1997

Simplified Entity Classification Under the Final Check-the-Box Regulations

Roger F. Pillow
John G. Schmalz
Samuel P. Starr

Repository Citation
https://scholarship.law.wm.edu/tax/338

Copyright c 1997 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
https://scholarship.law.wm.edu/tax
Planning possibilities are significant under the now-effective elective regime for noncorporate business entities. The disregard of single-member entities offers corporate members an attractive alternative to the consolidated return approach, and the certainty afforded to foreign entities makes the increased use of hybrids a substantial likelihood. There are some open questions, however, particularly with regard to state tax treatment.

The final entity classification Regulations (TD 8697, 12/17/96) are the last step in the Service’s streamlining of the process, which began on 3/29/95 with Notice 95-14, 1995-1 CB 297. The Notice suggested that taxpayers might be allowed to treat unincorporated business organizations as partnerships or associations on an elective basis. Having whetted the appetite of the tax community, IRS released Proposed Regulations under Section 7701 on 5/9/96 to replace the corporate-resemblance classification methodology that had been in use since 1960. The Proposed Regulations met with unprecedented applause. The final Regulations generally follow the proposals while providing additional clarity and guidance in specific areas.

Nevertheless, the ultimate fate of the Regulations began to be questioned even prior to their release, due to an announcement by the Joint Committee of Taxation staff that it had independently initiated a review of the tax rules governing the entity classification process. As discussed below, it is unclear as to what effect, if any, the ICT staff’s review will have on the future of the Regulations.

The final Regulations

Under the new Regulations, entities are categorized as either trusts or business entities. A business entity not required to be treated as a per se corporation is an “eligible” entity; its owners may choose to have the entity treated as either a corporation or a partnership for federal tax purposes. A single-owner eligible entity may be disregarded as an entity separate from its owner.

Determining whether an entity exists. The first step in the entity classification process is to determine whether a separate
entity exists for federal tax purposes.\(^4\) Under Reg. 301.7701-1(a)(1), an organization is an entity separate from its owners for federal tax purposes based on its treatment under federal tax law.

Reg. 301.7701-1(a)(2) states that a joint venture or other contractual arrangement may be a separate entity if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. In contrast, the mere sharing of expenses or co-ownership of property does not give rise to a separate entity. An organization wholly owned by and an integral part of a state and certain incorporated Indian tribes are not recognized as separate federal tax entities.\(^5\) Qualified cost sharing arrangements under Reg. 1.482-7 are likewise not separate federal tax entities.\(^6\)

An entity is treated as a domestic entity if it is created or organized in the U.S., under the laws of the U.S. or a state. An entity is foreign if it is not domestic.\(^7\)

**Distinguishing trusts from business entities.** Under old Reg. 301.7701-2(a)(2), trusts (excluding business trusts) were distinguished from associations since they lacked associates and an objective to carry on business and divide the gains therefrom. The new Regulations maintain these distinctions.\(^8\)

A "nonbusiness trust" will continue to mean an arrangement created either by will or inter vivos declaration whereby trustees take title to property to protect or conserve it for designated beneficiaries. Accordingly, an arrangement will continue to be treated as a trust for federal tax purposes if its purpose is to vest trustees with the responsibility of protecting and conserving property for beneficiaries who cannot share in the discharge of this responsibility and who are not associates in a joint enterprise for the conduct of business for profit.\(^9\) Because business trusts are usually created for other purposes, Reg. 301.7701-4(b) provides that they are more properly characterized as business entities.

Once an entity is determined to be a business entity, it will be treated for federal tax purposes as a corporation, a partnership, or simply disregarded as an entity separate from its owner.

**Classifying a Post-1996 Business Entity**

As indicated above, under Reg. 301.7701-2(a) a "business entity" is any entity recognized for federal tax purposes (including a single-owner entity that is disregarded as an entity separate from its owner under Reg. 301.7701-3), not properly classified as a trust under Reg. 301.7701-4 or otherwise subject to corporate treatment under the Code.

**Entities with more than one member.** A business entity with two or more members formed after 1996 is classified as either a corporation or an "eligible" entity. Reg. 301.7701-2(b) defines a "corporation" as including:

1. A business entity organized under a federal or state statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic.
2. An association (as determined under Reg. 301.7701-3).
3. A business entity organized under a state statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association.
4. An insurance company.
5. A state-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act or a similar federal statute.
6. A business entity wholly owned by a state or any political subdivision thereof.
7. A business entity that is taxable as a corporation under a provision of the Code other than Section 7701(a)(3).
8. Certain listed foreign entities.

