

**JOHN CUNNINGHAM'S LLC e-NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

ISSUE NO. 60 (JUNE 10, 2009)

**WHAT NEW HAMPSHIRE ACCOUNTANTS AND LAWYERS
FORMING NEW HAMPSHIRE LLCs
SHOULD KNOW ABOUT THE CHECK-THE-BOX REGULATIONS
—A PLAIN-ENGLISH INTRODUCTION**

**PART I—THE PURPOSE AND HISTORY OF
THE CHECK-THE-BOX REGULATIONS; ITS IMPACT ON LLCs; ITS PRINCIPAL RULES**

EXECUTIVE SUMMARY. The U.S. Treasury Department's Entity Classification Regulations, referred to by many federal tax practitioners as the Check-the-Box Regulations, play a crucial role in determining the federal income taxation of New Hampshire business entities, other state-law business entities and their owners. They have also played and will continue to play a major role in the remarkable emergence of the LLC form.

New Hampshire lawyers who handle only non-tax issues in LLC formations should have at least a basic knowledge of the Check-the-Box Regulations, since this knowledge is critical as general background for their LLC formation practice and since it can greatly facilitate discussions with tax specialists about particular LLCs. Accountants and lawyers who handle tax issues in these formations need to understand these regulations comprehensively, since they have a profound and continuing effect on the taxation of LLCs not only under the Internal Revenue Code (the "IRC") but also under the tax laws of most states.

The present issue of this newsletter discusses the purpose and history of the Check-the-Box Regulations, their impact on the LLC business organization form, and the key rules contained in them. Subsequent newsletters will discuss other critical matters relating to the Check-the-Box Regulations.

DISCUSSION

I. THE PURPOSE OF THE CHECK-THE-BOX REGULATIONS

- 1) In order to understand the purpose of the Check-the-Box Regulations,¹ one must first understand the distinction between:
 - a) *Federal tax classifications*; and
 - b) *Federal income tax regimens*.
- 2) *Federal tax classifications* are types of entities that have specified business organization law characteristics set forth in U.S. Treasury Department entity classification regulations. The IRC identifies only two such classifications—namely, “corporations” and “partnerships.” The Check-the-Box Regulations identifies these and two additional classifications—namely, “associations” and “disregarded entities.” An example of a state-law business entity whose federal tax classification under the Check-the-Box Regulations is that of a corporation is an entity formed under a state-law corporate statute.
- 3) *Federal income tax regimens* are unified sets of IRC rules that govern the federal income taxation of business entities. There are three principal federal income tax regimens—namely, taxation under IRC Subchapter C, Subchapter K and Subchapter S.² In addition, various rules under IRC §§ 1 and 2 impose federal income taxes on the income, including the business income, of individuals, and it is convenient to think of these rules as constituting a fourth federal income tax regimen, referred to here as “sole proprietorship taxation.” A determination as to which of these regimens governs a particular type of business entity or an individual business person depends upon the federal tax classification of that entity or person.
- 4) However, the purpose of the Check-the-Box Regulations is not to answer the question as to which types of *federal income tax regimens* are available to business entities classified as corporations; and these regulations *do not* answer this question. To answer the question, we have to look to rules in the IRC.
- 5) For example, the terms of the IRC provide by implication that entities whose federal tax classification is that of corporations are taxable either as corporations under Subchapter C or under Subchapter S; and Subchapter S provides rules that determine whether a business entity whose default federal income tax regimen is Subchapter C can elect to be taxable under Subchapter S.

¹ For readers who have only a limited knowledge of federal income tax law: The basic federal tax authority is, of course, the Internal Revenue Code, as enacted by the U.S. Congress. The U.S. Treasury Department has issued thousands of pages of regulations under the IRC, and it continues to issue them. The authority of these regulations is in some respects as that of the IRC itself. The Internal Revenue Service also publishes administrative guidelines under the IRC, including, among many other types, “Revenue Rulings” and “Revenue Procedures,” that often have substantial authority on the federal tax issues that they address.

² The principal IRC rules governing the federal income taxation of business entities classified as corporations are IRC Subchapter C, §§ 301-385; and IRC Subchapter S, §§ 1361-1379. The principal IRC rules governing the federal income taxation of business entities classified as partnerships are set forth in IRC Subchapter K, §§ 701-777. Subchapter C is a double-tax regimen that imposes a tax on business entities taxable as C corporations and then on their stockholders when they receive dividends from them. Subchapter S and Subchapter K are pass-through tax regimens that, with a few narrow exceptions, impose taxes only on the owners of, respectively, S corporations and entities taxable as partnerships.

