

Internal Revenue Service Proposes “Check-the-Box” Classification Regulations

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In the Federal Register for May 13, 1996, the Internal Revenue Service published a notice of proposed rulemaking for its so-called check-the-box regulations setting forth its simplification of the entity classification rules. These long-awaited regulations, when adopted, will dramatically change the rules governing classification of entities for federal income tax purposes as partnerships or as associations taxable as corporations. The stated objective is to “replace the increasingly formalistic rules under the current regulations with a much simpler approach that generally is elective.”

Overview

The proposed regulations are comprehensive in that they apply both to domestic and to foreign entities. They list a number of categories of domestic organizations which are always classified as corporations; they also list for each of 82 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 proposed 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 proposed regulations provide for “default” classification for entities failing to make an election.

Domestic Corporations

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,
- A business entity that is taxable as an insurance company under the Internal Revenue Code,
- 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).

Foreign Corporations

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

American Samoa, *Corporation*
Argentina, *Sociedad Anonima*
Aruba, *Naamloze Vennootschap*
Australia, *Public Limited Company*
Austria, *Aktiengesellschaft*
Barbados, *Limited Company*
Belize, *Public Limited Company*
Belgium, *Societe Anonyme or Naamloze Vennootschap*
Bolivia, *Sociedad Anonima*
Brazil, *Sociedade Anonima*
Canada, *Corporation*
Chile, *Sociedad Anonima*
People’s Republic of China, *Company Limited by Shares*
Republic of China (Taiwan), *Company Limited by Shares*
Colombia, *Sociedad Anonima*

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Costa Rica, *Sociedad Anonima*
 Cyprus, *Public Limited Company*
 Czech Republic, *Akciova Spolecnost*
 Denmark, *Aktieselskab*
 Ecuador, *Sociedad Anonima or Compania Anonima*
 El Salvador, *Sociedad Anonima*
 Egypt, *Sharikat Al-Mossahamah*
 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 Terbatas*
 Ireland, *Public Limited Company*
 Israel, *Public Limited Company*
 Italy, *Societa per Azioni*
 Jamaica, *Public Limited Company*
 Japan, *Kabushiki Kaisha*
 Kazakstan, *Ashyk Aktsionerlik 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*
 Netherlands Antilles, *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 Aktsionernoy 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, *Aktiebolag*
 Switzerland, *Aktiengesellschaft or Societe Anonyme*
 Thailand, *Borisat Chamkad (Machachon)*
 Trinidad & Tobago, *Public Limited Company*
 Turkey, *Anonim Sirket*
 Tunisia, *Societe Anonyme*
 Ukraine, *Aktsionerne Tovaristvo Vidkritogo Tipu*
 United Kingdom, *Public Limited Company*
 United States Virgin Islands, *Corporation*
 Uruguay, *Sociedad Anonima*
 Venezuela, *Sociedad Anonima or Compania Anonima*

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.

Elections

An eligible entity files an election as to its classification with the "appropriate" Internal Revenue Service Center. The election must contain the organization's name, address and taxpayer identification number, the classification being elected, whether the election results

in a change in classification and whether the organization is domestic or foreign. The election must be signed by (i) each member of the electing entity or (ii) any member, officer or owner of the electing entity authorized to make the election who must so represent under penalties of perjury. The election will be effective on a date specified in the election if that date is no earlier than 75 days prior to the election's filing date; otherwise the election is effective on the filing date.

An electing entity must also file a copy of its election with its first federal income tax return. If the organization is not required to file a federal income tax return, the direct and indirect owners of the organization are to file copies of the election with their federal income tax returns.

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. The preamble to the proposed regulations clarifies that an original election by a newly formed organization, even one to avoid default classification, is not an election to change the organization's classification and so does not trigger the 60-month rule. The preamble contains a reminder that a change in classification can have collateral tax effects; for example an eligible entity classified as a corporation which elects to change its classification to a partnership will be treated as having undergone a taxable liquidation.

An electing eligible entity that does not have a taxpayer identification number must apply for one at the time it makes its election. An organization eligible and electing to be disregarded for federal income tax purposes is to provide the taxpayer identification number of its single owner. An eligible entity is not required to obtain a new taxpayer identification number when it makes an election changing its classification.

Existing Organizations

The new classification rules will apply to periods beginning on or after the date final regulations are adopted. 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 once the new classification rules become effective. A foreign eligible entity is treated as in existence prior to the effective date of the new rules only if its classification is relevant to any person for federal tax purposes for the period which includes the date immediately preceding the new rules' effective date (the "relevancy test"). A foreign entity which does not satisfy this condition is treated as newly formed at the time it satisfies the relevancy test.

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. This rule appears to apply even to foreign eligible entities which do not meet the relevancy test.

Further, the Internal Revenue Service will not challenge the classification of any eligible entity or any foreign entity included in the list of 82 foreign organizations always classified as corporations for periods prior to the effective date of the new classification rules if (i) the organization had a reasonable basis (within the meaning of Internal Revenue Code section 6662) for its claimed classification, (ii) the organization claimed the same classification for all prior periods 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.