



Internal Revenue Service Adopts "Check-the-Box" Classification Regulations

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In Treasury Decision 8697, published in the Federal Register for December 18, 1996, the Internal Revenue Service adopted its so-called check-the-box regulations setting forth its simplification of the entity classification rules. These long-awaited regulations, which are effective January 1, 1997, dramatically change the rules governing classification of entities for federal income tax purposes as partnerships or as associations taxable as corporations. The new regulations replace classification rules which "have become increasingly formalistic" with "a much simpler approach that generally is elective."

Overview

The new regulations completely replace the existing classification rules and apply both to domestic and to foreign entities. They retain the approach of the regulations as proposed in the May 13, 1996 Federal Register and list a number of categories of domestic organizations which are always classified as corporations; similarly, they also list for each of 80 (82 in the proposed

regulations) foreign jurisdictions the entities formed in the jurisdiction which are also always treated as corporations (*e.g.*, a German *Aktiengesellschaft*). Any foreign or domestic entity which is not in a category always classified as a corporation (an "eligible entity" under the regulations) and which has two or more owners can elect whether to be treated as a partnership or as a corporation. A single owner eligible entity can elect either to be taxable as a corporation or to be disregarded for federal income tax purposes with its activities treated in the same manner as a sole proprietorship, branch or division of its owner. Finally, the regulations provide for "default" classification for entities failing to make an election.

Domestic Corporations

Under the new rules (as was the case under the proposed regulations) the following domestic organizations are always classified as corporations:

- Business entities organized under a federal or State statute, or under a statute of a federally recognized Indian tribe, if the statute describes or refers to the entity as incorporated or as a corporation, body corporate or body politic,
- A business entity organized under a State statute, if the statute describes or refers to the entity as a joint-stock company or joint-stock association,
- An insurance company,
- A State-chartered business entity conducting banking activities, if any of its deposits are insured under the Federal Deposit Insurance Act (as that Act requires those entities to be incorporated to be eligible for federal deposit insurance) or similar federal statute,
- A business entity wholly owned by a State or any political subdivision thereof, and
- A business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than the general classification rules of section 7701(a)(3) (such as a taxable mortgage pool or publicly traded partnership).

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<ftp://pmstax.com/part/td8697.pdf> and
<ftp://pmstax.com/forms/onscreen/f8832.pdf>.

For an earlier report on the proposed regulations, please see our **June 1996 Partnership Tax Bulletin** at <http://www.pmstax.com/part/bull9606.html> (also available via ftp at <ftp://pmstax.com/part/bull9606.pdf> as a 266K pdf file), which in turn contains a link to the IRS Notice of Proposed Rulemaking with the text of the proposed regulations; that Notice is also available via ftp as a 70K pdf file at <ftp://pmstax.com/part/prop7701-9605.pdf>. © 1996.

Foreign Corporations

Under the new regulations the following foreign organizations are always treated as corporations:

