

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS**

***THE CHECK-THE-BOX REGULATIONS
IN A NUTSHELL – PART III***

ISSUE NO. 5 (DECEMBER 1, 2003)

THE “STANDARD” AND “REVERSE” CHECK-THE-BOX RULES
IN TABULAR FORM

Dear Colleagues:

As you know, next to doing tax choice-of-entity analyses, the most important task that tax professionals must perform in assisting clients to start new businesses is to perform Check-the-Box analyses for them. As you may recall from the last two issues of this Newsletter, the need for these analyses arises in two quite different situations:

- Applying the Seven “Standard” Check-the-Box Rules. In the first situation, your clients have already formed a state-law business entity to conduct their business – e.g., a state-law business corporation, an LLC, or a limited partnership – before coming to you for tax advice. In this situation, after advising them as to which federal tax regimen (i.e., sole proprietorship taxation or taxation under Subchapters C, K or S) is best for them, you must then advise them whether, under the seven “standard” rules set forth in the Check-the-Box Regulations and other federal tax authorities, their entity can qualify for this regimen. Friends of mine in the CPA and EA communities have suggested to me that a need to apply these “standard” rules arises in the case of roughly 20% of their business start-up clients.

EXAMPLE: Before seeing you, your clients John and Mary Doe have formed a New Hampshire business corporation to conduct their new retail business. When they meet with you, you advise them that for federal income and Social Security Tax purposes and for New Hampshire state tax purposes, the best tax regimen for them is Subchapter K (partnership taxation). Then, applying the “standard” Check-the-Box rules, you advise them that their corporation cannot qualify for Subchapter K treatment and that they must either accept Subchapter C and S taxation or form another state-law business entity – for example, an LLC – that, under these rules, does qualify to be taxed under Subchapter K.

- Applying the Eight “Reverse” Check-the-Box Rules. In the second situation, your clients have not yet formed a state-law business entity to conduct their business before visiting you. In this situation, after having advised them of the federal tax regimen that will be best for them, you apply the eight “reverse” Check-the-Box rules to advise them as to which types of state-law business entities qualify for treatment under that regimen. CPAs and EAs have suggested to me that they find themselves applying the “reverse” Check-the-Box rules in the case of at least 80% of their business start-up clients.

***EXAMPLE:** Your clients John and Mary Doe come to you for tax advice before forming any state-law business entity to conduct their new retail business. You advise them that the best federal tax regimen for their business is Subchapter K. Then, applying the “reverse” Check-the-Box rules, you advise them that any type of state-law multi-owner unincorporated business entity can qualify for Subchapter K tax treatment and that only a state-law business corporation cannot qualify for this treatment. You then advise them that multi-owner unincorporated business entities include traditional general partnerships, limited liability partnerships (“LLPs”), limited partnerships and LLCs. Now it is up to John and Mary’s business lawyer to advise them as to which of these types of entities will be best for them from a nontax viewpoint.*

In my tax practice, I have found that once I understand the theory underlying any area of tax, I can best apply this theory if I first set forth its basic elements in the form of one or more tables. In particular, I find tables to be useful in applying the standard and reverse Check-the-Box rules. Set forth below are both of these tables in the form in which I use them in making Check-the-Box analyses. I doubt that you will find these two tables entirely self-explanatory, but I hope that on the basis of the theoretical discussions in Issues 3 and 4 of this Newsletter, you will find them to be practical tools in making Check-the-Box analyses. I am also including this Newsletter as an attachment to this e-mail as a Word document in case your e-mail program has difficulty with e-mail messages containing relatively complex formats such as tables.

TABLE 1 - THE SEVEN “STANDARD” CHECK-THE-BOX RULES

TYPE OF STATE-LAW ENTITY	FEDERAL TAX CLASSIFICATION	DEFAULT FEDERAL INCOME TAX REGIMEN	FEDERAL INCOME TAX REGIMENS AVAILABLE FOR ELECTION	FEDERAL INCOME TAX REGIMENS UNAVAILABLE TO ENTITY
1. Corporation – one shareholder	Corporation	Subchapter C	Subchapter S (subject to Subchapter S eligibility and election requirements)	Sole proprietorship
2. Corporation – two or more shareholders	Corporation	Subchapter C	Subchapter S (subject to Subchapter S eligibility and election requirements)	Subchapter K
3. Sole proprietorship	None	Sole proprietorship	None	Subchapters C, K and S
4. Division	None	Regimen of owner	None	Regimen different than that of owner

