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I. Introduction

On March 29, 1995, the Department of the Treasury (Treasury) issued Notice 95-14[1] in which it announced its intent to simplify the tax entity classification rules.[2] Within two years, on December 17, 1996, the Treasury finalized these rules that are popularly known as the "check-the-box" regulations.[3] The new regulations permit an eligible entity to indicate its desired tax treatment simply by checking a box.[4] This Note explains how the new regulations affect the classification of entities for tax purposes. Part II presents the fundamental distinction between corporate and partnership tax classification.[5] Part III summarizes the history of entity classification for federal tax purposes.[6] Part IV explains how an entity selects tax classification under the new check-the-box regulations.[7] Part V addresses the poten-

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1. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (proposing simplification of entity classification rules). Notice 95-14 addressed the prospect of simplifying Treas. Reg. §§ 301.7701-2 to -3. *Id.* Notice 95-14 states in part:

> The Service and Treasury are considering simplifying the existing classification regulations to allow taxpayers to elect to treat certain domestic unincorporated business organizations as partnerships or as associations for federal tax purposes. This approach would apply to all such organizations that have two or more associates and an objective to carry on business and divide the gains therefrom, unless the organization's classification is determined under another Code provision.

Id.

2. *See* Daniel Shefter, *Check the Box Partnership Classification: A Legitimate Exercise in Tax Simplification*, 67 TAX NOTES 279, 279 (1995) (stating that Treasury's announcement "almost sounds too good to be true"); *see also* Prop. Treas. Reg. §§ 301.7701-2 to -3, 61 Fed. Reg. 21,989 (1996) (providing proposed revisions to entity classification rules); *Attorney Urges Prompt Implementation of Check-the-Box Entity Classification Scheme for Domestic Organizations*, 68 TAX NOTES 1286, 1286 (1995) [hereinafter *Attorney Urges*] (recommending that Service implement election process immediately for domestic organizations); *NYSBA Tax Section Strongly Endorses 'Check-the-Box' Entity Classification Proposal*, 68 TAX NOTES 1285, 1285 (1995) [hereinafter *NYSBA*] (supporting prompt adoption of check-the-box regulations proposed by Notice 95-14).

3. *See* T.D. 8697, 1997-2 I.R.B. 11 (finalizing simplified entity classification rules); Sindhu G. Hirani, *IRS Issues Final 'Check-The-Box' Rules; Practitioners Find New Version Favorable*, Daily Tax Rep. (BNA) No. 243, at GG-1 (Dec. 18, 1996) (commenting that Treasury issued "long-awaited" check-the-box rules).

4. *See* Shefter, *supra* note 2, at 279 (noting that check-the-box system would allow taxpayers to elect treatment as either partnership or association status for tax purposes).

5. *See infra* notes 9-29 and accompanying text (discussing corporate-partnership tax distinctions).

6. *See infra* notes 30-94 and accompanying text (discussing former regulation scheme and its inadequacies).

7. *See infra* notes 95-147 and accompanying text (discussing application of check-the-box).

tial problems and opportunities that may accompany the new regulations during their transition into practice.[8] Part VI concludes that the check-the-box regulations provide a simple and efficient means for determining entity tax classification.

II. The Stakes: Partnership v. Corporate Classification

In the game of entity classification, choosing the most beneficial tax status for an entity is at stake. In most cases, the choice will result either in corporate or partnership tax status. Corporate tax status exposes an entity's income to double taxation because the Internal Revenue Code (Code) taxes corporate income at the corporate entity level and at the shareholder level.[9] On the other hand, partnerships, limited partnerships, limited liability partnerships (LLPs), and limited liability companies (LLCs) escape the entity-level tax.[10] Instead, their income flows through to the partners or members, and the Code taxes this income only at the individual partner's or member's rate.[11] Likewise, partners and members directly deduct partnership tax losses.[12]

To explain the effect of the difference between corporate and partnership tax treatment, consider the following example. A corporation producing $100 worth of taxable income can be taxed up to the 35% maximum corporate rate.[13] After taxes, the corporation has only $65 to disburse to its shareholders in the form of a dividend.[14] The Code taxes shareholder

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8. *See infra* notes 148-241 and accompanying text (discussing effects of new regulations in practice).

9. *See* I.R.C. § 11(b) (1996) (establishing corporate tax rate); *id.* § 61(a)(7) (including dividends in gross income). The highest tax rate imposed on a corporation is 35%. *Id.* § 11. The highest individual rate is 39.6%. *Id.* § 1. The dividend income an individual receives from a corporation is taxed both at the corporate level and when it is included in the individual's gross income. *Id.* § 61(a)(7).

10. *See id.* § 701 (providing no taxes on partnerships as separate entities). Section 701 provides: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." *Id.*

11. *See id.* (explaining that partners and not partnerships have tax liability).

12. *See* 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 2.02[4][a] (2d ed. 1990) (listing major tax advantages of operating in partnership form). Other tax advantages include no double taxation on the liquidation or sale of the business, distributions of appreciated property generally not causing the partnerships to recognize a gain, and the purchaser of a partnership interest being able to obtain a cost basis in the purchased share of partnership assets. *Id.*

13. *See* I.R.C. § 11(b) (listing tax rates for corporations).

14. *See id.* §§ 301, 316 (defining dividends and establishing their taxation).

dividends up to a maximum 39.6% rate for individuals.[15] Thus, the shareholders receive only $39 out of every $100 of corporate earnings because of double taxation.[16] In contrast, the Code does not impose an entity-level tax on partnerships.[17] Instead, $100 earned by a partnership flows through to the partners and the Code only taxes this amount up to the 39.6% maximum individual rate.[18] Therefore, partners in most circumstances ultimately receive $60 for every $100 of partnership income.

Tax treatment of partnerships was traditionally counterbalanced by the disadvantages of the partnership form, most notably individual liability for partnership debts.[19] However, these disadvantages are largely a remnant of the past. At one time, limited liability distinguished partnerships from corporations.[20] The corporate form allows shareholders to avoid personal liability for debts and obligations of the corporation.[21] Corporate creditors may not proceed against the personal assets of the corporation's shareholders.[22] Conversely, partnership creditors may proceed against a partner's personal assets to satisfy partnership liabilities.[23]

The limited liability distinction vanished over the years as partners devised new entity configurations to limit their liability. The first such entity was the limited partnership.[24] A limited partnership is a two-tiered structure

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15. *See id.* § 61(a)(7) (including dividend income in individual's gross income); *id.* § 1(a)-(d) (providing 39.6% maximum tax rate for individuals).

16. $100 x (100%- 35%) = $65. $65 x (100%-39.6%) = $39.

17. *See* I.R.C. § 701 (1996) (taxing partners rather than partnership). Section 701 provides in part that "partners shall be liable for income tax only in their *separate* or *individual* capacities." *Id.* (emphasis added).

18. *See id.* (requiring taxation of partners individually).

19. *See* 1 MCKEE ET AL., *supra* note 12, ¶ 2.02[4][a] (listing potential tax and business disadvantages of organizing under partnership form). McKee explains that many of the business and tax disadvantages which limit the partnership form are avoidable through careful planning and business formation. *Id.* For instance, by forming a limited partnership with a corporation as the sole general partner, a partnership can achieve limited liability. *Id.*

20. *See* Susan Pace Hamill, *A Case for Eliminating the Partnership Classification Regulations*, 68 TAX NOTES 335, 345 (1995) (noting that limited liability was traditional major advantage of corporations).

21. *See* REV. MODEL BUS. CORP. ACT § 6.22 (1984) (discussing liability of shareholders). Section 6.22(b) provides a shareholder of a corporation is not personally liable for the acts or debts of the corporation." *Id.* § 6.22(b).

22. *See id.* (stating shareholder is not liable to creditors).

23. *See* UNIF. PARTNERSHIP ACT (1914 Act) § 15, 6 U.L.A. 456 [hereinafter UPA] (stating all partners are liable jointly and severally for debts and obligations of partnership); UNIF. PARTNERSHIP ACT (1994) § 306, 6 U.L.A. 45 [hereinafter RUPA] (same).

24. *See generally* REV. UNIF. LIMITED PARTNERSHIP ACT, 6A U.L.A. 1 (1985) [hereinafter RULPA] (describing attributes and formation of limited partnerships).

consisting of general partners and limited partners.[25] The limited partnership form allows the limited partners to escape personal liability for partnership liabilities.[26] General partners, however, remain personally liable for partnership debts.[27] State created entities such as LLPs and LLCs took limited liability a step further and afforded complete limited liability for all members of the entity.[28] The advent of limited partnerships, LLCs, and LLPs blurred the traditional distinctions that once existed between corporations and partnerships.[29] With the elimination of these limited liability distinctions came the need for a new entity classification system.

III. The History of the Entity Classification Scheme

Economic differences between corporations and partnerships formed the basis of the old classification regulations.[30] These economic distinctions gradually eroded over the years, resulting in a classification test based on insignificant factors.[31] The classification regulations became, in essence, an elective regime for those taxpayers who could afford to manipulate the regulations in their favor.[32] An evaluation of the deficiencies presented by the old classification scheme highlights the benefits of the new regulations.

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25. *See id.* arts. III, IV (delineating two types of members in limited partnerships).

26. *See id.* § 303 (stating that limited partner is not liable for debts or obligations of limited partnership "unless he is also a general partner").

27. *See id.* § 403 (providing that general partners have same "liabilities of partner in a partnership without limited partners").

28. *See* RUPA § 306(c), 6 U.L.A. 36 (Supp. 1997) (stating that partners are not personally liable for debts of organization); UNIF. LIMITED LIABILITY COMPANY ACT § 303(a) (1995) (stating that members are not personally liable for debts of organization). Both LLPs and LLCs are unincorporated business entities that provide liability protection for their members. The major difference between the two entities is that LLPs organize according to a partnership agreement and have partners and LLCs organize under an operating agreement and have members in lieu of partners. For the purposes of this Note, it is important to understand that neither LLPs nor LLCs are incorporated entities and therefore income derived from such entities is not subject to double taxation under federal law.

29. *See* WILLIAM J. BROWN, BASIC CORPORATE/SHAREHOLDER TAXATION 7 (1996) (noting need to replace formalistic classification rules with elective approach).

30. *See infra* Part III.B (discussing use of outdated characteristics to determine entity classification); *see also* Treas. Reg. § 301.7701-2(b) to (e) (as amended in 1993) (listing characteristics that distinguish partnerships from associations).

31. *See infra* notes 59-67 and accompanying text (discussing demise of old entity classification scheme).

32. *See infra* notes 68-85 and accompanying text (discussing manipulation of classification factors by entities to achieve desired tax status).

A. The Morrissey *and* Kintner *Decisions*

The Supreme Court initially articulated the characteristics of corporate classification in *Morrissey v. Commissioner.*[33] In *Morrissey*, the Supreme Court considered whether a state law trust formed to develop a golf course for profit was an entity taxable as a corporation.[34] The Court found that the trustees had authority to acquire and operate a golf course, receive the profits therefrom, make loans and investments, make regulations governing the trust, increase the number of trustees, and choose their successors.[35] The Court further ascertained that the trust was to continue for a period of twenty-five years and would not dissolve upon the death of a trustee.[36] From these facts, the Court determined that the trust resembled a corporation for tax purposes.[37]

The Court identified five characteristics that, if present, favor treatment of an organization as a corporation.[38] The characteristics used to make the determination included: (1) ability of the organization to hold title in property, (2) continuation of the organization without interruption by the death of an owner, (3) centralization of management, (4) free transferability of ownership interests, and (5) limited liability for the organization's debts.[39] Ultimately, the *Morrissey* factors served as the basis of the corporate resemblance test adopted by the Internal Revenue Service (Service) in the *Kintner* entity classification regulations.[40]

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33. 296 U.S. 344 (1935).