American Samoa, *Corporation*
 Argentina, *Sociedad Anonima*
 Australia, *Public Limited Company*
 Austria, *Aktiengesellschaft*
 Barbados, *Limited Company*
 Belgium, *Societe Anonyme*
 Belize, *Public Limited Company*
 Bolivia, *Sociedad Anonima*
 Brazil, *Sociedade Anonima*
 Canada, *Corporation and Company*
 Chile, *Sociedad Anonima*
 People's Republic of China, *Gufan Youxian Gongsi*
 Republic of China (Taiwan), *Ku-fen Yu-hsien Kung-szu*
 Colombia, *Sociedad Anonima*
 Costa Rica, *Sociedad Anonima*
 Cyprus, *Public Limited Company*
 Czech Republic, *Akciova Spolecnost*
 Denmark, *Aktieselskab*
 Ecuador, *Sociedad Anonima or Compania Anonima*
 Egypt, *Sharikat Al-Mossahamah*
 El Salvador, *Sociedad Anonima*
 Finland, *Osakeyhtio/Aktiebolag*
 France, *Societe Anonyme*
 Germany, *Aktiengesellschaft*
 Greece, *Anonymos Etairia*
 Guam, *Corporation*
 Guatemala, *Sociedad Anonima*
 Guyana, *Public Limited Company*
 Honduras, *Sociedad Anonima*
 Hong Kong, *Public Limited Company*
 Hungary, *Reszvenytarsasag*
 Iceland, *Hlutafelag*
 India, *Public Limited Company*
 Indonesia, *Perseroan Terbuka*
 Ireland, *Public Limited Company*
 Israel, *Public Limited Company*
 Italy, *Societa per Azioni*
 Jamaica, *Public Limited Company*
 Japan, *Kabushiki Kaisha*
 Kazakstan, *Ashyk Aksionerlik Kogham*
 Republic of Korea, *Chusik Hoesa*
 Liberia, *Corporation*
 Luxembourg, *Societe Anonyme*
 Malaysia, *Berhad*
 Malta, *Partnership Anonyme*
 Mexico, *Sociedad Anonima*
 Morocco, *Societe Anonyme*
 Netherlands, *Naamloze Vennootschap*
 New Zealand, *Limited Company*
 Nicaragua, *Compania Anonima*
 Nigeria, *Public Limited Company*
 Northern Mariana Islands, *Corporation*
 Norway, *Aksjeselskap*
 Pakistan, *Public Limited Company*
 Panama, *Sociedad Anonima*
 Paraguay, *Sociedad Anonima*
 Peru, *Sociedad Anonima*
 Philippines, *Stock Corporation*
 Poland, *Spolka Akcyjna*
 Portugal, *Sociedade Anonima*
 Puerto Rico, *Corporation*
 Romania, *Societe pe Actiuni*
 Russia, *Otkrytoye Aksionerloy Obshchestvo*
 Saudi Arabia, *Sharikat Al-Mossahamah*
 Singapore, *Public Limited Company*
 Slovak Republic, *Akciova Spolecnost*
 South Africa, *Public Limited Company*
 Spain, *Sociedad Anonima*
 Surinam, *Naamloze Vennootschap*
 Sweden, *Publika Aktiebolag*
 Switzerland, *Aktiengesellschaft*
 Thailand, *Borisat Chamkad (Machachon)*
 Trinidad and Tobago, *Public Limited Company*
 Tunisia, *Societe Anonyme*
 Turkey, *Anonim Sirket*
 Ukraine, *Aksionerne Tovaristvo Vidkritogo Tipu*
 United Kingdom, *Public Limited Company*
 United States Virgin Islands, *Corporation*
 Uruguay, *Sociedad Anonima*
 Venezuela, *Sociedad Anonima or Compania Anonima*

The final regulations provide that different linguistic renderings of an entity are disregarded. For example, a Swiss *Societe Anonyme* is always regarded as a corporation even though only a Swiss *Aktiengesellschaft* is listed.

Notable differences from the proposed regulations are (i) the elimination from the list of any *Naamloze Vennootschap* formed under the laws of Aruba or the Netherlands Antilles and (ii) the addition of Canadian *companies* to the list. However, a Canadian corporation or company is treated as not being on the list of foreign entities always classified as corporations, and is thus an

eligible entity, if it is formed under any federal or provincial law which provides that the liability of all members of the corporation or company is unlimited. Similarly, an Indian company deemed to be a public limited company under certain provisions of Indian law may nonetheless qualify as an eligible entity.

Under a special grandfather rule, foreign organizations meeting the following criteria are treated as not being described in the list of foreign entities always classified as corporations:

- The entity was in existence on May 8, 1996;
- On May 8, 1996 the entity's classification affected the liability of any person for federal tax or information reporting purposes;
- No person, including the entity, who was so affected on May 8, 1996 treats the entity as a corporation for purposes of filing such person's federal income tax returns, information returns and withholding documents for the taxable year which includes May 8, 1996;
- Any change in the entity's classification within the 60 months prior to May 8, 1996 occurred solely as a result of a change in the entity's organizational documents, and the entity and each of its members recognized the federal tax consequences of any such change occurring during such 60-month period;
- A reasonable basis (within the meaning of Internal Revenue Code section 6662) existed on May 8, 1996 for treating the entity as other than a corporation; and
- Neither the entity nor any of its members had been notified in writing on or before May 8, 1996 that the classification of the entity was under examination by the Internal Revenue Service.

For purposes of this grandfather rule, the date of an organization's formation will be used in lieu of May 8, 1996 if the organization is formed after May 8, 1996 by virtue of a written binding contract in effect on that date and at all times thereafter, pursuant to which the parties agreed to engage, directly or indirectly, in an active and substantial business operation in the jurisdiction in which the entity is formed.

The grandfather rule ceases to apply, *i.e.*, a grandfathered foreign entity on the list of foreign

organizations always treated as corporations will be treated permanently as a corporation, upon the earliest of (i) the effective date of an election to be treated as a corporation, (ii) a constructive termination of the partnership under Internal Revenue Code section 708(b)(1)(B) (other than by reason of sales or exchanges of interests in an entity covered by the binding contract rule to "related persons" no later than 12 months after the entity's formation) or (iii) a division of the partnership under Internal Revenue Code section 708(b)(2)(B).