Under Reg. 301.7701-3(a), an entity that is not a per se corporation under categories 1 or 3 through 8 above is an eligible entity and may elect classification as either a partnership or an association (and thus a corporation under Reg. 301.7701-2(b)(2)). A major simplifying aspect of the Regulations is that the election process operates via a default mechanism. Accordingly, a domestic eligible entity need affirmative action only when it desires to be classified as a corporation; otherwise the entity will be classified as a partnership if it has two or more members or be disregarded as an entity separate from its owner if it has only one owner.\(^10\)

Eligible foreign entities also have a default mechanism, although the default is not always to a partnership classification. Under Reg. 301.7701-3(b)(2)(i), an eligible foreign entity

---


4. See the Preamble to TD 8697, part A.

5. Reg. 301.7701-4(a).

6. See the Preamble to TD 8697, part A.


10. Regs. 301.7701-2(c)(1) and (2). Under a special rule in Reg. 301.7701-2(c)(2)(ii), if the single owner of an eligible entity is a bank (as defined in Section 581), any tax rules applicable solely to banks will apply to the single owner as if its wholly owned entity were a separate entity.
with two or more members will default to association status if all of its members have limited liability, and to partnership status if any member does not have limited liability. Similarly, a single-member eligible foreign entity will default to association status if its owner has limited liability or be disregarded as an entity separate from its owner if not. Under Reg. 301.7701-3(b)(2)(ii), a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member, based solely on the statute or law under which the entity is organized. A member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member due to status as a member. The Regulations emphasize that a member has personal liability for this purpose even if the member is, by agreement, indemnified by another person (whether or not that other person is a member) with respect to the liability. Where liability for members is optional under applicable local law, the entity's organizational documents may also be relevant in determining whether limited liability exists.

The Preamble to TD 8697 indicates that the default rules reflect what the IRS believes entity members expect. Reg. 301.7701-3(a) provides that taxpayers who desire to choose an initial entity classification other than the regulatory default may do so; otherwise, the entity retains its default classification (regardless of any changes in the members' liabilities occurring during the period that such classification is relevant) until an election is filed. The Preamble to the Proposed Regulations warned that if a foreign entity's owners were uncertain as to whether they had limited liability under local law, the entity should file an election to secure the desired classification. That warning should continue to be heeded.

Single-member entities. Reg. 301.7701-3(b)(1)(ii) provides that a domestic single-member eligible entity is disregarded for federal tax purposes unless its owner elects to treat the entity as an association. The taxable income of a disregarded entity will be reported on Schedule C of an individual owner's federal income tax return, or as income from a division if the owner is a corporation or a partnership.

The default classification for a foreign single-member entity operates in a manner similar to that of a foreign entity with two or more owners. Accordingly, unless its owner elects association status, a foreign single-member eligible entity is disregarded as an entity separate from its owner if the owner does not have limited liability. An eligible single-member foreign entity whose owner has limited liability will be treated as an association, unless its owner elects to have the entity disregarded.

Although an eligible single-member entity may be disregarded for federal tax purposes, it is not disregarded for local business law purposes. Owners of single-member entities must adhere to local law single-member entity formation requirements. If those formalities are disregarded, an entity may be ignored under a "piercing the veil" approach and state law limited liability protection could be lost.

Status imposed by the Code. Regardless of the above classification rules, Reg. 301.7701-2(b)(7) imposes corporate classification on a business entity that is required to be treated as a corporation under any other provision of the Code. Accordingly, a publicly traded partnership treated as a corporation under Section 7704 or a Section 7701(i) taxable mortgage pool may not elect out of corporate status.

**Election out of Subchapter K.** Section 761(a) permits an unincorporated organization availed of (1) for investment purposes only and not for the active conduct of a business, (2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or (3) by certain dealers in securities, to elect to be excluded from all or a portion of Subchapter K. The election out is available only if the organization's members can adequately determine their income without the computation of partnership income.

A Section 761(a) election may be made only by a qualifying entity that would otherwise be subject to Subchapter K. An entity that is treated as a partnership for federal tax purposes (whether by election or operation of the default rule) then will be entitled to elect out of Subchapter K if it meets the requirements of Section 761(a). Accordingly, the choice of whether to make an election out is not affected by the Regulations.**

Clarifications regarding listed foreign per se corporations. The Regulations clarify the per se corporation treatment of entities formed in Aruba, Canada, People's Republic of China, Republic of China (Taiwan), India, Indonesia, Netherlands Antilles, and Sweden. The modifications to the Proposed Regulations include:

- **Aruba.** A Naamloze Vennootschap is no longer treated as a per se corporation.
- **Canada.** The Proposed Regulations

**Notes**

11 Prop. Reg. 301.7701-3(b)(2)(ii) treated newly formed foreign eligible entities as associations if no member had unlimited liability. To ensure that contractual joint ventures (in which members are not jointly and severally liable for all debts of the entity but have unlimited liability for only a certain proportion of the entity's debts) would not default to association status, the language was modified.

12 Reg. 301.7701-3(b)(2)(ii)(C).

13 In this regard, it is the Service's position that a separate juridical entity cannot elect out of Subchapter K because the partners do not own the property as co-owners. See Regs. 1.761-2(i)(2)(ii) and -2(i)(3)(ii). As a result, it is unlikely that an LLC will be able to elect out of Subchapter K.

14 See part II.C. of the Preamble to the Proposed Regulations. The final Regulations do not change this conclusion.

15 Reg. 301.7701-2(b)(8). See also the Preamble to TD 8697, part B.
treated all Canadian corporations as per se corporations. Reg. 301.7701-2(b)(8)(ii)(A) provides that any corporation or company formed under any Canadian federal or provincial law where all the entity's members have unlimited liability will not be treated as a per se corporation.

