company

Honduras, Sociedad Anonima

Hong Kong, Public Limited Company

Hungary, Reszvenytarsasag

Iceland, Hlutafelag

India, Public Limited Company

Indonesia, Perseroan Terbuka

Ireland, Public Limited Company

Israel, Public Limited Company

Italy, Societa per Azioni

Jamaica, Public Limited Company

Japan, Kabushiki Kaisha

Kazakstan, Ashyk Aktsionerlik Kogham

Republic of Korea, Chusik Hoesa

Latvia, Akciju Sabiedriba

Liberia, Corporation

Liechtenstein, Aktiengesellschaft

Lithuania, Akcine Bendroves

Luxembourg, Societe Anonyme

Malaysia, Berhad

Malta, Public Limited Company

Mexico, Sociedad Anonima

Morocco, Societe Anonyme

Netherlands, Naamloze Vennootschap

New Zealand, Limited Company

Nicaragua, Compania Anonima

Nigeria, Public Limited Company

Northern Mariana Islands, Corporation

Norway, Allment Aksjeselskap

Pakistan, Public Limited Company

Panama, Sociedad Anonima

Paraguay, Sociedad Anonima

Peru, Sociedad Anonima

Philippines, Stock Corporation

Poland, Spolka Akcyjna

Portugal, Sociedade Anonima

Puerto Rico, Corporation

Romania, Societe pe Actiuni

Russia, Otkrytoye Aktsionernoy Obshchestvo

Saudi Arabia, Sharikat Al-Mossahamah

Singapore, Public Limited Company

Slovak Republic, Akciova Spolocnost

Slovenia, Delniska Druzba

South Africa, Public Limited Company

Spain, Sociedad Anonima

Surinam, Naamloze Vennootschap

Sweden, Publika Aktiebolag

Switzerland, Aktiengesellschaft

Thailand, Borisat Chamkad (Mahachon)

Trinidad and Tobago, Limited Company

Tunisia, Societe Anonyme

Turkey, Anonim Sirket

Ukraine, Aktsionerne Tovaristvo Vidkritogo Tipu

United Kingdom, Public Limited Company

United States Virgin Islands, Corporation

Uruguay, Sociedad Anonima

Venezuela, Sociedad Anonima or Compania Anonima

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