Default Classification

Domestic Entities

Partnership (or, in the case of single owner entities, disregarded) status is the default classification for domestic eligible entities. Accordingly, a newly formed domestic organization not in a category always classified as a corporation will be considered a partnership (or disregarded for federal income tax purposes if it has a single owner) unless an election is filed to be taxable as a corporation; no affirmative action will be required to assure partnership (or disregarded) classification.

Foreign Entities

Partnership (or, in the case of single owner entities, disregarded) status is the default classification for a foreign eligible entities only where at least one of the organization's members has personal liability for the debts of the organization; otherwise, corporate status is the default classification. The question of member liability for an organization's debts is determined solely by reference to the applicable local statute or law under which the entity is organized. The final regulations clarify that personal liability exists where a member is personally liable for all or any portion of an organization's debts and that an entity's organizational documents may be relevant if local law permits the entity to specify in those documents whether members have limited liability.

Elections

An eligible entity files an election as to its classification on Internal Revenue Service Form 8832, Entity Classification Election, with the Internal Revenue Service Center specified therein (Philadelphia). The election will not be effective unless all information required by Form 8832, including the entity's taxpayer identification number, is provided. The election must be signed by

(i) each member of the electing entity as of the filing date or (ii) any member, officer or owner of the electing entity authorized to make the election who must so represent under penalties of perjury. However, if the election is to be effective prior to its filing date, the election must also be signed by each person who was a member during the effective period who is not also a member on the filing date.

The election will be effective on the date specified in the election if that date is no earlier than 75 days prior to the election's filing date or no later than 12 months following that filing date. The election will be effective January 1, 1997 if the specified effective date is earlier than that date. If the specified effective date is earlier than 75 days prior to the filing date, the election is effective 75 days prior to its filing date. Similarly, if the specified effective date is more than 12 months following the filing date, the election will be effective 12 months after its filing date. If no effective date is specified in the election, the election is effective on its filing date.

An electing entity must also file a copy of its election with its federal income tax return for the taxable year for which the election is made. If the organization is not required to file a federal income tax return for that year, the direct and indirect owners of the organization are to file copies of the election with their federal income tax returns for the taxable year which includes the election's effective date. The final regulations clarify that the failure by an electing entity or its direct or indirect owners to comply with this filing requirement will not invalidate an otherwise valid election, but note that the noncomplying parties may be subject to certain penalties.

Although an eligible entity can elect to change its classification, once it does so it cannot again change its classification by election during the ensuing 60 months. However, this rule is not triggered by an existing entity electing to change its classification as of January 1, 1997 and, in addition, the IRS may permit a change in classification within the 60-month period if more than 50 percent of the organization's ownership interests as of the effective date of the subsequent election are held by persons who held no interests in the organization on the filing date or effective date of the earlier election.

Existing Organizations

The new classification rules apply to periods beginning on or after January 1, 1997. Unless it elects otherwise, an eligible entity in existence prior to that time will retain its classification without the need for an election, except that a single owner organization which claimed to be a partnership will be disregarded for federal income tax purposes. A foreign eligible entity is treated as in existence prior to January 1, 1997 only if its classification affected the liability of any person for federal tax or information reporting purposes at any time during the sixty months preceding January 1, 1997.

An election by an existing eligible entity to change its classification as of the effective date of the new classification rules does not prevent the organization from subsequently electing to change its classification within the ensuing 60 months.

Further, the Internal Revenue Service will not challenge the classification of any eligible entity or any foreign entity included in the list of 80 foreign organizations always classified as corporations for periods prior to January 1, 1997 if (i) the organization had a reasonable basis (within the meaning of Internal Revenue Code section 6662) for its claimed classification, (ii) the organization and each of its members recognized the federal income tax consequences of any change in the organization's classification within the 60 months prior to January 1, 1997 and (iii) neither the organization nor any of its members had been notified in writing on or before May 8, 1996 that the organization's classification was being examined by the Internal Revenue Service.

State and Local Taxation

Some planning opportunities or pitfalls may exist as to classification of entities for state or local tax purposes, particularly in those jurisdictions which do not automatically classify an organization based upon its status for federal income tax purposes. For example, the California Franchise Tax Board has expressed some concern over adopting for California tax purposes the new federal rule which treats single-member organizations not classified as corporations as sole proprietorships, branches or divisions of their owners.