- People's Republic of China. A Gu fen Youxian Gongsi rather than a Company Limited by Shares will be treated as a per se corporation.
- Republic of China (Taiwan). A Ku fen Yu-hsien Kung-szu rather than a Company Limited by Shares will be treated as a per se corporation.
- India. A company deemed to be a public limited company solely by operation of Section 43A(1) (relating to corporate ownership of the company), Section 43A(1A) (relating to annual average turnover), or Section 43A(1B) (relating to ownership interests in other companies) of the Companies Act, 1956 (or any combination of these), provided that the organizational documents of such deemed public limited company continue to meet the requirements of Section 3(1)(iii) of the Companies Act, 1956, will not be treated as a per se corporation.
- Indonesia. A Perseroan Terbuka will be treated as a per se corporation.
- Netherlands Antilles. A Naamloze Vennootschap is no longer a per se corporation.
- Sweden. A Publika Aktiebolag will be treated as a per se corporation.

Finally, Reg. 301.7701-2(b)(8)(iii) provides that with regard to Cyprus, Hong Kong, Jamaica, or Trinidad and Tobago, a public limited company includes any limited company that is not a private limited company under local law.

Future modifications to the per se

foreign corporation entity list will be announced in a notice of proposed rulemaking and will be prospective only.16

Classifying a Pre-1997 Business Entity

Under Reg. 301.7701-3(b)(3)(i), an eligible domestic entity in existence before 1997 (a "pre-existing entity") that chooses to retain its classification will not be required to act—its status simply continues as previously claimed unless it is a single-member entity that had claimed to be a partnership. In that situation, the single-member entity will be disregarded as an entity separate from its owner. Only an entity that chooses to change its status should file an election (and, as discussed below, filing such an election to change status may have adverse consequences).

Pre-existing foreign eligible entities. Reg. 301.7701-3(b)(3)(ii) provides that a foreign eligible entity is treated as being in existence before 1997 only if its classification was relevant at any time during the 60 months prior to 1/1/97. For this purpose, if different classifications were claimed by an entity before 1997, its classification is the last one claimed. If an entity's classification is relevant prior to 1997 but no federal tax or information return was filed, or the returns filed did not indicate the entity's classification, the entity's classification for the period before 1997 is determined under the old Regulations.

Reg. 301.7701-3(d)(1) provides that a foreign eligible entity's classification is relevant when it affects the liability of any person for federal tax or information purposes. Usually this is the date it becomes necessary to file a federal tax return, information return, or statement for which the entity's classification must be determined. For example, a foreign entity's classification is relevant if U.S. income was paid to the entity and the tax withholding under chapter 3 of the Code varies depending on whether the entity is a partnership or an association. Since the entity's classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared, the entity's classification is relevant no later than the date on which an interest in the entity is acquired that would require a U.S. person to file an information return on Form 5471.

Lapse in relevancy. It is possible that a foreign entity's classification may be relevant, cease being relevant, then become relevant again. If classification has not been relevant for 60 months or more, when classification is again relevant the entity will be treated as a new entity (with its classification determined under the default rules previously discussed).17 If, however, classification relevancy is re-established within 60 months, generally the entity will retain its prior classification.18 Accordingly, when a person's acquisition of a foreign eligible entity interest causes that entity's U.S. tax classification to become relevant, the acquiree should inquire about the entity's classification relevancy during the last 60 months.

Example: J, a U.S. resident, and X, a foreign corporation, own 20% and 80%, respectively, of Z, an eligible foreign business entity doing no business in the U.S. Z elected to be treated as a corporation for U.S. tax purposes; X has unlimited liability under the law of the country in which Z was organized. On 6/1/97, J sells his interest in X to S, a foreign person. Concurrent with J’s sale, Z’s U.S. tax classification is no longer relevant for U.S. tax or information purposes. On 12/1/99, U.S. resident R purchases S’s 20% interest in Z. Rather than Z being treated as a new entity, Z would return to its prior corporate classification. Accordingly, R will be treated as a shareholder of Z rather than a partner under the default rules of Reg. 301.7701-3(b)(2)(i)(A).

Making a Classification Election

Reg. 301.7701-3(c) provides that an eligible entity should make a classification election by filing Form 8832 with the service center designated on the form. The instructions on the form provide that the Philadelphia service center should be used. An election will not be accepted unless all of the information required by Form 8832 (and its

NOTES

16 See the Preamble to TD 8697, part B.
17 Reg. 301.7701-3(d)(2). The 60-month intermission was added in the final Regulations in response to queries concerning the proper treatment of an entity whose classification relevancy is interrupted by a period in which the entity's classification is not relevant.
18 See the Preamble to TD 8697, part C.
instructions), including the entity’s taxpayer identification number, is provided.

In addition to the Philadelphia service center filing requirement, Reg. 301.7701-3(c)(1)(ii) provides that an electing eligible entity must attach a copy of Form 8832 to its federal tax or information return for the tax year for which the election is made. If the entity is not required to file a return for that year, a copy of Form 8832 must be attached to the federal income tax or information return of any direct or indirect owner of the entity for the tax year of the owner that includes the election’s effective date. An indirect owner need not attach a copy of Form 8832 to its return if a copy is being filed by an entity in which the indirect owner holds an interest. Failure to follow this additional notification requirement will not invalidate an otherwise valid election but the Regulations caution that the nonfiling party may be subject to penalties, including applicable penalties for filing returns inconsistent with their entity’s election.