34. *See* Morrissey v. Commissioner, 296 U.S. 344, 346-47 (1935) (classifying trust that possessed corporate characteristics for federal income tax purposes). The *Morrissey* Court addressed whether a state law trust should be treated as an association for federal tax purposes. *Id.* The Court determined that the term association implies "associates" and "the entering into a joint enterprise . . . for the transaction of business." *Id.* at 356. The Court also enumerated five characteristics which, if present, indicate when an association resembles a corporation. *Id.* at 359. The Court concluded that associations are taxable as corporations if associations possess the enumerated corporate characteristics. *Id.* at 360.

35. *Id.* at 347.

36. *Id.* at 347-48.

37. *Id.* at 360.

38. *Id.* at 359. *See* 1 MCKEE ET AL., *supra* note 12, ¶ 3.06[1] (explaining that *Morrissey* Court focused on these characteristics to distinguish between corporations and those associations that did not bear significant resemblance to corporations). Because the Court determined that associations imply the existence of "associates" and "an objective to carry on business," it was necessary to determine which associations most closely resembled a corporation. *Id.*

39. *See Morrissey*, 296 U.S. at 359 (listing five characteristics for determining entity's tax treatment).

40. *See* Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993) (establishing corporate

The *Kintner* regulations resulted from a taxpayer's victory[41] in *United States v. Kintner*.[42] In *Kintner*, the United States Court of Appeals for the Ninth Circuit held that an association of doctors would receive corporate tax treatment despite the fact that the organization was a partnership for state law purposes.[43] The doctors structured a state law partnership to meet the definition of an association in order to take advantage of certain pension benefits not available to partnerships.[44] The doctors imbued their association with sufficient corporate characteristics such as "continuity [of life], centralized control and limitation of liability."[45] These attributes led the Ninth Circuit to determine that the association possessed more of the criteria of a corporation than of a partnership and therefore should receive corporate tax treatment despite its state law partnership status.[46] The court concluded that basing the taxation of an association on state law would create anarchy in federal taxation.[47]

B. The Kintner *Regulations*

The Commissioner of the Internal Revenue Service (Commissioner) responded to the Ninth Circuit's decision by promulgating the *Kintner*

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resemblance test based on *Morrissey* characteristics). After listing the five *Morrissey* factors, the corporate resemblance test states:

> Whether a particular organization is to be classified as [a corporation] must be determined by taking into account the presence or absence of each of these corporate characteristics. The presence or absence of these characteristics will depend upon the facts in each individual case. . . . An organization will be treated as [a corporation] if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust.

Id.; *see also* Hamill, *supra* note 20, at 339 (asserting that *Morrissey* factors formed basis of 1960 partnership classification regulations).

41. *See* Treas. Reg. §§ 301.7701-1 to -11 (1960) (incorporating Morrissey factors into entity classification test); *see also* 1 MCKEE ET AL., *supra* note 12, ¶ 3.06[1] (explaining that even though organization in *Kintner* was state law partnership, "it was imbued with sufficient corporate characteristics" to be taxed as corporation); William J. Rands, *Organizations Classified as Corporations for Federal Tax Purposes*, 59 ST. JOHN'S L. REV. 657, 665-66 (1985) (noting that during time before 1960 Regulations, Commissioner sought to narrow definition of "association" to exclude large numbers of associations seeking corporate status).

42. 216 F.2d 418 (9th Cir. 1954).

43. United States v. Kintner, 216 F.2d 418, 418 (9th Cir. 1954).

44. *Id.* at 420-21.

45. *Id.* at 423.

46. *Id.* at 422.

47. *Id.* at 424.

regulations.[48] These regulations attempted to limit corporate tax treatment of unincorporated organizations.[49] The *Kintner* regulations accomplished this goal by dividing organizations into associations, partnerships, and trusts for tax purposes.[50] The regulations then provided four major corporate characteristics that distinguished partnerships from corporations: (1) continuity of life, (2) centralized management, (3) limited liability for the organization's debts, and (4) free transferability of interests.[51]

An entity possessed the first characteristic, continuity of life, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of a member did *not* cause a dissolution of the entity.[52] An entity had centralized management if "any person . . . [had] continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed."[53] Limited liability existed if no member of the entity was personally liable for the debts or claims against the entity.[54] The

48. Treas. Reg. §§ 301.7701-1 to -11 (1960).

49. *See* Kurzner v. United States, 413 F.2d 97, 105 (5th Cir. 1969) (noting obvious object of Kintner Regulations "was to cut back the broad definition of the term *corporation* given by the courts and previous regulations"); 1 McKEE ET AL., *supra* note 12, ¶ 3.06[1] (explaining Commissioner's attempts to resist *Kintner* decision prior to promulgation of 1960 Regulations).

50. *See* Treas. Reg. § 301.7701-1(b) (1980) (stating that entities must fall into one of three designated categories for federal tax purposes). The *Kintner* regulations defined an association as "an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as . . . a partnership. . . ." *Id.* § 301.7701-2(a)(1) (as amended in 1993). The term partnership included "a syndicate, group, pool, joint venture, or other unincorporated organization . . . by means of which any business . . . is carried on, and which is not a corporation. . . ." *Id.* § 301.7701-3(a) (as amended in 1995).

51. *See id.* § 301.7701-2(a)(1) (as amended in 1993) (listing characteristics used to determine if entity resembled corporation for tax purposes); 1 McKEE ET AL., *supra* note 12, ¶ 3.06[1] (noting that 1960 Regulations "track the *Morrissey* opinion more closely than the prior [r]egulations"); Rands, *supra* note 41, at 669 (noting that regulations take mechanical approach to classification issue).

52. *See* Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993) (describing necessary elements of continuity of life); 1 McKEE ET AL., *supra* note 12, ¶ 3.06[4][a] (noting that dissolution negates continuity of life); Hamill, *supra* note 20, at 343 (noting corporations traditionally possess continuity of life).

53. Treas. Reg. § 301.7701-2(c)(1) (as amended in 1993). *See* 1 McKEE ET AL., *supra* note 12, ¶ 3.06[4][b] (explaining situations in which centralization of management does and does not exist); Hamill, *supra* note 20, at 344 (noting corporations possess centralized management). A corporation possesses centralized management because "a board of directors manages the corporation's business in a representative capacity for the [stockholders]." *Id.*

54. *See* Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993) (explaining requirements for limited liability). The old regulations state that "[p]ersonal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the

fourth characteristic, free transferability of interest, existed if each of an entity's members had the power to transfer all attributes of ownership to a person not currently a member of the organization without consent from the other members.[55] The *Kintner* regulations treated an organization as a corporation only if, after counting each factor equally,[56] "such organization [had] more corporate characteristics than noncorporate characteristics."[57] Consequently, under the *Kintner* regulations, the classification of an organization hinged on whether the entity had at least three of the four enumerated corporate characteristics.[58]

The *Kintner* regulations did not avoid criticism. Commentators attacked the regulations as overly formalistic and susceptible to abuse.[59] As a practical economic matter, limited liability proved the crucial factor

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extent that the assets of such organization are insufficient to satisfy the creditor's claim." *Id.*

55. *See id.* § 301.7701-2(e)(1) (explaining definition of transferability of interests); Hamill, *supra* note 20, at 346 (noting corporations possess free transferability of interests because shares of stock can be traded by shareholders).

56. *See* Larson v. Commissioner, 66 T.C. 159, 185 (1976) (noting that equal weight will be given to corporate characteristics found in regulations); Rev. Rul. 88-76, 1988-2 C.B. 360 (applying equal weight to corporate characteristics when deciding tax classification for first LLC statute); 1 MCKEE ET AL., *supra* note 12, ¶ 3.06[2] (explaining how organization may attain corporate or noncorporate status).

57. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1993).

58. *See* 1 MCKEE ET AL., *supra* note 12, ¶ 3.06[1] (explaining that determination of entity turns on last four elements in regulations). In order to ascertain effectively the treatment of an entity for tax purposes, the taxpayer must also consider the publicly traded partnership rules found in Code § 7704(a). *Id.* Section 7704 treats most publicly traded partnerships as corporations for tax purposes. *Id.* Previously, as long as partnerships, LLCs, and LLPs did not trade their shares on an established exchange, their only concern was meeting the requirements of the *Kintner* test. *Id.* Section 7704 will continue to apply to publicly traded partnerships, LLCs, and LLPs under the new check-the-box regulations. *See* Michael L. Schler, *Initial Thoughts on the Proposed 'Check-the-Box' Regulation,* 71 TAX NOTES 1679, 1682 (1996) (noting that new regulations effectively create one factor test based on public trading for unincorporated entities).

59. *See, e.g.*, Rod Garcia, *Treasury Officials Address Check-the-Box Entities*, 67 TAX NOTES 1009, 1009 (1995) (noting that entities seeking professional advice have better chance of achieving desired tax status); Schler, *supra* note 58, at 1681 (calling four-factor test extremely formalistic); Shefter, *supra* note 2, at 280 (noting that in practice *Kintner* regulations have proven to be "remarkably complex and fact-specific and have spawned a vast body of interpretative law . . . that even today leaves many issues unresolved"); Sheryl Stratton et al., *Check-the-Box Regulations Dominate Discussions at Several Meetings,* 71 TAX NOTES 985, 986 (1996) (quoting principal architect of check-the-box regulations who termed abandoned classification rules "drive-by shooting way of keeping people out of partnerships"); Victor E. Fleischer, Note, *"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 526 n.36 (1996) (citing *Kurzner* and *Larson* as examples of decisions by courts criticizing four-factor test).

distinguishing corporations from partnerships.[60] Nonetheless, the *Kintner* regulations treated limited liability as one of four equal factors.[61] To combat the apparent incongruity between tax treatment and economic reality, the Treasury attempted to make limited liability a supercharacteristic.[62] The Treasury proposed that any organization possessing limited liability automatically be taxed as a corporation.[63] Eventually, however, the Treasury withdrew this attempt to alter the *Kintner* regulations.[64]

In practice, the *Kintner* Regulations provided an elective system for determining tax classification that depended on the aptitude of a business's tax planner.[65] Thus, many unincorporated entities found the application of the *Kintner* test meaningless.[66] To attain partnership tax classification,

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60. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (stating that one of traditional differences between corporations and partnerships was limited liability). In Notice 95-14, the Service acknowledged that limited liability once played an important role in determining an entity's tax status:

> The existing classification regulations are based on the historical differences under local law between partnerships and corporations. However, many states recently have revised their statutes to provide that partnerships . . . may possess characteristics that have traditionally been associated with corporations. . . . For example, some partnership statutes have been modified to provide that no partner is unconditionally *liable* for all the debts of the partnership. . . . These entities are designed to provide *liability protection* to all members and to otherwise resemble corporations.

Id. (emphasis added).

61. *See* Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993) (omitting any indication that more weight should be given to any one factor). The old regulations do not specify that one characteristic should be weighed more heavily than another. *See Larson*, 66 T.C. at 185 (noting that equal weight is given to corporate characteristics found in regulations).

62. *See* Prop. Treas. Reg. § 301.7701-2(a)(2), (a)(3), (a)(4), (g), 45 Fed. Reg. 75709 (1980) (proposing limited liability supercharacteristic); 1 MCKEE ET AL., *supra* note 12, ¶ 3.06[1] (commenting on failed attempts to modify entity classification rules).

63. *See* 1 MCKEE ET AL., *supra* note 12, ¶ 3.06[1] (noting proposed regulations would automatically classify organization as corporation if organization's members possessed limited liability).

64. *See id.* (noting "[t]he Service eventually withdrew the Proposed Regulations in 1982").

65. *See Attorney Urges*, *supra* note 2, at 1286 (commenting that *Kintner* Regulations essentially provide elective classification system); *NYSBA*, *supra* note 2, at 1285 (commenting that "current classification system is 'effectively elective'"); Shefter, *supra* note 2, at 281 (noting that choice of classification flexibility "generally exists under current law so long as the proper transactions are undertaken").

66. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (noting state statutes allow unincorporated organizations to possess characteristics of corporations); Jill E. Darrow, *Limited Liability Companies and S Corporations: Deciding Which is Optimal and Whether to Convert to LLC Status*, 48 TAX LAW. 1, 10-11 (1994) (discussing flexible LLC statutes that assure partnership tax treatment).

unincorporated organizations only needed to structure their organizations such that they lacked two of the four characteristics.[67]

Larson v. Commissioner[68] demonstrates the ease with which taxpayers could manipulate the *Kintner* regulations.[69] In *Larson*, the taxpayer owned a limited partnership interest in two real estate syndications organized under California limited liability partnership law.[70] The sole general partner was a corporation whose only business was promoting the real estate ventures.[71] The Service classified the limited partnerships as corporations because the Service contended that the partnerships satisfied all four of the *Kintner* factors.[72] The Tax Court rejected the Service's classification, deciding that the limited partnerships were not taxable as corporations because the partnerships only possessed two of the four corporate characteristics.[73] The Tax Court found that the limited partnerships possessed the corporate characteristics of centralized management and free transferability of interest, but lacked continuity of life and limited liability.[74]

A limited partnership lacks continuity of life if state law provides that the entity dissolves upon the death, insanity, bankruptcy, retirement, resignation, or expulsion of a member.[75] The Tax Court confirmed that continuity

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67. *See* Shefter, *supra* note 2, at 279 (noting election is made "up-front" rather than through manipulation of *Kintner* test).

68. 66 T.C. 159 (1976).

69. *See* Larson v. Commissioner, 66 T.C. 159, 173-75 (1976) (determining that taxpayer's limited partnership structure lacked continuity of life). In *Larson*, the taxpayer owned minor interests in two limited partnerships. *Id.* at 160. The Service did not allow the taxpayer to take a deduction for losses incurred by the limited partnerships because the Service concluded that the partnerships were associations taxable as corporations. *Id.* at 171. The Tax Court applied the *Kintner* factors to the limited partnerships and concluded that the limited partnerships lacked two of the four characteristics. *Id.* at 185. Therefore, the court held the limited partnerships were partnerships for federal tax purposes. *Id.*

70. *Id.* at 171.

71. *Id.* at 161.

72. *Id.* at 172.

73. *Id.* at 185.

74. *Id.* at 175, 179, 182, 184.

75. *See id.* at 173 (outlining Service's argument against taxpayer with respect to continuity of life). The Tax Court explained:

> The significant difference between a corporation and a partnership as regards continuity of life, then, is that a partner can always opt out of continued participation in and exposure to the risks of the enterprise. A corporate shareholder's investment is locked in unless liquidation is voted or he can find a purchaser to buy him out.

Id. at 173-74. *See also* Treas. Reg. § 301.7701-2(b)(1) (as amended in 1993) (defining continuity of life). The regulation provides:

> An organization has continuity of life if the death, insanity, bankruptcy, retirement,

of life is negated if dissolution results from the occurrence of *any one* of these events.[76] The terms of the *Larson* limited partnerships provided that the partnerships would dissolve upon the bankruptcy of the general partner.[77] Because the only assets owned by the general partner were the partnerships themselves, the corporate general partner could go bankrupt only if the partnerships went bankrupt.[78] Hence, the taxpayer manipulated and avoided the continuity of life factor by structuring the partnerships to dissolve only if the partnerships first went bankrupt.[79]

The taxpayer also avoided the limited liability factor by manipulating the structure of the limited partnerships.[80] A partnership possesses limited liability if no member is personally liable for the debts of the organization.[81] The taxpayer structured the partnerships to lack limited liability by making the corporate general partner individually liable for the debts of the partnerships.[82] Under this arrangement, creditors could proceed only against the assets of the corporate general partner.[83] Even so, the taxpayer reserved the right to remove the general partner at any time.[84] Thus, the taxpayer avoided limited liability without relinquishing any control over the partnerships.[85]

> resignation, or exclusion of any member *will not cause* a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or exclusion of any member *will cause* a dissolution of the organization, continuity of life does not exist.

Id. (emphasis added).

76. *See* Larson v. Commissioner, 66 T.C. 159, 175 (1976) (emphasizing that bankruptcy of any member is sufficient to cause dissolution and thereby cause organization to lack continuity of life).

77. *See id.* at 165 (quoting terms from limited partnership agreement).

78. *Id.* at 161.

79. *Id.*

80. *Id.* at 182.

81. *See* Treas. Reg. § 301.7701-2(d)(1) (as amended in 1993) (defining limited liability factor). Section 301.7701-2(d)(1) states:

> An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or the claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim.

Id.

82. Larson v. Commissioner, 66 T.C. 159, 181 (1976).

83. *See* RULPA § 403 (providing that general partners have liabilities for obligations of partnership).

84. *Larson*, 66 T.C. at 165.

85. *Id.* at 182.

C. *Departing from the* Kintner *Regulations*

As evidenced by *Larson*, the entity classification system was in need of repair. The Service offered two justifications for changing the entity classification rules.[86] First, the Service stated that the recent creation of entities that look and act like corporations, but that the Code treats as partnerships, muddled the distinction that once existed between partnerships and corporations.[87] Specifically, the Service identified LLCs as no longer displaying the "historical differences . . . between partnerships and corporations."[88]

Simplification comprised the second reason for change.[89] The Service asserted that simplification was necessary to reduce the amount of government resources expended to determine the proper classification of domestic unincorporated business organizations.[90] The election process purported not only to simplify classification procedures for the Service, but also to allow

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86. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (stating that Service recognized that new classification rules would conserve resources and simplify classification process).

87. *See id.* (noting that partnership-corporate distinction is narrowed by new entities); 1 MCKEE ET AL., *supra* note 12, ¶ 3.06[1] (Cum. Supp. No. 2 1996) (noting that LLCs are catalyst for reexamination of entity classification); *see also* Rod Garcia et al., *LLCs, or How the Government Got to Check-the-Box Classification*, 67 TAX NOTES 1139, 1139 (1995) (explaining how proliferation of LLCs had important influence on check-the-box regulations).

88. I.R.S. Notice 95-14; *see* Hamill, *supra* note 20, at 351 (stating that "applying the classification regulations to LLCs and limited partnerships serves no legitimate tax policy purpose"); *IRS Considering Proposal to Permit Election of Partnership or Association Status*, 67 TAX NOTES 45, 45 (1995) [hereinafter *IRS Considering*] (noting that many unincorporated entities possess corporate characteristics). This article explains that "[a]lmost all states have enacted statutes allowing the formation of limited liability companies. Thus, taxpayers can achieve partnership tax classification for [an] . . . organization that, in all meaningful respects, is virtually indistinguishable from a corporation." *Id*; *see also* William J. Rands, *Passthrough Entities and Their Unprincipled Differences Under Federal Tax Law*, 49 SMU L. REV. 15, 37 (1995) (commenting that check-the-box would eliminate "the nettlesome problem" of LLCs conforming with obsolete entity classification rules).

89. *See* I.R.S. Notice 95-14 (noting Service has expended considerable resources in determining proper classification); *NYSBA*, *supra* note 2, at 1285 (commenting that check-the-box "will greatly simplify the law without materially changing the substantive results in most cases"). *But see* Aaron W. Brooks, *Chuck the Box: Proposed Entity Classification Regulations Bring Bad Policy*, 70 TAX NOTES 1669, 1673 (1996) (arguing that simplification may be temporary effect caused by influx of LLCs and that expenses of current system will subside over time). The Tax Executives Institute respectfully disagreed with Brooks's assertions. Jack R. Skinner, Letters to the Editor, *TEI Endorses Check-the-box*, 71 TAX NOTES 263, 263 (1996). Mr. Skinner explains that the current distinction between partnerships and corporations is "clear as mud" and that check-the-box would bring much needed clarity to this "gray" area of tax law. *Id.*

90. *See* Hamill, *supra* note 20, at 352 (noting that eliminating partnership classification regulations will save Service significant amount of transaction costs); *IRS Considering*, *supra* note 88, at 45 (stating taxpayers and Service continue to expend considerable time and effort in determining proper entity classifications).

many businesses previously unable to "afford" a desired tax classification to make the election without the cost of expensive tax planners.[91] As one commentator noted, "[T]he costs of administering the [former] entity classification system [were] enormous."[92]

The *Kintner* regulations proved to be no match for the creativity of tax planners who manipulated the partnership form to achieve tax benefits.[93] The formalistic structure of *Morrissey* and *Kintner* became completely meaningless due to the proliferation of entities such as LLPs and LLCs.[94] The time was ripe for the Treasury to act.

IV. The Surrender: Check-the-Box

A. Determining Eligibility for Check-the-Box

The check-the-box regulations allow eligible entities to choose between corporate and partnership treatment for federal tax purposes.[95] Three possible entity classifications comprise the check-the-box universe: tax nothings (entities disregarded from their owners for tax purposes), business entities, and trusts.[96] To determine entity classification under check-the-box, an

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91. *See* I.R.S. Notice 95-14 (citing as reason for simplification lack of small business resources to achieve desired tax classification under existing regulations); *see, e.g.*, Hamill, *supra* note 20, at 354 n.171 (concluding that "[c]losely held corporations that seek out and *can afford* competent tax advice can always minimize or avoid the double tax" (emphasis added)); *NYSBA*, *supra* note 2, at 1285 (stating that taxpayers expend tremendous amount of resources in entity classification); Shefter, *supra* note 2, at 280 (noting *Kintner* regulations are "trap for unwary and *ill-advised* proprietor" (emphasis added)); Garcia, *supra* note 59, at 1009 (quoting Treasury acting deputy tax legislative counsel as saying that "[c]lassification 'becomes a very intricate game that if you have counsel you get out of the maze and you're home free'"); *Unofficial Transcript of IRS Hearing on 'Check-the-Box' Regs*, TAX NOTES TODAY, Aug. 21, 1996, *available in* LEXIS, Fedtax Library, Tnt File (explaining *Kintner* regulations have been problem for many small businesses that do not have resources to hire attorneys to work around regulations).

92. Shefter, *supra* note 2, at 281. Shefter explains that the former classification system required excessive compliance and monitoring costs. *Id.*

93. *See* Hamill, *supra* note 20, at 340 (stating that "1960 Regulations allowed creative tax planners to devise new ways to use the partnership form to achieve tax benefits"); Rands, *supra* note 88, at 34 (asserting that *Kintner* regulations produced two unintended byproducts — proliferation of tax shelter LLPs and emergence of LLCs).

94. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (noting states have opened door for new corporate-like entities); Rands, *supra* note 88, at 34 (stating that "*Kintner* regulations are . . . a product of a bygone era").

95. Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (permitting eligible entities to select between corporate and partnership tax status).

96. *See id.* §§ 301.7701-2, -3, -4 (providing for tax nothings, business entities, and trusts); Schler, *supra* note 58, at 1680 (summarizing new entity classification universe).

organization only needs to make two important determinations.[97]

The first step of entity classification is to determine whether general federal income tax principles recognize the organization as an entity separate from its owners.[98] Federal income tax law determines this recognition regardless of the entity's status under local law.[99] For instance, "a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes."[100] Thus, if two persons jointly construct a ditch to drain water from their properties, they have not created a separate entity for federal tax purposes.[101] Rather, entities separate from their owners include

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Schler provides a convenient chart outlining the potential entity classification structure of entities under check-the-box:

Summary of the New Entity Classification Universe

1. "Nothings" under general tax principles [disregarded as separate from its owner]
2. Trusts (no business activity)
3. Business entities
   - (a) automatic corporations
     - (i) U.S. entities called corporations
     - (ii) specified foreign entities, unless grandfathered as partnerships
     - (iii) statutory corporation: e.g., sections 7704 (publicly traded), 7701(i) (TMP)
   - (b) other entities: "eligible entities"
     - (i) entities making an election
       - (x) if single member: elect "nothing" or corporation
       - (y) if multiple members: elect partnership or corporation
     - (ii) entities not making an election: default classification
       - (x) existing entities (if foreign, only if U.S. status is currently relevant): as claimed previously
       - (y) new domestic entities
         - (1) if single member: "nothing"
         - (2) if multiple members: partnership
       - (z) new foreign entities
         - (1) if no member has unlimited liability: corporation
         - (2) if any member has unlimited liability
           - (a) if single member: "nothing"
           - (b) if multiple members: partnership

Id.