- 6) The IRC section that originally defined the meaning of the classifications of business entities identified in the IRC as “corporation” and “partnership” was § 7701(a). The definitions in this section were—and they remain—at best partial and vague. However, for many years, the deficiencies of the section didn’t much matter, since, during this period, most of the business entities subject to IRC taxation were specifically identified as corporations or as partnerships under state law and were self-evidently subject to federal income taxation as, respectively, corporations and partnerships.
- 7) However, in recent decades, several new kinds of business entities have arisen, including:
 - a) Single-member LLCs;
 - b) Multi-member LLCs;
 - c) Limited liability partnerships;
 - d) Limited liability limited partnerships; and
 - e) Statutory trusts.
- 8) Furthermore:
 - a) Under amendments to the corporate statutes of several states in recent decades, it has become possible to form state-law business corporations that have a management structure and many other business organization law features that make them virtually indistinguishable from traditional general and limited partnerships.
 - b) In recent decades, the state statutory law governing general and limited partnerships has also undergone major change. For example:
 - i) Historically, neither general nor limited partnerships were treated as entities under state statutory law. However, most contemporary state general and limited partnership statutes endow partnerships with entity status.
 - ii) In addition, traditional state limited partnership statutory law provided that limited partners who participated in limited partnership management would lose their liability shield. However, many contemporary limited partnership statutes permit limited partners to exercise extensive management rights in their limited partnerships without forfeiting their limited liability.
 - c) The purpose of the Check-the-Box Regulations is to define the default federal tax classification of domestic and foreign business entities and, in the case of unincorporated business entities, to permit elections into other classifications. These rules are summarized in Part III of this newsletter. The Check-the-Box Regulations provide that the determination of the default classifications of all types of business entities must be made on the basis of specified business organization law characteristics.

Among other things, the Check-the-Box Regulations provide very clear rules for determining the federal tax classification of single- and multi-member LLCs and of the other new types of entities identified above; and in defining what types of

entities must be classified for federal tax purposes as corporations and partnerships, the Check-the-Box Regulations take into account the above major changes in corporate, general partnership and limited partnership statutory law.³

II. THE IMPACT ON THE LLC BUSINESS ORGANIZATION FORM

- 1) The federal tax classification rules that immediately preceded the Check-the-Box Regulations were referred to by tax practitioners as the Kintner Regulations. The rules in the Kintner Regulations were complex and often difficult to apply; they did not address the federal tax classification of single-member LLCs; and to facilitate the classification of LLCs as partnerships under them, state LLC statutes contained tax-driven provisions that made little sense from a business organization law viewpoint.
- 2) The rules in the Check-the-Box Regulations are far clearer and easier to apply than the Kintner Regulation rules; they address the federal tax classification of single-member LLCs; and they are easy and safe to apply to all types of business entities. The adoption of the Check-the-Box Regulations made it possible to remove the above tax-driven LLC statutory provisions; and the adoption of the Check-the-Box Regulations triggered a vast nationwide increase in the formation of LLCs.
- 3) To illustrate the explosion of the popularity of the LLC form: In 1998, the year after the adoption of the Check-the-Box Regulations, a total of 30,701 LLCs were formed under the Delaware Limited Liability Company Act; in 2007, the total was 81,923.

III. THE KEY RULES IN THE CHECK-THE-BOX REGULATIONS

The three most important rules in the Check-the-Box Regulations are those that deal with the federal tax classification of *domestic* state-law business entities. These rules and their impact on the determination of the federal income tax regimens of business entities are summarized below and in the table in Exhibit A to this newsletter.

- 1) The federal tax classification of business entities formed under corporate statutes; the federal income tax regimens available to these entities. If a domestic business entity is formed under a state-law business organization statute under which it is identified as a corporation:
 - a) Its federal tax *classification* will be that of a corporation.
 - b) Its default federal income tax *regimen* will be Subchapter C.
 - c) However, if it meets Subchapter S eligibility requirements and makes a valid S election, its federal income tax regimen will be Subchapter S.
- 2) The federal tax classification of single-owner unincorporated business entities; the federal income tax regimens available to these entities. If an entity is a *single-owner* “unincorporated” business entity (i.e., an entity *not* formed under a corporate statute):
 - a) Its default federal tax *classification* will be that of a disregarded entity—a new classification not appearing in the IRC itself and specifically developed by the U.S. Treasury Department for use in the Check-the-Box Regulations.