Example: AB is an eligible entity that began business on 11/23/97, the date it was formed by A, a calendar-year individual who owns a 75% profits and capital interest, and B, an October 30 fiscal-year corporation that owns the remaining 25%. A and B want to ensure that AB is classified as a partnership for federal tax purposes. Accordingly, an election is filed with the Philadelphia service center on Form 8832 in accordance with Reg. 301.7701-3(c)(1) on 12/31/97, designating AB as a partnership beginning 11/23/97. AB’s majority interest tax year is the calendar year, under Section 706(b)(1)(B)(i). Therefore, AB’s first return will be for the period ended 12/31/97. AB will include a copy of Form 8832 with its 1997 partnership return. If AB remains inactive until 1/3/98 (and, therefore, has no return filing obligation for 1997), Reg. 301.7701-3(c)(1)(ii) requires that a copy of its classification be attached to the 1997 federal income tax return of either A (initially due 4/15/98) or B (initially due 1/15/99).

Reg. 301.7701-3(c)(1)(iii) provides that a classification election may be made at any time and will be effective on the date specified on Form 8832, provided the date selected is not more than 75 days prior to, or more than 12 months after, the date Form 8832 is filed. If no date is specified on the election form, the election will be considered effective on the date it is filed. Should an election specify an effective date more than 75 days prior to or 12 months after the date Form 8832 is filed, it will be effective on the date that is either 75 days prior to or 12 months after the election filing date, as appropriate. Under no circumstances will an election be considered effective prior to 1997.

Signing the election. Reg. 301.7701-3(c)(2) requires that an election must be signed by (1) each member of the electing entity who is an owner at the time the election is filed or (2) any officer, manager, or member of the electing entity authorized (under local law or by the entity’s organizational documents) to make the election and who represents as to having such authorization under penalties of perjury. An election requesting an effective date that is prior to the date Form 8832 is filed will not be effective unless all persons who were owners during the interim period consent (by signing Form 8832) to the classification chosen.

Under the default mechanism, a domestic eligible entity need affirmatively act only when it desires to be classified as a nonpartnership.

The Regulations do not discuss the process of delegating authority to make a classification election, how specific any grant of authority must be, or whether any granted election authority may be restricted to an initial election. Form 8832 simply requires that the signing person affirm their authority under penalties of perjury. Presumably, a person is authorized to make an election provided that person has actual or apparent authority under local law agency principles. Accordingly, care must be exercised to prevent a disgruntled member (or designated third person) with authority under local law from executing a Form 8832 without the knowledge or consent of the other members.

Limitation on elective classification changes. An eligible entity that makes a classification election (other than an existing entity that makes an election to change its classification as of 1/1/97) is barred, by Reg. 301.7701-3(c)(1)(iv), from changing its classification during the succeeding 60 months. This rule applies only to changes in classification by election—a new entity that elects out of its default classification at formation is not considered to have made a change. A waiver of this 60 month re-election prohibition is available if more than 50% of the ownership interests in the entity on the subsequent election date are owned by persons that did not own any interests in the entity on the filing date or the effective date of the entity’s prior election. While “ownership interest” is not defined in the Regulations, this rule differs from the requirements used in determining whether a Section 708(b)(1)(B) technical termination has occurred.

Example: A owns a 30% profits interest in PS, a partnership currently subject to Reg. 301.7701-3(c)(1)(iv)’s classification change limitation rule. B owns the remaining 70% profits interest and a 100% capital interest in PS. If B transferred a 60% capital and a 10% profits interest to C, PS could change its classification by making a new Reg. 301.7701-3(c)(1) election (with the Service’s approval); PS would not technically terminate under Section 708(b)(1)(B).

Notes:

19 Reg. 301.7701-3(c)(1)(iii). Where an election specifies a date prior to 1997, it will be considered effective on 1/1/97.

20 This retroactive election owner requirement applies even if the election is being made by an authorized person. See the Preambles to TD 8697, part C.

21 Cf. Reg. 301.6231(a)(7)-1 (specific requirements for designating a tax matters partner).

22 See the Preambles to TD 8697, part C. See also the Preamble to the Proposed Regulations, part III.C.3.
If instead B owned a 69% profits interest and a 100% capital interest, C already owned 1% of PS's profits interest, and B transferred a 60% profits interest and a 60% capital interest to C, PS would terminate under Section 708(b)(1)(B). Since the reconstituted entity would be treated as another partnership under Reg. 301.7701-3(e), it should be entitled to make a new classification election despite its predecessor having made a classification election within the past 60 months. Although IRS consent would not be available under Reg. 301.7701-3(c)(1)(iv)'s waiver procedure (because C owned an interest in PS at the time of B's transfer to C), reconstituted PS should be considered a new entity, entitled to make a new classification election.

It is unclear from the Regulations as to whether an entity will be eligible to request a waiver of the 60 month election restriction where there has been an indirect change of more than 50% of an entity's ownership interests. For example, if a partnership is owned equally by two partnerships and the ownership interests of both of the owning partnerships completely change, will the requesting partnership be considered to have had an ownership change? Future guidance from the IRS will be needed to clarify this issue, which will probably take the form of private letter rulings. Approval for a second change within the 60-month restriction period that follows an election may be obtained only by letter ruling and will not be granted unless there has been more than a 50% ownership change. Finally, the Preamble notes that this 60-month restriction applies on an entity-by-entity basis. Thus, the limitation may be avoided by transferring an entity's business to another entity.