97. *See infra* notes 98-110 and accompanying text (discussing entity's ability to use check-the-box).

98. *See* Treas. Reg. § 301.7701-1 (as amended by T.D. 8697, 1997-2 I.R.B. 11) (providing classification of organizations for federal tax purposes).

99. *Id.* § 301.7701-1(a)(3).

100. *Id.* § 301.7701-1(a)(2); *see* Schler, *supra* note 58, at 1680 (noting that such cost-sharing arrangements are disregarded for tax purposes).

101. Treas. Reg. § 301.7701-1(a)(2) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (providing ditch-digging example).

joint ventures and other contractual arrangements that seek to carry on a trade or business and to divide the profits therefrom.[102]

If an entity is separate from its owners, the entity takes the second step and chooses partnership or corporate tax classification.[103] Only eligible business entities may freely choose their tax classification.[104] One provision of the regulations states that an eligible business entity is "any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner . . .) that is not properly classified as a trust . . . or otherwise subject to special treatment under the Internal Revenue Code."[105] Check-the-box allows business entities with two or more members to have the choice of qualifying as a corporation or a partnership.[106] Business entities with only one member may choose to qualify as a corporation or be disregarded as an entity separate from its owner.[107]

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102. *Id.*

103. *Id.* § 301.7701-3(a) (noting that eligible entities may choose either passthrough or corporate tax treatment). Section 301.7701-3(a) states:

> A business entity that is not classified as a corporation . . . can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either [a corporation] or a partnership, and an eligible entity with a single owner can elect to be classified as [a corporation] or to be disregarded as an entity separate from its owner.

Id.

104. *Id.* § 301.7701-2(a).

105. *Id.*

106. *See id.* § 301.7701-3(a) (permitting eligible two member entities to select partnership or corporate tax treatment); *see also* Hamill, *supra* note 20, at 352 (asserting that selection of noncorporate tax treatment will not displace revenue base generated by corporations); Shefter, *supra* note 2, at 282 (noting that "benefits of flow-through taxation [will] still be unavailable to publicly owned companies" under new regulations). It is "the Treasury's worst fear that corporate America would begin to convert to LLC form to avoid corporate-level taxation." *Id.* The publicly traded partnership provisions of I.R.C. § 7704 will prevent LLCs and limited partnerships from escaping taxes that otherwise could be avoided by choosing partnership tax treatment. Hamill, *supra* note 20, at 352. Also, closely held businesses selecting partnership treatment will not cause a loss of revenue because "the well-advised have always been able to avoid the corporate tax" by structuring their business to satisfy the *Kintner* test. *Id.* Additionally, because the maximum marginal tax rate is currently lower for corporations than for individuals, it could be beneficial for closely held businesses to elect corporate status over passthrough treatment. Stratton et al., *supra* note 59, at 988.

107. *See* Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (providing that eligible single owner entities may select corporate tax treatment or be disregarded as entity separate from its owner); Schler, *supra* note 58, at 1682 (acknowledging that one of major breakthroughs in new regulations is that single member entity can be "disregarded" for tax purposes). This treatment is possible "even if the [owner of the entity] is not liable for debts of the entity, such as in a single member LLC." *Id.* This new treatment is considered a "breakthrough" because prior to the new regulations, the treatment of single member LLCs was uncer-

A corporation is not an eligible business entity under the check-the-box regulations.[108] Therefore, corporations do not have a choice of tax treatment.[109] Check-the-box automatically classifies the following entities as corporations: (1) entities incorporated under state or federal law, (2) entities characterized as corporations under the Code, such as publicly traded partnerships found under Section 7704, (3) insurance companies, banks, and joint stock companies, (4) business entities wholly owned by the state, and (5) entities found on a list of over eighty foreign corporate-like entities.[110]

B. Checking the Box

The check-the-box election is functional for two reasons. First, it allows eligible entities to select corporate tax treatment.[111] Second, it provides a protective election for those entities that wish to ensure partnership tax treatment.[112]

An eligible entity elects its tax classification by filing Form 8832, Entity Classification Election.[113] All the owners or an authorized member or manager must sign the election form.[114] The eligible entity attaches the election form to its federal tax return or, if the Service does not require an entity to file a return, to the return of any direct or indirect owner.[115] The election goes into effect on the date specified on Form 8832[116] or on the date that the

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tain for federal income tax purposes. Darrow, *supra* note 66, at 4-5; *see also infra* Part V.C (discussing impact of check-the-box on single member LLCs).

108. *See* Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (stating business entities not classified as corporations, except associations, can elect tax treatment).

109. *See id.* (noting corporations are not eligible entities).

110. *See id.* § 301.7701-2(b)(1) to (8) (listing entities classified as corporations).

111. *See id.* § 301.7701-3(a) (stating that business entities may elect corporate tax treatment).

112. *See id.* § 301.7701-3(a) (providing that entities may elect to be classified as partnership for tax purposes). *But see id.* § 301.7701-3(b) (providing default rules for those entities not making election).

113. *See id.* § 301.7701-3(c)(1) (providing time and place for filing). The election must be filed at the appropriate service center designated on Form 8832, state the "entity's name, address, taxpayer ID number, an EIN, the chosen classification, and whether the entity is domestic or foreign." *Final 'Check-The-Box Regs' Open New Planning Opportunities*, 84 Stand. Fed. Tax Rep. (CCH) 2 (Dec. 26, 1996) [hereinafter *Planning Opportunities*]. .

114. *See* Treas. Reg. § 301.7701-3(c)(2) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (stating certain members of organization must sign classification election form).

115. *See id.* § 301.7701-3(c)(1)(ii) (providing procedure for returning election form).

116. *See id.* § 301.7701-3(c)(1)(iii) (noting that specified date cannot be more than 75 days prior to filing date and no more than 12 months after filing date). In addition, an entity specifying an election date prior to January 1, 1997, will be treated as if the election was made on January 1, 1997. *Id.*

entity files the form.[117] Once an eligible entity has made an election, the entity may not change its classification again for five years.[118] The Commissioner may override the five year rule after determining that a fifty percent change in the ownership of the entity has occurred.[119]

1. Domestic Default Rules

Check-the-box does not require that all eligible entities file an election for tax classification. In an effort to simplify entity classification even further, the new regulations contain default rules to provide new and pre-existing entities with a tax classification absent an election.[120] This provision simplifies matters for the taxpayer and reduces the number of elections and the amount of paperwork submitted to the Service.[121]

Under the default rules, newly formed domestic entities are subject to two possible classifications.[122] The regulations classify new entities with two or more members as partnerships,[123] and disregard single member organizations as entities separate from their owners.[124] Only if a new entity seeks

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117. *See* T.D. 8697, 1997-2 I.R.B. 11 (explaining that regulations retain requirement that election be made at beginning of taxable year). The Treasury and the Service believe that an entity's classification should be decided at the time the entity begins its operations rather than when the entity files its tax return. *Id.*

118. *See* Treas. Reg. § 301.7701-3(c)(1)(iv) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (stating eligibility to make second election).

119. *See id.* (providing Commissioner opportunity to override five year rule).

120. *See id.* § 301.7701-3(b)(1) (providing default rules for entities not choosing tax status). Section 301.7701-3(b)(1) provides: "[U]nless the entity elects otherwise, a domestic eligible entity is (i) A partnership if it has two or more members; or (ii) Disregarded as an entity separate from its owner if it has a single owner." *Id.*; *see also Planning Opportunities*, *supra* note 113, at 2 (explaining that default rules simplify the classification even further); Stratton et al., *supra* note 59, at 985 (noting default rules for domestic entities are intended to be "seamless"). The default rules should permit entities to keep whatever status they previously had, without having to file an election. *Id.*

121. *See* Treas. Reg. § 301.7701-3(c)(1)(i) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (stating that in order to elect classification, only Form 8832 must be used).

122. *See id.* § 301.7701-3(b)(1) (permitting entities to be partnerships or disregarded for tax purposes).

123. *See id.* § 301.7701-3(b)(1)(i) (stating "a domestic eligible entity is . . . [a] partnership if it has two or more members").

124. *See id.* § 301.7701-3(b)(1)(ii) (stating "a domestic eligible entity is . . . [d]isregarded as an entity separate from its owner if it has a single owner"); Stratton et al., *supra* note 59, at 986 (explaining that default rules reflect taxpayer's expectations about preferred tax classification in absence of election). *Id.* The default rules were designed to address the preference of most taxpayers to be classified as partnerships for tax purposes. *Id. But see* Schler, *supra* note 58, at 1681 (noting that default provisions are easily overridden by affirmative election).

corporate status must the entity make an election.[125]

On the other hand, existing entities retain the classification they claimed immediately prior to the effective date of the regulations.[126] However, the check-the-box regulations only respect an entity's prior classification if the entity can demonstrate the following: (1) the entity had a reasonable basis for the prior classification, (2) the entity recognized the classification for five years prior to the effective date, and (3) the entity's classification is not under examination.[127] Part V further discusses satisfaction of the reasonable basis standard.[128]

2. *Foreign Entities and Check-the-Box*

Prior to the new regulations, the Service deemed all foreign business organizations unincorporated for federal tax purposes.[129] Application of the *Kintner* regulations to foreign entities required the Service to review extensively the agreements of foreign entities and to study the complexities of the

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125. *See* Treas. Reg. § 301.7701-3(b)(1) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (noting default rules apply "unless the entity elects otherwise").

126. *See id.* § 301.7701-3(b)(3)(i) (explaining default rules for existing entities). Section 301.7701-3(b)(3)(i) provides:

> Unless the entity elects otherwise, an eligible entity in existence prior to the effective date of this section will have the same classification that the entity claimed under § 301.7701-1 through § 301.7701-3 as in effect on the date prior to the effective date of this section; except that if an eligible entity with a single owner claimed to be a partnership under those regulations, the entity will be disregarded as an entity separate from its owner under this paragraph (b)(3)(i).

Id.; *see also* Stratton et al., *supra* note 59, at 986 (explaining mechanisms of default rules). Treasury's associate tax legislative counsel, John J. Rooney, explains that the Treasury will treat "parties [who] enter into a contractual relationship that rises to the level of an entity for federal tax purposes" as a partnership under the default provisions. *Id.* If a two member entity, treated as a partnership, becomes a one member entity then the default rules would treat the entity as a sole proprietorship. *Id.* However, the entity could always elect association status. *Id.* Rooney commented: "There is no possibility in this scenario of being exposed to an entity classification you didn't want." *Id.* Michael Schler commented that the new regulations prevent "inadvertent creation of a domestic entity taxable as a corporation." Schler, *supra* note 58, at 1681. The default rules provide that "[e]ven if an entity is unexpectedly found to exist, . . . the entity will automatically be a partnership rather than a corporation for tax purposes." *Id.* at 1682.

127. Treas. Reg. § 301.7701-3(f)(2)(i) to (iii) (as amended by T.D. 8697, 1997-2 I.R.B. 11).

128. *See infra* notes 172-83 and accompanying text (discussing reasonable basis standard and its application to transition period between regulations).

129. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (noting that "all foreign business organizations are currently considered unincorporated"); Rev. Rul. 88-8, 1988-1 C.B. 403 (finding that *Kintner* regulations must be applied to determine foreign entity's tax status).

governing foreign law.[130] In practice, "foreign entity classification issues [were] often more difficult and expensive to resolve than [were] domestic entity classification issues, more uncertain in their ultimate outcome, and more likely to frustrate the commercial expectations of the owners of the foreign entity."[131] Thus, the potential simplification opportunities more than justify the Treasury's decision to extend the check-the-box regulations to cover eligible foreign entities.[132]

The new regulations considered a foreign entity as a per se corporation or an entity eligible to make an election.[133] The check-the-box regulations automatically classify certain foreign businesses as corporations for federal tax purposes by providing a list, by country, of eighty-eight foreign entities that the regulations treat as per se corporations.[134] This list of foreign corporations provides taxpayers with certainty and simplicity that was nonexistent under the *Kintner* regulations.[135] Foreign entities that are not deemed corporations are

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130. Schler, *supra* note 58, at 1686 (noting that "[a]pplication of the four-factor test has often been most difficult in the context of a foreign entity"). Schler acknowledges that "numerous uncertainties arise from the fact that the rights and obligations of the owners of the entity must be determined under foreign law prior to application of the four-factor test." *Id.* at 1686-87. *See also Council Supports Extension of Check-the-box Proposal To Foreign Entities, Say There Is No Need for 'International Consistency,'* TAX NOTES TODAY, July 28, 1995, *available in* LEXIS, Fedtax Library, Tnt File [hereinafter *Council Supports*] (advocating extension of check-the-box to foreign entities). The United States Council for International Business, New York, commented that

> [i]mplementing an elective approach to classification of foreign organizations will substantially reduce administrative costs for both U.S. investors in foreign organizations and for the Service, eliminate the disadvantages engendered by the uncertainties that exist in many cases today, and decrease the structural complexity that is necessary to comply with U.S. tax rules.

Id.

131. *Council Supports*, *supra* note 130.

132. *See* I.R.S. Notice 95-14 (stating that complexities and resources devoted to classification of domestic entities are "mirrored in the foreign context"); *see also* Reuven S. Avi-Yonah, *To End Deferral As We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219, 220 (1997) (noting that "check-the-box is definitely a step in the right direction"). Avi-Yonah asserts that under the old regulations, foreign entity classification could almost always be achieved, but with more complexity and transaction costs. *Id.* Check-the-box allows taxpayers to avoid transaction costs without putting the Service in a worse position than it was under the former regulations. *Id.* Simplification of foreign entity classification also reduces the likelihood that classification issues will be the subject of costly litigation between the Service and the taxpayer. *Id.*

133. *See* Treas. Reg. §§ 301.7701-2(b)(8)(i), -3(a), -3(b)(2) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (setting classification criteria for foreign entities).

134. *See id.* § 301.7701-2(b)(8)(i) (listing eighty countries and organizations in each country that automatically receive corporate tax classification).

135. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297 (noting complexities of classifying entities

eligible to choose their entity classification.[136] An entity with two or more members may elect either partnership or corporate tax treatment.[137] A foreign entity with only one member may choose to be disregarded as an entity separate from its owner or may elect corporate tax treatment.[138]

The default rules for foreign entities rest on a limited liability determination.[139] A foreign entity does not have limited liability "if the creditors of the entity may seek satisfaction of *all or any portion* of the debts or claims against the entity from [any] member."[140] As one commentator notes: "In order to have unlimited liability, you only need one member that is liable for some of the liabilities."[141] Thus, the regulations classify foreign entities as partnerships if they have "two or more members and at least one member does not have limited liability" or as associations "if all members have limited liability."[142] Finally, the regulations disregard an entity if it has a single owner and the owner does not have limited liability.[143]

Unlike domestic entities, foreign entities must use caution when relying on the default classification rules.[144] For instance, contractual arrangements

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in foreign context); *Council Supports*, *supra* note 130 (commenting that complexities of entity classification would be reduced if Service extended check-the-box to foreign entities); *Planning Opportunities*, *supra* note 113, at 2 (noting benefits to practitioners of per se corporation list). One practitioner commented that foreign organizations in the per se corporation list can provide a "safe harbor [when] structuring joint ventures with foreign entities." *Id.*

136. *See* Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (permitting those entities that are not corporations to choose tax classification).

137. *See id.* (providing that entities with at least two members may elect partnership or corporate tax treatment).

138. *See id.* (permitting single member entity to elect corporate tax classification or to be disregarded).

139. *See id.* § 301.7701-3(b)(2)(i) (basing foreign entity classification on presence or absence of limited liability). Section 301.7701-3(b)(2)(i) states:

> [U]nless the entity elects otherwise, a foreign eligible entity is—
> (A) A partnership if it has two or more members and at least one member does not have *limited liability*;
> (B) An association [taxed as a corporation] if all members have *limited liability*; or
> (C) Disregarded as an entity separate from its owner if it has a single owner that does not have *limited liability*.

Id. (emphasis added).

140. *Id.* § 301.7701-3(b)(2)(ii) (emphasis added).

141. Hirani, *supra* note 3, at GG-2.

142. *See* Treas. Reg. § 301.7701-3(b)(2)(i)(A) to (B) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (providing default rule for foreign entity to receive corporate tax classification).

143. *See id.* § 301.7701-3(b)(2)(i)(C) (providing default rule for single member foreign entity to be disregarded).

144. *See* Schler, *supra* note 58, at 1687 (warning taxpayers to be careful when relying

in a foreign country may unexpectedly give rise to an entity for tax purposes.[145] Although partnership status may be sought for the entity, this classification may not be available if no member has unlimited liability.[146] Therefore, an affirmative election of the desired classification may be necessary to ensure the desired tax treatment.[147]

V. *Check-the-Box in Practice*

The simplicity of the new classification regulations does not make tax advisors obsolete for resolving entity classification issues.[148] Business entities still require advice from tax practitioners on entity structuring issues and on the proper implementation of the check-the-box scheme.[149] This Part discusses several areas in which the check-the-box regulations affect tax practice and planning, including the effect on corporations electing partnership status, the transitional period between the old and new regulations, the effect on single member LLCs, state law recognition of the new regulations, and the continued benefit of selecting corporate status.

A. *Corporations Electing Partnership Status: Deemed Liquidations*

A change in the tax classification of an existing eligible entity may require the entity to report certain tax consequences to the Service.[150] A

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on default classification rules for foreign entities).

145. *See id.* (hypothesizing unexpected tax classification of contractual arrangements in foreign countries).

146. *See* Treas. Reg. § 301.7701-3(b)(2)(i)(A) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (requiring at least one member to have unlimited liability in order to receive partnership tax classification).

147. *See* Schler, *supra* note 58, at 1687 (noting potential for increased use of election in foreign context).

148. *See id.* at 1692 (noting that "[t]ax practitioners will clearly not be made redundant by the new regulations"); Stratton et al., *supra* note 59, at 988 (citing attorney who cautioned that "the planning opportunities afforded by the check-the-box regs are not yet totally clear"). Schler recognizes "the ease of electing tax status will place increased responsibility on the [tax] practitioner to properly evaluate the benefits and detriments of each alternative." Schler, *supra* note 58, at 1692. *But see* Shefter, *supra* note 2, at 282 (asserting that tax professional appears to be only real loser under check-the-box regime). Shefter notes that the billable hours that were once required to form a LLC or partnership will now be greatly reduced. *Id.* Check-the-box, however, is a sound tax policy despite the potential effect on tax practitioners. *Id.*

149. *See* Schler, *supra* note 58, at 1692 (stating that many changes in tax planning will be necessary to conform with new regulations).

150. *See* T.D. 8697, 1997-2 I.R.B. 11 (reminding taxpayers that changes in entity classification, "no matter how achieved, will have tax . . . consequences that must be re-

partnership converting to an LLC under the new regulations will not suffer any adverse tax consequences because the Code taxes both partnerships and LLCs as passthrough entities.[151] However, an entity treated as a corporation under the *Kintner* regulations deciding to elect partnership status is not as fortunate.[152] The Service treats such an election as the formation of a new partnership.[153] Consequently, the election results in a deemed liquidation of the corporation and requires the owners to recognize any gain.[154] The following example illustrates the tax ramifications of an existing corporation electing partnership treatment under the check-the-box regulations.

Suppose that A and B are the sole shareholders of XYZ, an entity treated as a corporation for federal tax purposes.[155] XYZ owns appreciated

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ported"); I.R.S. Notice 95-14, 1995-1 C.B. 297 (acknowledging that election to change classification of organization would have same federal tax consequences as election under *Kintner* regime).

151. *See* Rev. Rul. 95-37, 1995-1 C.B. 130 (holding that conversion from partnership to LLC is treated as partnership-to-partnership conversion and no gain or loss is recognized); *see also* Rev. Rul. 95-55, 1995-2 C.B. 313 (asserting partnership-to-partnership conversion recognizes no gains or losses). As long as the new entity does not become a corporation listed under § 301.7701-2(b), then the tax treatment will remain the same for a partnership converting to another entity such as a LLC. *Id.*; *cf.* Rev. Rul. 84-52, 1984-1 C.B. 157 (finding that conversion from general partnership to limited partnership provides no gain or loss recognition). A partnership, unlike a corporation, experiences no liquidation when it changes to a different kind of passthrough entity. Darrow, *supra* note 66, at 34. In such a scenario the partnership is not electing a different tax treatment, it is merely electing to change its business form. *Id.*

152. *See* T.D. 8697, 1997-2 I.R.B. 11 (cautioning that corporations choosing partnership status will undergo deemed liquidations). Treasury Decision 8697 states that if "an organization classified as an association elects to be classified as a partnership, the organization and its owners must recognize gain, if any, under the rules applicable to liquidations of corporations." *Id.*

153. *See* 1 MCKEE ET AL., *supra* note 12, ¶¶ 3.01, 3.02, 3.03 (setting out indicia of partnerships). McKee notes that "[a] partnership generally comes into existence upon commencement of the enterprise contemplated by the partnership." *Id.* ¶ 3.01[3]. Further, McKee states that "[i]n determining whether a particular arrangement is a partnership, the ultimate question is whether 'the parties acting in good faith and with a business purpose intended to join together in the present conduct of the enterprise.'" *Id.* ¶ 3.03 (citations omitted).

154. I.R.C. § 336(a) (1996) (providing that gain shall be recognized on liquidation). Section 336(a) states that "gain or loss shall be recognized to a liquidating corporation on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value." *Id.*

155. *See* Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (stating that "[a] business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) . . . can elect its classification"). Associations, found in § 301.7701-2(b)(2), are noticeably absent from the list of corporations barred from electing classification under check-the-box. *Id.* An association of two or more persons (a corporation under § 301.7701-2(b)(2)) is an eligible entity and may choose its tax status under check-the-

assets with a fair market value of $200,000 and a basis of $50,000. A and B each own 50 percent of the stock of XYZ. Both individuals have a basis of $10,000 in their respective shares.

Then suppose that XYZ elects partnership status under the check-the-box regulations and subsequently undergoes a deemed liquidation.[156] In a deemed liquidation, the Service treats XYZ as if it distributed all of the corporation's assets to A and B.[157] The Code taxes the liquidating corporation as if it sold its assets at their fair market value on the date of distribution.[158] Subsequently, the Code taxes A and B's receipt of the liquidation distributions as payments received in exchange for their stock.[159] Any gain recognized by A and B is a capital gain.[160]

In this example, the Code taxes XYZ on the $150,000 gain ($200,000 fair market value minus $50,000 basis) from the "sale" of its corporate assets.[161] After applying a 34% corporate tax rate, XYZ has approximately $100,000 to disburse to A and B.[162] The amount recognized by each shareholder ($50,000 less the shareholder's $10,000 basis in the stock) is subject to a 28% capital gains tax.[163] Thus, the shareholders each receive proceeds of only $29,000 from their corporate interests after the deemed liquida-

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box. *Id.* Therefore, an association is the only type of corporation permitted to make the check-the-box election.

156. *See* I.R.C. §§ 331, 336 (providing basic gain or loss rules for shareholders and corporations during liquidation).

157. *See id.* § 336(a) (stating that in liquidation, property is distributed to shareholders).