TYPE OF STATE-LAW ENTITY	FEDERAL TAX CLASSIFICATION	DEFAULT FEDERAL INCOME TAX REGIMEN	FEDERAL INCOME TAX REGIMENS AVAILABLE FOR ELECTION	FEDERAL INCOME TAX REGIMENS UNAVAILABLE TO ENTITY
5. Single-member LLC owned by individual	Disregarded entity	Regimen of owner	Subchapter C Subchapter S (subject to Subchapter S eligibility and election requirements)	Subchapter K
6. Single-member LLC owned by entity	Disregarded entity	Regimen of owner	Subchapter C Subchapter S (subject to Subchapter S eligibility and election requirements)	Subchapter K
7. Multi-owner unincorporated business entity (includes (i) non-LLP general partnership, (ii) LLP; (iii) limited partnership and (iv) LLC	Partnership	Subchapter K	Subchapter C Subchapter S (subject to Subchapter S eligibility and election requirements)	Sole proprietorship taxation

[TABLE 2, WHICH PRESENTS THE “REVERSE” CHECK-THE-BOX RULES, BEGINS ON THE NEXT PAGE.]

TABLE 2 - THE EIGHT “REVERSE” CHECK-THE-BOX RULES

RULE NUMBER	NUMBER AND TYPE OF BUSINESS OWNERS	CLIENT WANTS THE FOLLOWING FEDERAL INCOME TAX REGIMEN	AVAILABLE TYPES OF STATE-LAW ENTITIES	COMMENTS
1)	One owner, who is an individual	Sole proprietorship taxation	<ol style="list-style-type: none"> 1. State-law sole proprietorship 2. Single-member LLC 	Under the Check-the-Box Regulations, sole proprietorship taxation is the default federal income taxation for single-member LLCs owned by individuals.
2)	One owner, who is an individual	Subchapter C taxation	<ol style="list-style-type: none"> 1. State-law corporation 2. Single-member LLC 	Under the Check-the-Box Regulations, individuals who own single-member LLCs may elect Subchapter C taxation by using Form 8832.
3)	One owner, who is an individual	Subchapter S taxation	<ol style="list-style-type: none"> 1. State-law corporation 2. Single-member LLC 	Shareholders of state-law corporations and members of single-member LLCs who have elected Subchapter C may elect Subchapter S taxation using Form 2553.
4)	One owner, which is an entity	Division of owner	<ol style="list-style-type: none"> 1. Division 2. Single-member LLC 	Under the Check-the-Box Regulations, the default federal tax treatment of single-member LLCs owned by entities is divisional treatment.
5)	One owner, which is an entity	Subchapter C taxation	<ol style="list-style-type: none"> 1. Division; 2. Corporation 3. Single-member LLC 	Under the Check-the-Box Regulations, entities that own single-member LLCs may elect Subchapter C treatment for these LLCs.

RULE NUMBER	NUMBER AND TYPE OF BUSINESS OWNERS	CLIENT WANTS THE FOLLOWING FEDERAL INCOME TAX REGIMEN	AVAILABLE TYPES OF STATE-LAW ENTITIES	COMMENTS
6)	Two or more individuals or entities	Subchapter K taxation	Any type of multi-owner unincorporated business entity	<p>There are four main types of multi-owner unincorporated business entities – namely:</p> <ol style="list-style-type: none"> 1. Non-LLP general partnership 2. LLP 3. Limited partnership 4. LLC <p>Under the Check-the-Box Regulations, the default tax treatment of multi-owner unincorporated business entities is taxation under Subchapter K.</p>
7)	Two or more individuals or entities	Subchapter C taxation	<ol style="list-style-type: none"> 1. Any type of multi-owner unincorporated business entity 2. Corporation 	Under the Check-the-Box Regulations, owners of multi-owner unincorporated business entities may elect Subchapter C treatment for their entities using Form 8832.
8)	Two or more individuals or other persons (e.g., QSSTs) permitted to be Subchapter S shareholders	Subchapter S taxation	<ol style="list-style-type: none"> 1. Any type of multi-owner unincorporated business entity 2. Corporation 	See note immediately above. Under Subchapter S, any entity (including a multi-owner unincorporated business entity) that meets Subchapter S requirements may elect Subchapter S treatment.

A parting message: During the past few months, many of you have called or e-mailed me with LLC tax and legal questions that have arisen in your practice. I love receiving these questions, and I always learn something from answering them. Please keep them coming! If you care to call me, my telephone number is (603) 228-0125. My e-mail address is lawjmc@comcast.net.