Notes:
23 Had AB not terminated under Section 708(b)(1)(B), AB would not have been eligible to request the IRS to allow it to change its partnership classification until Reg. 301.7701-3(c)(1)(iv)'s 60-month period had ended. Although there would have been a more than 50% ownership change (from B to C), C already owned an interest in AB (i.e., 1% of profits), making AB ineligible for an IRS waiver of the 60-month limitation rule.
24 See the Preamble to TD 8697, part C.
25 Id., part B.

Protective elections. An entity that is uncertain as to whether it is a business entity may make a protective election. For example, an entity believes it is a trust rather than a business entity but some doubt exists about this conclusion. The entity could make a protective election to ensure partnership or corporation status. The IRS later determine it to be a business entity. Similarly, protective elections also may be appropriate for:
- A foreign entity formed after 1996 that is uncertain as to whether it is a partnership or corporation.
- An entity in existence before 1997 that believes it is a corporation and that wants to retain corporate status.

Caution should be exercised when making a protective election, however. If an entity in existence before 1997 believes it is a partnership and makes a protective partnership election, and is ultimately determined by the IRS to have been a corporation (i.e., it had no reasonable basis for claiming partnership status), the entity would be treated as having liquidated and distributed its assets to its shareholders, followed by a contribution of those assets to a new partnership. This deemed liquidation could result in gain to the distributees if the distributed property's FMV exceeds the distributees' tax bases in their corporate stock.

Deemed elections. It is possible that an eligible entity will be deemed to have chosen association status, under Reg. 301.7701-3(c)(1)(v). An eligible entity determined to be, or that claims to be, exempt from taxation under Section 501(a) will be deemed to have elected association status as of the first day the entity is deemed to be, exempt from taxation under Section 501(a). If X's tax-exempt claim is considered effective 1/1/97, it is deemed to have elected association status on that date. Presumably, C and D need not obtain A and B's approval to treat X as a corporation.

Similarly, Reg. 301.7701-3(c)(1)(v) (B) provides that an eligible entity electing REIT treatment under Section 856(c)(1) will be deemed to have made an election under Reg. 301.7701-3(c)(1) to be classified as a corporation as of the first day the entity is treated as a REIT. Since an entity must be treated as a corporation for federal income tax purposes before it can make a REIT election, a business trust desiring REIT status, but that had elected to associate status within 75 days of beginning business, would have been unable to make a REIT election. The REIT deemed election rule prevents this inadvertent circumstance from occurring.

Coordination with termination rules. Except as provided in Reg. 301.7701-2(d)(3) (regarding termination of grandfather status for certain foreign business entities), a reconstituted entity resulting from a Section 708(b)(1)(B) termination, or an entity...
resulting from a Section 708(b)(2)(B) division, will be a partnership.

Effective Data and Transition Rules
Reg. 301.7701-3(f)(1) states that the new classification rules are effective as of 1/1/97.

Transition rule safe harbor. Under Reg. 301.7701-3(f)(2), the classification of an eligible entity in existence before 1997 will be respected by the IRS for all periods before that date if all of the following conditions are met:
1. The entity had a reasonable basis (within the meaning of Section 6662) for its claimed classification.
2. The entity and all of its members recognized the federal tax consequences of any change in the entity's classification within the 60 months prior to 1997.
3. Neither the entity nor any member was notified in writing on or before 5/8/96 that its classification was under examination.

The transition rule in Prop. Reg. 301.7701-3(e)(2)(ii) would have granted transition relief only if a pre-existing entity had claimed the same classification for all prior periods. The final rule acknowledges that having more than one prior period classification is not relevant for transition purposes, provided an entity appropriately recognizes the federal tax consequences associated with a prior period classification change. Thus, for example, an entity treated as a corporation that modified its organizational documents to achieve partnership status would not be prohibited from using the transition rule provided it recognized the tax consequences of its corporate liquidation. As noted earlier, under Reg. 301.7701-3(b)(3)(ii) a foreign eligible entity is considered to be in existence before 1997 only if its classification was relevant to any person for federal tax or information purposes.

Special grandfather rule for pre-existing foreign business entities. Reg. 301.7701-2(b)(8) treats certain listed foreign business entities as per se corporations. Under a grandfather exception, however, a listed foreign business entity historically treated as a partnership may continue to be classified as a partnership if all of the following conditions are met:
1. The entity was in existence on 5/8/96.
2. The entity's classification was relevant (as defined in Reg. 301.7701-3(d)) on 5/8/96.
3. No person (including the entity) for whom the entity's U.S. tax classification was relevant on 5/8/96 treated the entity as a corporation for purposes of filing a federal income tax return, information return, or withholding document for the tax year including 5/8/96.
4. Any change in the entity's claimed classification within the 60 months prior to 5/8/96 occurred solely as a result of a change in the organizational documents of the entity, and the entity and all of its members recognized the federal tax consequences of any such change in classification within the 60 months prior to 5/8/96.
5. The entity had a reasonable basis (within the meaning of Section 6662) on 5/8/96 for treating itself other than as a corporation.
6. Neither the entity nor any member was notified in writing before 5/9/96 that the entity's classification was under examination.