158. *See id.* (treating distributed property as if it were sold by corporation). Section 336(a) states that "gain or loss shall be recognized to a liquidating corporation on the distribution of property in . . . liquidation as if such property were sold to the distributee at its fair market value." *Id.*

159. *See id.* § 331(a) (providing treatment for received distributions). Section 331(a) provides that "[a]mounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." *Id.*

160. *See id.* § 1001(a) (providing directives necessary to determine amount of gain); *id.* § 331(a) (prescribing treatment for amounts received by shareholder upon liquidation); *see also* Treas. Reg. § 1.331-1(b) (as amended in 1968) (noting that distribution gain is calculated under § 1001 by comparing amount of distribution with basis of stock).

161. *See* I.R.C. § 336(a) (taxing liquidating corporation as if distributed property were sold).

162. *See id.* § 11(b)(1)(C) (providing 34% corporate tax rate for income between $75,000 and $10 million).

163. *See id.* § 1001(a) (determining gain on distribution). Under § 1001(a), the basis of the stock is subtracted from the amount realized. *Id.* The excess amount is the gain realized from the corporation's distribution. *Id.* In the example above, each shareholder subtracts the stock's basis ($10,000) from the amount realized ($50,000). The realized gain is therefore $40,000. *See also* I.R.C. § 1(h) (providing capital gains rate of 28%).

tion.[164] As this simple example shows, the deemed liquidation of a corporation is a costly transaction for those taxpayers who abandon corporate tax treatment in favor of partnership status.

One commentator has criticized the liquidation treatment that results when a pre-existing association (a corporation under check-the-box) elects partnership status.[165] Unfortunately, entities that selected corporate treatment prior to the check-the-box regulations must bear the costs of changing classification under the new regulations.[166] However, avoidance of this result would require a major change in the tax law.[167] Arguably, the cost to pre-existing corporations is small given the large number of entities that benefit from the simplicity of the check-the-box regulations.

B. *Transition Between the Old and New Regimes*

Tax experts do not anticipate a major exodus of businesses from the corporate form.[168] Because the entity classification system was essentially elective in the past, most businesses appropriately elected their desired classification prior to the check-the-box regulations.[169] The courts, however, not the taxpayer, ultimately must determine whether an entity's classification

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164. (100%-28%) x ($50,000 -$10,000) = $29,000.

165. *See* Brooks, *supra* note 89, at 1675 (noting many corporations would not have incorporated had check-the-box been in place).

166. *See* Scott E. Grimes et al., *Proposed Entity Classification Regs. Greatly Simplify Rules*, 25 TAX'N FOR LAW. 68, 74 (1996) (noting that liquidation prevents many corporations from becoming LLCs). *But see* Treas. Reg. § 301.7701-2(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (implying that unincorporated business with two or more members is classified as partnership for tax purposes); Darrow, *supra* note 66, at 34 (claiming partnerships should be able to convert to LLCs without income recognition). The majority of the elections under check-the-box will not yield such dire results as a deemed liquidation. *Id.* A partnership desiring status as an LLC or LLP suffers no adverse tax consequences when changing entity structure. *Id.* In order to convert to an LLC, partners merge their partnership into the newly formed LLC. *Id.* Thus, Darrow concludes that "the conversion should not result in the recognition of gain or loss by any of the partnership, the LLC, or the partners, except in the unlikely event that the conversion causes a partner's adjusted basis in his LLC interest to be reduced to zero." *Id.*

167. *See supra* notes 155-164 and accompanying text (requiring multiple code sections to calculate tax ramifications of corporate liquidation).

168. *See* Darrow, *supra* note 66, at 36 (noting individuals will not rush to embrace passthrough entities over corporations); Shefter, *supra* note 2, at 282 (stating that it is unlikely that "a check-the-box system would have a material impact on the use of corporations as a choice of entity"). Shefter notes that, in his experience, the defections to the LLC and LLP form have come from limited and general partnerships rather than corporations. *Id.* at 281-82.

169. *See supra* notes 68-85 and accompanying text (explaining former classification regulations were essentially elective system for knowledgeable taxpayers).

is permissible.[170] Pre-existing entities uncertain of their tax classification should exercise caution in the transition period to avoid unexpected consequences imposed by the Service.[171]

Treasury Regulation 301.7701-3(f)(2)(i) requires an entity existing prior to the check-the-box regulations to have a reasonable basis for its claimed classification.[172] Therefore, taxpayers still need to refer to the four factor classification system to ascertain whether the taxpayer's entity had a reasonable basis for its classification prior to the enactment of check-the-box.[173] A position lacks a reasonable basis if the taxpayer fails to ascertain the correctness of a position that would seem "too good to be true" to a prudent and reasonable person.[174] Commentators have expressed concern that not all

170. *See generally* Morrissey v. Commissioner, 296 U.S. 344 (1935) (determining whether trust has attributes of corporation); United States v. Kintner, 216 F.2d 418 (9th Cir. 1954) (determining tax status of partnership imbued with corporate characteristics); 1 MCKEE ET AL., *supra* note 12, ¶¶ 3.03, 3.06, 3.09 (citing cases used to distinguish partnerships from other business arrangements). The Service also takes an active role in classifying organizations through the issuance of Revenue Rulings. Over the past nine years, the Service has issued seventeen Revenue Rulings on the tax classification of LLCs. *See* Rev. Rul. 93-50, 1993-2 C.B. 310 (West Virginia) (classifying LLC as partnership for federal tax purposes); Rev. Rul. 93-30, 1993-1 C.B. 231 (Nevada) (same); Rev. Rul. 93-6, 1993-1 C.B. 229 (Colorado) (same); Rev. Rul. 93-5, 1993-1 C.B. 227 (Virginia) (same); Rev. Rul. 88-76, 1988-2 C.B. 360 (Wyoming) (same); *see also* Rev. Rul. 95-9, 1995-1 C.B. 222 (South Dakota) (classifying LLC as either partnership or association, depending on provisions of LLC's operating agreement); Rev. Rul. 94-79, 1994-2 C.B. 409 (Connecticut) (same); Rev. Rul. 94-51, 1994-2 C.B. 407 (New Jersey) (same); Rev. Rul. 94-30, 1994-1 C.B. 316 (Kansas) (same); Rev. Rul. 94-6, 1994-1 C.B. 314 (Alabama) (same); Rev. Rul. 94-5, 1994-1 C.B. 312 (Louisiana) (same); Rev. Rul. 93-93, 1993-2 C.B. 321 (Arizona) (same); Rev. Rul. 93-92, 1993-2 C.B. 318 (Oklahoma) (same); Rev. Rul. 93-91, 1993-2 C.B. 316 (Utah) (same); Rev. Rul. 93-81, 1993-2 C.B. 314 (Rhode Island) (same); Rev. Rul. 93-53, 1993-2 C.B. 312 (Florida) (same); Rev. Rul. 93-49, 1993-2 C.B. 308 (Illinois) (same); Rev. Rul. 93-38, 1993-1 C.B. 233 (Delaware) (same).

171. *See* Schler, *supra* note 58, at 1686 (fearing potential deemed liquidations of pre-existing corporations choosing partnership status).

172. Treas. Reg. § 301.7701-3(f)(2)(i) (as amended by T.D. 8697, 1997-2 I.R.B. 11).

173. *See supra* notes 48-58 and accompanying text (discussing application of *Kintner* regulations).

174. *See* Treas. Reg. § 301.7701-3(f)(2)(i) (requiring reasonable basis as defined in I.R.C. § 6662); *see also id.* § 1.6662-3(b)(1) (1996) (attributing negligent position as one without reasonable basis). Section 1.6662-3(b)(1) provides in part:

> A position with respect to an item is attributable to negligence if it lacks a reasonable basis. Negligence is strongly indicated where—
>
> . . .
>
> (ii) A taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

Id.

previously existing entities satisfy the reasonable basis standard.[175] Michael Schler, a partner in a New York law firm, hypothesized that a "short-lived tax subspecialty [may] now develop to determine not what is required by the existing four-factor test, but to determine what is required to have a reasonable basis for a desired position under the four-factor test."[176]

The tax ramifications of not having a reasonable basis can be extremely costly to the taxpayer. The costliness arises from the deemed liquidation that could occur if the entity lacks a reasonable basis for its partnership classification.[177] To illustrate the cost to an entity lacking a reasonable basis, Schler provides a hypothetical involving a new or existing entity intended to be a partnership under the four factor text.[178] The hypothetical involves an entity that believes it has a reasonable basis for partnership tax treatment.[179] On January 1, 1997, when check-the-box is implemented, the entity elects partnership treatment or reaches the same result under the default rule.[180] In 1998 the entity fails the reasonable basis test, resulting in the determination that it should have been taxed as a corporation until the election on January 1, 1997.[181] Consequently, Schler concludes that "there would be a retroactive deemed liquidation of the corporation on January 1, 1997."[182] A corporate liquidation is a costly and unexpected surprise to a taxpayer who otherwise thought the entity was in compliance with the reasonable basis standard.[183]

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175. *See* Schler, *supra* note 58, at 1686 (expressing concern about certain entities satisfying reasonable basis standard); Memorandum from J. William Callison on Single Member Limited Liability Companies 4 (Nov. 12, 1996) (on file with the *Washington and Lee Law Review*) (acknowledging that some entities may have difficult time satisfying reasonable basis standard).

176. *See* Schler, *supra* note 58, at 1686 (hypothesizing new tax subspecialty); *see also* Stratton et al., *supra* note 59, at 985 (quoting Treasury counsel on rule of reasonable basis). The Treasury's associate tax legislative counsel believes that the "real cottage industry that will develop between now and the time the regs are finalized . . . will be defining 'reasonable basis.'" *Id.*

177. *See supra* notes 155-164 and accompanying text (analyzing tax effects of deemed liquidations).

178. Schler, *supra* note 58, at 1686.

179. *Id.*

180. *Id.*; *see* Treas. Reg. § 301.7701-3(b)(3) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (providing that entity not making election will have same classification as claimed prior to new regulations).

181. Schler, *supra* note 58, at 1686.

182. *Id.*; *see* I.R.C. §§ 301(a), (c), 311 (1996) (providing tax ramifications of liquidation); *see also* Part V.A (providing example of deemed liquidation).

183. *See* Schler, *supra* note 58, at 1686 (exclaiming that retroactive liquidation is "quite severe and not in keeping with the general approach of the [new] regulations").

C. Single Member LLCs

1. Uncertainty Prior to Check-the-Box

One of the more significant provisions in the check-the-box regulations is the treatment of single member LLCs as noncorporate entities.[184] The new regulations treat single member LLCs that do not elect corporate treatment as "tax nothings."[185] A tax nothing is a single member entity that the regulations disregard for federal income tax purposes and treat as an extension of its owner.[186] Thus, the owner must report the income and losses of a single member LLC directly on the owner's tax return.[187]

Prior to the new regulations, confusion surrounded the tax treatment of single member LLCs.[188] Single member LLCs could not be partnerships because of their lack of partners.[189] Still, conflicting authority created

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184. *See* Hirani, *supra* note 3, at GG-1 (noting that "biggest news" concerning new regulations is that IRS did not change passthrough treatment for single owner entities); Robert R. Keatinge, *The Single-Member LLC: Operating Agreement Questions and Other Issues,* 3 J. LTD. LIAB. CO. 87, 87 (1996) (stating that "[o]ne of the most important possibilities opened by . . . [check-the-box] is the clear treatment of single member LLCs"); Schler, *supra* note 58, at 1682 (calling treatment of single member entities under new regulations "[a] major breakthrough").

185. *See* Treas. Reg. § 301.7701-2(c)(2) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (stating single owner entities that are not corporations are disregarded as entities separate from their owners). The default rules also automatically disregard domestic single member LLCs as entities separate from their owners. *Id.* § 301.7701-3(b)(1)(ii).

186. *See* David S. Miller, *The Tax Nothing*, 74 TAX NOTES 619, 619 (1997) (defining tax nothings as extensions of their owners).

187. *Cf.* I.R.C. § 701 (asserting that partners are liable for income taxes in their individual capacities).