³ “Federal tax purposes” principally include purposes relating to federal income taxes, Social Security taxes and federal excise taxes.

- b) However, the entity may elect to be classified as an *association*. Associations are a type of business entity that is identified in IRC § 7701 as fitting within the federal tax classification of “corporation” but that is not defined in that section. In general, associations are state-law business entities that are not denominated as corporations under the relevant state business organization law, but that, for policy reasons, the U.S. Treasury Department has decided should be taxable as corporations.
 - c) The default federal income tax *regimen* of a business entity classified as an association is Subchapter C.
 - d) However, if the entity meets Subchapter S eligibility requirements and makes a valid S election, its federal income tax regimen will be Subchapter S.
- 3) The federal tax classification of multi-owner unincorporated business entities; the federal income tax regimens available to these entities. If an entity is a multi-owner “unincorporated” business entity:
- a) Its default federal tax *classification* will be that of a partnership.
 - b) Its default federal income tax *regimen* will be IRC Subchapter K.
 - c) However, it may elect out of its default federal income tax regimen as a partnership and into classification as an association. If it makes this election:
 - i) Its default federal income tax regimen will be Subchapter C.
 - ii) However, if meets Subchapter S eligibility and election requirements, its federal income tax regimen will be Subchapter S.

IV. CONCLUSION

The Check-the-Box Regulations determine the federal tax classification of business entities formed under U.S. statutory business organization law or foreign business organization law. On the basis of these federal tax *classifications*, federal tax practitioners can determine from the terms of the IRC which federal income tax *regimens* are available to these entities. All lawyers who form New Hampshire LLCs should have at least a basic understanding of the Check-the-Box Regulations. Lawyers who handle LLC tax issues must understand them comprehensively.

EXHIBIT A

**FEDERAL TAX CLASSIFICATION AND TAXATION OF BUSINESS ENTITIES
—OVERVIEW**

TYPE OF STATE-LAW BUSINESS ENTITY	DEFAULT FEDERAL TAX CLASSIFICATION; AVAILABLE ELECTION TO ANOTHER CLASSIFICATION	AVAILABLE FEDERAL INCOME TAX REGIMENS	EXAMPLES UNDER NEW HAMPSHIRE BUSINESS ORGANIZATION LAW
1. Single-owner or multi-owner entity identified as corporation in the statute under which it is formed	Default federal tax classification is that of corporation. May not elect any other federal tax classification.	Default federal income tax regimen is Subchapter C. May elect Subchapter S if Subchapter S eligibility and election rules are met.	Corporation formed under New Hampshire Business Corporation Act
2. Single-owner unincorporated business entity	Disregarded entity, but may elect to be classified as an association	If entity accepts default federal tax classification of disregarded entity, it will be disregarded for federal tax purposes and its tax items will be deemed to be those of its member. If it elects to be classified as an association, its default federal income tax regimen will be Subchapter C but it may elect Subchapter S if it meets the relevant requirements.	Single-member LLC formed under New Hampshire Limited Liability Company Act
3. Multi-owner unincorporated business entity	Partnership, but may elect to be classified as an association.	If entity accepts default federal tax classification of disregarded entity, it will be disregarded for federal tax purposes and its tax items will be deemed to be those of its member. If it elects to be classified as an association, its default federal income tax regimen will be Subchapter C but it may elect Subchapter S if it meets the relevant requirements.	Multi-member LLC formed under New Hampshire Limited Liability Company Act; general partnerships and limited liability partnerships formed under New Hampshire Partnership Act; limited partnerships and limited liability limited partnerships formed under New Hampshire Limited Partnership Act

If you have comments on this column or wish to contact me for any other reason, please send me an e-mail at lawjmc@comcast.net or give me a call at (603) 228-0125. If you'd like to visit my website, the link is www.llcformations.com.

C:\Users\Ken Chalifour\Desktop\Issue 60 - 6-10-09 - CTBR -- purpose history impact - basic rules.doc