This grandfather rule is somewhat different from its counterpart in Prop. Reg. 301.7701-2(d). Most helpful is the elimination of the requirement that an entity wishing to avail itself of the grandfather rule have claimed partnership status for all periods prior to and including 5/8/96. Taxpayers argued that this requirement would have precluded grandfather treatment for entities that had restructured in the past even though the resulting tax consequences had been recognized. The IRS agreed; an entity may now use the grandfather rule even if it changed its status before 5/8/96, but only (1) if the tax consequences of any change within the 60 months preceding 5/8/96 have been recognized by the entity and its members and (2) no member for whom classification was relevant on 5/8/96 treated the entity as a corporation for federal income tax, information return, or withholding return purposes. Accordingly, those who want to continue to treat a pre-5/9/96 foreign per se corporation as a partnership must insure that no member's reporting jeopardizes their ability to use the Reg. 301.7701-2(d)(1) grandfather rule.

The grandfathered per se corporation rule is also available for an entity formed after 5/8/96 provided the entity is formed pursuant to a written binding contract (including an accepted bid to develop a project) in effect on that date and all times thereafter, to engage (directly or indirectly) in an active and substantial business operation in the jurisdiction in which the entity is formed.

Finally, grandfathered foreign partnerships must avoid transactions or events that would terminate their special status. Reg. 301.7701-2(d)(3) caution that a grandfathered partnership will not receive grandfather treatment after a Section 708(b)(1)(B) termination or if it participates in a Section 708(b)(2)(B) division. Fortunately, Reg. 301.7701-2(d)(3)(ii) provides that the loss of grandfather status may be avoided where the sale or exchange of interests causing a termination is among related persons.

A summary of the Regulations' classification process appears in flowchart form in Exhibit 1 on pages 204-205.

Redetermined trusts. An entity claiming to be a trust for the period before 1997 and that subsequently is determined to be a business entity will be entitled to choose its classification at the time it is determined to be a business entity. This choice, made at the time status is redetermined, applies for purposes of the pre-existing entity transition rule.

Notes
20 Reg. 301.7701-2(d)(2).
27 See the Preamble to TD 8697, part D.
EXHIBIT 1

The Check-the-Box Decision-Making Process

Separate taxable entity

no  yes

Rules do not apply:
1. Joint undertaking
2. Owned by state
3. Indian tribes
4. Qualified cost sharing arrangement

Associates and profit objective?

no  yes

Trust

Preexisting entity?

no  yes

Eligible entity?

yes  no

Per se corporation:
1. Organized under federal or state statute that refers to entity as "incorporated"
2. Joint stock company
3. Insurance company
4. Bank
5. Owned by state
6. "Listed" foreign entity

Eligible entity?

no  yes

May not elect; retains prior status (special grandfathering for per se entity)

Foreign entity?

yes  no

Classification relevant to any person for federal tax or information purposes within the 60 months preceding 1/1/97?

Members want to retain status?

yes  no

No action required (a single-member LLC that claimed partnership status, however, is treated as disregarded entity)

File election to pick status

Treated as a preexisting entity; retain classification unless election made

Classify when relevant
PARTNERSHIPS, S CORPORATIONS, AND LLCs

Is entity foreign or domestic?

Domestic

Foreign

Does entity have two or more members?

yes

no

Has classification been relevant within last 60 months?

yes

no

Does entity have two or more members?

yes

no

Retain previous classification or elect new classification

Want association status?

no

yes

Do nothing—default rule applies; entity is a partnership

Elect out of default rule; election may be retroactive 75 days or prospective no more than 12 months

Do nothing—entity will be disregarded under default rule

Do all members have limited liability?

yes

no

Entity default is:
1. Disregarded if member has unlimited liability, or
2. Association taxable as a corporation if member has limited liability but
3. The entity may elect the alternative classification

Classified as an association, taxable as a corporation

Partnership

Does entity want to be an association?

yes

no

Do nothing

Elect partnership status

Does entity want to be a partnership?

yes

no

Do nothing

Elect association status
EXAMPLE: Entity X was organized in 1983 as a state law trust; its organizers believed X to be a trust for federal tax purposes. In 1997, X is audited and the IRS determines that no reasonable basis existed for X's claim that it was a trust for tax purposes. Rather, it is determined that X is a business entity. Accordingly, X need not determine its classification under the Regulations for the period prior to 1997 as a state law trust; its organizers may choose its classification under the Regulations on discovering that they had worked to the taxpayer's detriment in a particular case. According to the JCT staff's review following the conference on 11/25/96 stating that their entity classification review was precipitated by the Regulations and the widespread state extension of limited liability statutes.

If local law single-member entity formation requirements are disregarded, state law limited liability protection could be lost.

Additionally, the JCT staff voiced its concern regarding the policy of effectively imposing a toll charge (i.e., a double tax regime) only on entities that need access to the public debt and equity markets. Finally, concerns were raised about the possibility that an aggrieved taxpayer might successfully challenge the legislative authority of the Regulations on discovering that they had worked to the taxpayer's detriment in a particular case. Accordingly, one possible recommendation following the JCT staff's review would be that Congress simply codify the Regulations by explicitly granting Treasury the authority to write classification Regulations.