188. *See* Rev. Proc. 95-10, 1995-1 C.B. 501 (stating that Service will not consider classifying single-member LLCs as partnerships for federal tax purposes); Jonathan Axelrad, Letters to the Editor, *Setting the Record Straight on Single-Member LLCs*, 68 TAX NOTES 361, 361 (1995) (commenting that both Service and taxpayers have defensible arguments for treatment of single member LLCs); Rod Garcia, *Single Member LLCs: Basic Entities Raise Complex Problems*, 68 TAX NOTES 142, 143 (1995) (noting that entity classification test loses some meaning when applied to single member LLCs); Larry E. Ribstein, *The Loneliest Number: The Unincorporated Limited Liability Sole Proprietor*, J. ASSET PROTECTION, May/June 1996, at 46, 47 (noting state statutes permitting one member LLCs invite firms into "a world of trouble and uncertainty"); Jerry S. Williford & Donald H. Standley, *How Should Single Member LLCs Be Classified for Federal Tax Purposes?*, 2 J. LTD. LIAB. CO. 27, 31-32 (1995) (attempting to apply *Kintner* regulations to single member LLCs); Bernard Wolfman, Letters to the Editor, *How to Treat Single-Member LLCs*, 68 TAX NOTES 361, 361 (1995) (explaining how single member LLCs should be treated under current tax law). *See generally* Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of the One-Member Limited Liability Company*, 59 TAX NOTES 1829 (1993) (analyzing *Kintner* regulations to determine how single member LLCs should be treated for tax purposes).

189. *See* UPA § 6(1) (defining partnership as "an association of two or more persons . . ."); RUPA § 202(a) (stating that "association of two or more persons . . . forms a partnership");

uncertainty in determining whether the classification of the entity for tax purposes was an association, a sole proprietorship, or even a trust.[190] Prudent tax planners formed LLCs with more than one member to ensure pass-through tax treatment.[191]

2. *Benefits and Pitfalls of the Single Member LLC Structure*

The regulations' treatment of single member LLCs provides tax planners with an important new tool for structuring businesses.[192] The primary benefit of organizing a single member LLC is the limited liability protection afforded the owner.[193] Prior to check-the-box, S-corporations provided the only certain means for a single member entity to obtain limited liability without incurring corporate tax.[194] The new regime permits individuals to

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Lawrence M. Axelrod, *Are Consolidated Returns Obsolete?*, 74 TAX NOTES 89, 89 (1997) (commenting that single member LLC cannot be taxed as partnership because it lacks essential element of partners).

190. *See* Wirtz & Harris, *supra* note 188, at 1830 (commenting that single member LLC should not be taxed as partnership nor classified as corporation); Kenneth Kral & Jack Serota, *The Check-the-Box Proposal: Simpler Classification for Both Foreign and U.S. Companies*, J. ACCT., Sept. 1996, at 34, 35 (noting little guidance on whether single owner entity receives flow-through tax treatment).

191. *See* Memorandum from J. William Callison, *supra* note 175, at 2 (noting proposed regulations raise question whether taxpayers should form single member LLCs prior to new regulations). Callison acknowledges that a reasonable basis probably exists for single member LLCs, but he recommends taking the conservative route (forming an LLC with two members) until the new regulations are approved. *Id.*; *see also* Steve Montgomery et al., *Classification of Single-Member LLCs to Be Clarified Under Final "Check-the-Box" Regulations*, 28 TAX ADVISER 13, 13 (1997) (stating major risk of structuring single member LLC under old rules was potential for Service to treat entity as corporation for tax purposes); Wirtz & Harris, *supra* note 188, at 1830 (asserting strong argument for passthrough treatment of single member LLC).

192. *See* Grimes et al., *supra* note 166, at 75 (acknowledging enormous planning flexibility for business organizations). Under the new regulations, an LLC may be structured in any manner and still receive partnership tax treatment. *Id.* Grimes warns, however, that LLCs treated as corporations will not be able to rely on state corporate law. *Id.* Instead, LLCs must include in their operating agreements those default corporate principles traditionally covered under state law. *Id.*; *see also Planning Opportunities*, *supra* note 113, at 2 (noting practitioners feel significant planning opportunity exists for many clients who may wish to form single member LLCs).

193. *See* Montgomery et al., *supra* note 191, at 14 (stating that "[a] single-member LLC provides liability protection while remaining transparent for Federal tax purposes"); Wirtz & Harris, *supra* note 188, at 1830 (noting primary advantage of single member LLC over sole proprietorship is limited liability protection for owner). Practitioners have viewed the single member LLC as a "limited liability, passthrough alternative to the S corporation" when only one equity owner exists. *Id.* at 1829.

194. *See* Miller, *supra* note 186, at 620 (stating that tax nothings are alternative to S-corporations); Wirtz & Harris, *supra* note 188, at 1829 (noting single member LLCs may provide alternative to S-corporations).

elect to shield themselves from liability and still achieve passthrough tax treatment.[195] This desired passthrough treatment is now available without abiding by the complicated S-corporation accounting and tax filing rules.[196] Other significant benefits of forming a tax nothing include the avoidance of consolidated returns and the reduction of some state tax liabilities.[197]

Normally, a sole proprietor wishing to form a single member LLC has no tax consequences when contributing assets to the new entity.[198] Tax consequences can arise, however, "if the [sole proprietor] is successful in convincing existing creditors to release the taxpayer from personal liability, and hav[ing] the liability assumed by the taxpayer's tax nothing."[199] This shift from recourse to nonrecourse debt can result in income with respect to the transferred liability.[200] Such modification of debt represents a trap for the unwary, and sole proprietors should consider the tax consequences before proceeding with a conversion.[201]

Another consideration regarding tax nothings is their ability to issue financial instruments.[202] Because a tax nothing is by definition a single member entity, outside persons purchasing equity interests could jeopardize the entity's tax status.[203] Financial instruments giving the holder an equity interest in the tax nothing would allow the holder to acquire an ownership interest in the tax nothing when the holder exercises the instrument.[204] Thus, the issuance of equity interests in a tax nothing could inadvertently result in the transformation of a tax nothing into a partnership.[205]

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195. *See* Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (stating that "single owner can elect to be . . . disregarded as an entity separate from its owner").

196. *See* Miller, *supra* note 186, at 620 (noting tax nothings under check-the-box are simpler to use than S-corporations).

197. *See id.* (providing benefits of tax nothings).

198. *See generally* Rev. Rul. 95-55, 1995-2 C.B. 313 (asserting partnership-to-partnership conversion recognizes no gains or losses); Rev. Rul. 95-37, 1995-1 C.B. 130 (holding that conversion from partnership to LLC is treated as partnership-to-partnership conversion and no gain or loss is recognized).

199. Miller, *supra* note 186, at 624.

200. *See id.* at 624 n.31 (citing Treasury Regulations that provide for gain when debt is modified).

201. *See id.* at 624 (warning of possible unintended costs of modifying debt from recourse to nonrecourse).

202. *See id.* at 628 (stating that one issue that will arise is extent to which tax nothings may issue financial instruments).

203. *See id.* (asserting that tax nothings may jeopardize their tax status by issuing equity instruments to nonmembers).

204. *See id.* (stating that financial instruments may give holder ownership interests in tax nothing).

205. *See id.* (hypothesizing undesired results if tax nothing issued equity interest in itself).

Single member LLCs also present potential problems regarding recognition at the state level.[206] For example, California has expressed concern with the complexities of disregarding single member LLCs for state tax purposes.[207] The chief counsel for the California Franchise Tax Board has commented that "California and those states with similar laws are not likely to permit a business entity with limited liability to have its separate existence ignored for state tax purposes."[208] Currently, California assesses an $800 tax on each LLC and imposes a $4,500 maximum gross receipts tax.[209] Such inconsistent state tax treatment creates confusion and unnecessary diligence for tax planners operating under the different federal and state rules.[210]

Currently, twelve states explicitly permit single member LLCs.[211] Uncertain federal tax treatment was the main reason why many states originally prohibited single member LLCs.[212] Check-the-box alleviates this uncer-

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206. *See id.* at 627 (noting tax nothing are subject to "significant uncertainties" under state tax laws); Marshall B. Paul & Stuart Levine, *One-Member LLCs Pose Often-Overlooked State Law Issues*, 1 J. LTD. LIAB. CO. 162, 163 (1995) (stating that "question of how the single-member LLC should be treated for state law purposes is of real concern"); Ribstein, *supra* note 188, at 48 (noting that single member LLC may have recognition problems outside "limited context" of formation state); Memorandum from J. William Callison, *supra* note 175 at 2 (expressing concern about possible nonrecognition of single member LLCs by some states); *cf.* Williford & Standley, *supra* note 188, at 27 (noting uncertainty in laws of some states when LLC is owned by one member).

207. *See* Hirani, *supra* note 3, at GG-2 (noting that California may not conform to regulations regarding single member LLCs); Miller, *supra* note 186, at 627 (same).

208. Hirani, *supra* note 3, at GG-2.

209. *See* CAL. REV. & TAX. CODE §§ 23,091(a), 23,153(d)(1) (West Supp. 1997) (imposing $800 franchise tax on LLCs); *id.* § 23,092 (imposing gross receipts tax on LLCs); FLA. STAT. ANN. § 608.471 (West 1996) (imposing tax on LLC); TEX. TAX CODE ANN. § 171.001(a)(2) (West 1992) (imposing franchise tax on "each limited liability company that does business in this state . . . or is authorized to do business in this state"); *see also* Kathryn A. Pischak, *State Tax Issues Complicate the Decision to Do Business as a Limited Liability Company*, 83 J. TAX'N 76, 79 (1995) (noting other states imposing entity level taxes on LLCs).

210. *See* Hirani, *supra* note 3, at GG-2 (noting confusion resulting from all states not conforming to check-the-box).

211. *See* Axelrod, *supra* note 189, at 89 n.3 (listing states recognizing single member LLCs). Examples include: ARK. CODE ANN. § 4-32-201 (Michie 1996); COLO. REV. STAT. ANN. § 7-80-203 (West 1996); DEL. CODE ANN. tit. 18, § 201 (1996); IDAHO CODE § 53-607 (1996); IND. CODE ANN. § 23-18-2-4 (Michie 1996); MO. ANN. STAT. § 347.037 (West Supp. 1997); MONT. CODE ANN. § 35-8-201 (1996); NEV. REV. STAT. § 86.151 (1996); N.M. STAT. ANN. § 53-19-7 (Michie 1996); N.Y. LTD. LIAB. CO. LAW § 203 (McKinney 1997); TEX. REV. CIV. STAT. ANN. art. 1528n (West 1996); VA. CODE ANN. § 13.1-1010 (Michie 1996). *But see* Keatinge, *supra* note 184, at 89 (noting that not all states permit organization of single member LLCs); Memorandum from J. William Callison, *supra* note 175, at 2 (warning that persons contemplating formation of single member LLCs must consider treatment of these entities in other jurisdictions).

212. *See* Keatinge, *supra* note 184, at 89 (noting principal reason for states prohibiting

tainty.[213] Therefore, many states that once prohibited single member LLCs may follow the Service and recognize them. However, at this time, it remains uncertain how the Service will treat single member LLCs formed before the effective date of the new regulations.[214] It is possible that some single member LLCs formed prior to check-the-box may experience difficulty in attaining a reasonable basis for prior tax treatment because of the uncertainty surrounding their classification under the old regulations.[215] Such results remain speculative and single member LLCs should proceed with caution when transacting business in foreign jurisdictions.[216]

D. *State Recognition of Check-the-Box*

Although check-the-box permits an eligible entity to select its tax treatment at the federal level, no such assurance exists under state tax law.[217]

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single member LLCs was concern with federal tax classification).