Although the impact, if any, of the JCT staff's review cannot be determined until it is completed, it seems clear that taxpayers must rely on the Regulations in the interim. Undoubtedly, the validity of the Regulations will depend on whether it is ultimately determined that Treasury was acting within the permissible bounds of administrative construction in revising the Regulations. Until this matter is resolved, however, it would be prudent to contractually require all entity members and their assignees to agree not to challenge the entity classification chosen.

Bona fide owners. Several commenters requested that the Regulations provide guidance as to when a member will be respected as a bona fide owner for federal tax purposes. The concern was highlighted by the treatment of single-member entities in the Proposed Regulations. A two-person domestic entity that was thought to be a partnership would simply default to disregarded entity status if the interest of a member is determined to be too nominal, making this issue of little concern for most domestic entities. It may be of more concern to foreign entities, however.

EXAMPLE: J is a foreign entity owned by M, a U.S. person and N, a foreign person. N's interest is nominal and exists because local law permits foreign entities to operate in the jurisdiction only if a local person (with unlimited liability) has an ownership interest in the foreign entity. M has limited liability with respect to J. If N is disregarded as a de minimis member, J will default to corporation status since its sole remaining member has limited liability.

In response to the comments received, the Service stated that the determination of whether an organization has more than one owner must be based on all the facts and circumstances. Although raised in the context of the Regulations, this issue appears to have been covered in part by the legislative history of Section 707(a)(2)(A) in DRA '84. That section provides that a purposed partnership interest representing an allocation and distribution of partnership income may be determined to be a disguised fee for services or payment for property. The legislative history goes through an extensive six-factor analysis to determine whether a partner that receives such an allocation is, in fact, a partner. It appears that a person respected as a partner under this analysis also should be treated as a partner in determining whether an entity has more than one member. The fact that some or all of an organization's owners are under common control (as described in Rev. Rul. 93-4, 1993-1 CB...
225), however, does not require the common parent to be treated as the sole owner.

Form of conversions. An existing eligible entity's election to change its status must consider the federal tax consequences, if any. Rev. Rul. 84-111, 1984-2 CB 88, for example, set forth three different forms taxpayers may use when incorporating a partnership.

The Regulations do not elaborate on whether a particular form must be used when an eligible entity elects to change its classification. The Preamble to TD 8697 indicates that Treasury and the IRS are considering issuing guidance on this matter. It is likely that guidance will mandate a form to be used since, unlike Rev. Rul. 84-111's incorporation scenario, a partnership-to-corporation or corporation-to-partnership conversion by election has no form. Presumably, pending the issuance of further guidance, taxpayers should be free to choose the conversion form most advantageous to them.

Single-member entities and Section 1031. As indicated above, the Regulations disregard a single-member entity for federal tax purposes unless the entity elects to be treated as a corporation (or, if a foreign entity, defaults to corporate status because its one member has limited liability). Presumably, this disregard will enable the exchange of state law single-member LLC interests if the entities in which such interests are exchanged hold qualifying like-kind property. It is expected the Treasury will clarify this matter with additional guidance.

State tax considerations. It is not clear how the 50 states will react to the Regulations. Certainly, the majority "piggyback" the federal rules for general tax purposes, but it is not known if they will follow the federal lead with regard to entity classification. For example, New York has officially adopted the Regulations, while California has unofficially given indications that it will not. Should states continue to apply the old Regulations' four-factor classification analysis, it will be necessary to retain that analysis in an entity's operating documents.

Of more significance is the ability to disregard wholly owned unincorporated entities. Again, it is not clear whether every state will follow the federal disregarded-entity concept. Some states require more than one member to form an LLC. If the wholly owned disregarded entity becomes a popular vehicle for holding business assets, more states will modify their LLC statutes to allow for single-member LLCs.

PLANNING CONSIDERATIONS

The Regulations provide an excellent opportunity for all businesses to re-examine their existing structures and future business plans.

Corporate Restructuring

The Regulations offer new opportunities to traditional corporate federal tax planning for both new and existing corporations.

Avoiding the S corporation subsidiary restriction. The single-member disregarded entity will facilitate S corporation planning with affiliated entities.

The Small Business Jobs Protection Act of 1996 (P.L. 104-188, 8/20/96) modified Subchapter S to allow S corporation subsidiaries to own C corporation subsidiaries; an S corporation owning 100% of a qualified Subchapter S subsidiary (QSSS) may disregard that entity. Only a domestic entity may be a QSSS. With the Regulations' single-member disregarded entity concept, however, the same structure is possible even if the owned subsidiary is a foreign entity. Such a structure will allow an S corporation parent to be treated as incurring foreign taxes directly, and title its shareholders to a foreign tax credit. Thus, the combination of the newly enacted Subchapter S subsidiary rules and the Regulations will make S corporation planning with affiliates much more flexible and practical.