213. *See* Treas. Reg. § 301.7701-3(a) (as amended by T.D. 8697, 1997-2 I.R.B. 11) (permitting single member LLC to choose to be disregarded as entity separate from its owner). *But see* Grimes et al., *supra* note 166, at 75 (acknowledging that benefits of single member LLCs will only be available if states amend their LLC statutes); Hirani, *supra* note 3, at GG-2 (explaining that different sets of state and federal rules will confuse those aware and unaware of distinction); Keatinge, *supra* note 184, at 89 (noting that treatment of single member LLC in jurisdiction that does not provide for domestic single member LLCs is untested). Keatinge further points out that single member LLCs doing business in such jurisdictions should proceed with caution. *Id.*

214. At the time this Note was written, no known authority discussing the reasonable basis of a single member LLC prior to the check-the-box regulations exists.

215. *See* Treas. Reg. § 301.7701-2(a)(2) (as amended in 1993) (stating that *associates* are essential for all organizations engaged in business for profit); Grimes et al., *supra* note 166, at 75 (noting that satisfying transition provisions of check-the-box is important for any entity that did not receive letter ruling regarding its classification); Montgomery et al., *supra* note 191, at 13 (noting that "generally the transition rules under the [new] regulations are favorable to taxpayers"). Regulation § 301.7701-3(b)(3)(i) provides that an entity in existence prior to January 1, 1997 that claimed to be a partnership will be disregarded as an entity separate from its owner. Treas. Reg. § 301.7701-3(b)(3)(i) (as amended by T.D. 8697, 1997-2 I.R.B. 11). Therefore, a single member LLC that claimed partnership treatment under the old regulations will be disregarded for tax purposes under check-the-box. However, the real question is whether the LLC had a reasonable basis for partnership treatment under the old regulations. Showing a reasonable basis may prove difficult because the old regulations required a partnership to have more than two members. Wirtz & Harris, *supra* note 188, at 1831.

216. *See* Bruce P. Ely & Joseph K. Beach, *State Tax Treatment of LLCs and RLLPs*, 3 J. LTD. LIAB. CO., 45, 45-48 (1996) (listing states imposing entity level tax); Keatinge, *supra* note 184, at 89 (noting some states will tax single member LLCs because they tax all LLCs as matter of policy). Keatinge urges tax practitioners to consult the local tax authority before embarking on business in a state using a single member LLC. *Id.*

217. *See* Darrow, *supra* note 66, at 5 (explaining differing state tax treatments of LLCs). Darrow states that it "cannot be assumed that a state that has an LLC statute will accord flow-

Some states may choose not to conform their classification systems to the federal classification system.[218] Therefore, both practitioners and business entities must be aware of the potential differing tax treatments that may exist among the states.[219]

LLCs are likely to cause the majority of the discontinuities between state and federal tax recognition.[220] Most states imposing a state income tax will follow the Service's classification of an entity for state tax purposes.[221] States without an income tax, however, may impose an entity level tax or tax LLCs as corporations.[222] States that continue to tax LLCs as separate entities will prevent those entities from achieving the full tax benefits under check-the-box.[223] For example, Pennsylvania treats all LLCs as corporations

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through tax treatment to an LLC even if the LLC has flow-through status for *federal income tax purposes.*" *Id.* (emphasis added); *see also* Ely & Beach, *supra* note 216, at 45-48 (noting that at least 21 states impose entity tax on LLCs).

218. *See* Ely & Beach, *supra* note 216, at 45-48 (enumerating those states that deviate from federal classification of entities). Currently, Florida, Pennsylvania, and Texas tax LLCs as corporations. *Id.* at 45, 47-48; Pischak, *supra* note 209, at 78 (noting that some states impose state corporate tax on LLCs classified as partnerships for federal tax purposes); Shefter, *supra* note 2, at 283 (explaining state tax variations make task of classifying entities "more daunting"). Shefter makes his point by citing two jurisdictions that do not follow the federal classification. *Id.* Pennsylvania taxes LLCs as corporations, but allows limited partnerships and general partnerships to enjoy flowthrough treatment. *Id.* In New York City, LLCs, sole proprietorships, and corporations are all subject to different tax regimes. *Id.*

219. *See* Schler, *supra* note 58, at 1686 (commenting that "[t]o avoid unexpected surprises, taxpayers desiring a particular classification for federal income tax purposes would be well-advised to confirm that the same classification is available for state and local tax purposes"); Robert B. Thompson, *The Taming of the Limited Liability Companies,* 66 U. COLO. L. REV. 921, 943 (1995) (noting that state taxation of LLCs "is a separate question").

220. *See* Darrow, *supra* note 66, at 5, 19 n.105 (commenting on state entity tax imposed on LLCs by Florida, Michigan, New Hampshire, and Texas); Ely & Beach, *supra* note 216, at 45-48 (providing chart that classifies treatment of LLCs under every state law); Pischak, *supra* note 209, at 77-79 (discussing differing tax treatment of LLCs under state law).

221. *See* Pischak, *supra* note 209, at 77 (noting correlation between state income tax and federal tax classification).

222. *See id.* at 78-79 (noting entity level taxes on LLCs by some states without income taxes). For example, both Florida and Texas tax domestic and foreign LLCs as corporations. *Id.* Such a position is not surprising because neither state imposes an individual income tax. *Id.* Corporate tax treatment for LLCs is necessary to ensure the taxation of the LLC. *Id.* Otherwise, an LLC would be taxed as a passthrough entity and could escape state taxes altogether because no income tax is assessed at the individual level. *Id.*; *see also* Ely & Beach, *supra* note 216, at 45-48 (listing states imposing level tax on LLCs despite federal treatment). States choosing to impose entity level taxes on LLCs include: Alaska, Arkansas, California, Delaware, Georgia, Illinois, Kansas, Maryland, Michigan, Minnesota, New Hampshire, New York, South Carolina, Tennessee, Washington, West Virginia, and Wisconsin. *Id.* at 45-48.

223. *See supra* notes 207-209 and accompanying text (discussing California franchise tax imposed on LLCs).

for state tax purposes.[224] Thus, a Pennsylvania LLC is subject to a state double tax despite its passthrough status at the federal level.[225] Such treatment hinders the efficiency of the new regulations.

E. *The Corporation as a Viable Entity Choice*

Throughout this Note, the discussion has suggested that organizations should avoid corporate classification. Corporations, however, still remain an important and useful entity for structuring business transactions.[226] Two obvious benefits result from an entity's selection of the corporate form. First, corporate tax rates are lower than the individual rates.[227] Second, corporations can achieve many of the same advantages enjoyed by partnerships.[228] Both reasons are illustrated in the following example.

An owner of a small business forms a corporation in order to take advantage of the 15% corporate tax rate on a corporation's first $50,000 of income.[229] The owner's business subsequently makes $50,000. Out of the corporate profits, the corporation pays the owner a $36,000 salary. The salary is a deductible business expense for the corporation.[230] The corporation deducts the salary payment of $36,000 and pays the $2000 tax (15% tax on $14,000).[231] The Code taxes the owner's salary ($36,000) at the individual rate of 28 percent, leaving the owner with $26,000.[232] Combined, the owner and the corporation have a total tax bill of $12,000. Had the $50,000 income instead passed through to the owner, the tax bill would have been $14,000 (28 percent of $50,000).[233] In this example, the corporate form

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224. *See* PA. STAT. ANN. tit. 15, § 8925(a) (West 1995) (stating that any foreign or domestic LLC shall be treated as corporation for state tax purposes).

225. *See supra* Part II (discussing corporate double tax).

226. *See* 1 MCKEE ET AL., *supra* note 12, ¶ 2.02[4][a] (commenting on situations where corporate form may continue to be advantageous).

227. *See* I.R.C. § 11 (1996) (stating corporate tax rate is 15% for up to $50,000 of corporate income); Thompson, *supra* note 219, at 944 (commenting that "immediate tax bill for pass-through enterprises is often higher than a similar business in corporate form").

228. *See infra* notes 229-235 and accompanying text (indicating that careful corporate tax planning can yield benefits similar to those enjoyed by partnerships).

229. *See* I.R.C. § 11 (stating corporate tax rate is 15%).

230. *See id.* § 162(a)(1) (stating "[t]here shall be allowed as a deduction . . . a reasonable allowance for salaries").

231. *See id.* (providing deduction for salaries).

232. *See id.* § 1(c) (stating individual tax rates). Section 1(c) provides that individual with income up to $53,500 is to be taxed at the marginal rate of 28%. *Id.*

233. *See id.* (providing tax rate for $36,000 of income).

resulted in a lower tax bill for the owner than if the owner had selected passthrough treatment.[234] The owner avoided the double tax by receiving a salary rather than a dividend, thereby receiving an advantage normally available only to passthrough entities.[235]

Another reason a business may select corporate form is to avoid the extremely complex partnership rules.[236] Although partnership classification offers passthrough treatment, it can be very difficult to allocate the partnership's earnings among the various members.[237] Partnership taxation rules are virtually incomprehensible to the average business person, making tax practitioners essential to ensure the proper tax treatment of a partnership's earnings.[238]

Finally, investors in an entity may not desire partnership treatment in some situations. For example, a partnership may allocate two percent of its net profits to each partner. However, an allocation does not necessarily mean that each partner receives cash.[239] In order to receive cash, there must be a partnership agreement to make a cash disbursement.[240] The two percent allocation is still included in a partner's gross income and is subject to tax.[241] Thus, such a partnership may fail to attract passive investors who do not wish to incur taxes without receiving a cash payment.

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234. *See* 1 MCKEE ET AL., *supra* note 12, ¶ 2.02[4][a] (providing example of small business taking advantage of corporate rates). *But see* Thompson, *supra* note 219, at 944 (explaining that over long run, corporation double tax will overshadow immediate corporate tax advantage). Thompson's analysis depends on the amount of salaries and dividends paid by the corporation. A small unincorporated business with only a few shareholders could continue to invest the corporation's earnings back into the corporation, while only paying necessary compensation for shareholder services. Such an arrangement exposes a minimal amount of income to the double tax, thus yielding a tax advantage to the corporate owners.

235. *See* I.R.C. § 162(a)(1) (1996) (permitting deductibility of salaries); *id.* § 61(a)(7) (1996) (including dividends in individual's gross income).

236. *See generally id.* at subch. K (providing complex web of partnership taxation rules).

237. *See generally* Treas. Reg. §§ 1.704-1 to -4 (1996) (comprising over 93 pages in Code of Federal Regulations).

238. *Compare* I.R.C. subch. K (providing partnership taxation rules) *with* subch. C (providing less complex rules for determining corporate taxation).

239. *See* RUPA § 401(b) (entitling each partner to equal share of partnership profits). Section 401 merely requires the partnership to credit the partner's account and not to pay out the partner's equal share in cash. *See id.* (providing no cash payout requirement).

240. *See id.* (omitting any requirement to pay out partner's share of profits in cash).

241. *See generally* I.R.C. § 704(a) (1996) (providing that partner's distributive share shall be determined by partnership agreement).

VI. Conclusion

Under the *Kintner* regulations, an entity based its tax classification on the presence or absence of four corporate characteristics. Initially, this classification regime provided an accurate distinction between partnership and corporate tax classification. However, the advent of state-created entities such as LLCs quickly made the *Kintner* regulations obsolete. The former classification system became arbitrary and permitted taxpayers to achieve whatever tax classification they desired simply by manipulating the *Kintner* elements. Ultimately, the former regulations resulted in a system that benefited the tax proficient, but proved to be a trap for the unsophisticated.

The new check-the-box regulations represent a necessary departure from the old classification regulations. Check-the-box brings clarity, certainty, and simplicity to an entity's tax classification decision. The new regulations also provide flexibility by allowing eligible entities to choose between partnership and corporate tax classifications. The departure from the *Kintner* regulations does not mean that all entities (existing or new) automatically will choose passthrough status. Instead, check-the-box gives eligible entities the freedom to structure their business operations without worrying about meeting tax classification requirements. Taxpayers are given the best of both worlds — desired tax treatment and their choice of entity. Thus, the new regulations shift the concerns of the taxpayer away from satisfying the regulations and back to earning a profit.