Consolidated return alternative

Section 1501 affords an affiliated group of eligible corporations the privilege of calculating its federal income tax liability by making a consolidated return. Filing as a consolidated group offers many benefits, including (1) using unused losses of a member or members to offset current income of other group members, subject to many exceptions including the separate return limitation year (SRLY) rules and possibly Section 382. (2) excluding from the distributee's gross income dividends paid by another member, (3) generally deferring profits from intercompany transactions, and (4) adjusting a parent's tax basis in a subsidiary to reflect the subsidiary's distributions, taxable income or loss, certain tax-exempt income, and noncapital, nondeductible items.

There are several disadvantages of filing a consolidated return, including (1) a general prohibition on deducting losses from the disposition of member stock, (2) the general irrevocability of the election to make a consolidated return, (3) deferral of intercompany losses, and (4) the inclusion in income of "excess losses" in a parent's basis in its subsidiary on the disposition of the subsidiary's stock.

Subject to exit strategy complica-
tions and state tax issues discussed later, the Regulations' disregard of a single-member LLC may offer a viable alternative to a consolidated return structure. Division treatment would enable an owner to benefit from the losses attributable to its wholly owned LLC without being concerned about SRLY or other loss limitation restrictions. Similarly, "dividends" paid by a single-member LLC would be disregarded, as would the gain or loss associated with intercompany transactions. On the other hand, if a parent wants to sell a subsidiary and has a higher basis in the subsidiary's stock than the subsidiary has in its assets, a consolidated return enables the parent to obtain the advantage of that excess stock basis to reduce its gain. A parent that wishes to dispose of a single-member LLC would not have that advantage.

Exit strategy complications. Corporate shareholders have a variety of techniques available when considering the disposition of a corporation, including selling the corporation's assets or stock, engaging in a Section 368 tax-free reorganization, or spinning or splitting off a subsidiary under Section 355. Similarly, corporate purchasers often consider whether an asset or stock purchase makes the most sense, the impact of making a Section 338 or 338(h)(10) election, and the benefit of any corporate attributes (subject to Sections 269, 382, 384, and other limitations) in the target.

In contrast, a corporation that forms a single-member LLC as an alternative to a corporate subsidiary, that owns additional assets not held in the LLC, and that wishes to dispose of the LLC's assets, will be limited to selling the LLC's assets. Although a non-S corporation parent always could incorporate a division, any planned attempt to use Section 351 as a means of converting a taxable asset sale into a tax-free exchange (e.g., a B reorganization) will not be permitted; the IRS will recharacterize, as an asset transfer rather than a stock disposition, any purported transfer of LLC assets to a new corporation (Newco) or existing subsidiary (Sub) that is followed by the immediate disposition of the Newco or Sub stock to an acquiring corporation. Accordingly, a transfer by a parent of a single-member LLC's assets to a new corporation must be other than as part of a plan to engage in a tax-free reorganization.

For an asset acquisition to be tax free, it must satisfy the requirements of Section 368(a)(1)(A), (C), (D), or (a)(2)(D), or Section 351. If the transferor-corporation is not disposing of all of its assets in the transaction (e.g., if it is not selling the assets held in its other single-member LLCs), the asset transfer will not qualify as a merger unless the transferor first distributes to its shareholder via a spinoff all of the assets that Acquiring does not want, after which the transferor can merge into Acquiring. A spinoff must satisfy the requirements of Section 355, including the requirements that Distributing and Controlled each be engaged in a five-year active trade or business and that the transaction be undertaken for a valid business purpose. This is not easily accomplished.

Absent a spinoff, for a transfer to qualify for tax-free treatment it must qualify under Section 351 (meaning the LLC's owner must control acquiring immediately after the transfer) or satisfy the substantially all requirement of Section 368(a)(1)(C), (D), or (a)(2)(D). Section 351 will apply only if either (1) the transferor transfers assets representing 80% of the value of Acquiring after the transfer or (2) the other shareholders of Acquiring contribute significant assets to Acquiring in conjunction with the transfer of the LLC's assets. The substantially all requirement cannot be met if the transferor retains operating assets of any significant value. The transfer of the assets of one single-member LLC division while the transferor retains assets in other single-member LLCs would make it difficult, if not impossible, for the contributor-parent to satisfy the substantially all requirement.

Foreign Tax Matters

The Regulations should enable most foreign entities to achieve partnership classification for U.S. tax purposes quickly, and with more certainty, than ever before. This should encourage U.S. businesses to use hybrid entities in international structuring. In fact, concern over the proliferation of hybrids is apparently what led to the warning that Treasury and the IRS will monitor the use of international partnerships to ensure that they are not being used inconsistently with the policies and rules of the Code or U.S. tax treaties.

Additionally, the ability to have a single-member entity treated as a branch may be quite significant to multinational groups. For example, a U.S. corporation that owned a foreign single-member entity could make outbound "transfers" of property, including cash, operating assets, and intangibles to that entity without being subject to Sections 367 or 1491.

The use of a branch structure could also reduce Subpart F deemed dividend transactions. Since many "intercompany" transactions would be between branches of the same corporation rather than affiliated controlled foreign corporations, in many instances Subpart F income simply would not arise.

CONCLUSION

The check-the-box Regulations represent tremendous simplification for most domestic and foreign entities. The Regulations deal with most of the significant questions that were unanswered under the Proposed Regulations. Although some of the momentum has been taken from the Regulations by the news of the pending review by the ICT staff, taxpayers should see immediate benefits from this regulatory effort. ■