Reconsidering Entity Selection

in

Uncertain Times

William P. Streng
Professor of Law
University of Houston Law Center
Houston, Texas 77204-6060
Email: wstreng@uh.edu

Presentation
at
Tax Section
Houston Bar Association
October 21, 2009

This material will also be available at the following website: www.law.uh.edu/faculty/wstreng

myf\sp\HBA Tax Section -2009.2 -rev-10-27-2009
October 27, 2009

CHOICE OF ENTITY

SYNOPSIS

When initiating a commercial business, conducting a professional practice, managing a portfolio of real estate or oil and gas investments or engaging in many other types of business or investment activities a most important element is deciding what type of entity should be chosen for owning and conducting these activities. This is a question certainly involving federal tax considerations for both the entity and its owners, but it also concerns many other elements such as state business entity laws and creditors rights rules.

The choices are particularly difficult when federal income tax rates may be changing and when economic conditions are fluctuating dramatically. Consequently, the professional advisor must proceed with knowledge, experience and wisdom in advising clients about the available entity choices in this context. The identification in the title to this paper that we are in "uncertain times" emphasizes the necessity of carefully differentiating between the many factors important for choosing a business or investment entity when that entity must be functional both currently and when dramatic economic and tax changes occur.

This paper identifies many of the important elements in making these choices. This paper clearly can not be exhaustive of this subject and, consequently, much of the approach in this analysis is to address this subject through identifying recent developments: legislation, court decisions, IRS pronouncements and evolving planning possibilities.

Prof. William P. Streng
HBA Section of Taxation
October 21, 2009

TABLE OF CONTENTS

A. BIBLIOGRAPHY CONCERNING OBAMA ADMINISTRATION CHECK-THE-BOX PROPOSALS

B. ATTACHMENTS

One: Tax Rate Comparison Chart

Two: Chart Showing Alternative Business Organization Forms (Excerpted from Streng, "Choice of Entity," Tax Management Portfolio No. 700-2nd, Worksheet 1)

Three: Chart Showing Comparison of Business Entity Requirements (Excerpted from Streng, "Choice of Entity," Tax Management Portfolio No. 700-2nd, Worksheet 2)

Four: LLC & LLP Comparison Chart

Five: Charts Showing Foreign Based Structures, including Disregarded Entities Structures

I. Introduction

The objective of this paper is to enable the possible consideration (and reevaluation) of the choice of an entity to use for business or investment activities.[1] A basic premise in this discussion is that, from the local law business organization perspective, the advisor understands the fundamental structure and the business law rules and regulations applicable to the available entities.[2] Of course, to facilitate this examination the various parties do need to have an adequate understanding of the basic business entities and the pertinent terminology. In this context consider the following from the first paragraph of Justice Scalia's opinion in Arthur Andersen LLP, et al., Petitioners v. Wayne Carlisle et al., ___ US ___, 129 S. Ct. 1896 (May 4, 2009):

> "As a part of the scheme, respondents invested in various stock warrants through newly created **limited liability corporations (LLCs)**, which are also respondents in this case." (Emphasis added).

Perhaps Justice Scalia has tried to invent a new form of business entity. Since the attempted tax shelter transaction generated losses through the use of stock warrant investments Justice Scalia presumably was identifying a limited liability company (i.e., a real LLC), not a "corporation" (as defined for state law purposes). We must assume that he was not seeking to imply that some other type of corporation also exists, e.g., an unlimited liability corporation. Consequently, what this reference really emphasizes is the absolute necessity for clarity in the identification of the specific type of entity desired.[3]

---

[1] For the author's more detailed analysis of the subject of the "choice of entity" see Streng, "Choice of Entity," Tax Management Portfolio No. 700-2nd (2007).

[2] Useful materials for Texas practitioners for examining these questions are the course materials for the State Bar of Texas CLE program entitled "Choice of Entity in Troubled Times," May, 2009.

[3] An interesting discussion concerning the status of a corporation (in contrast to a human being) occurred recently in an argument in the U.S. Supreme Court concerning a campaign finance case. See Bravin, "Sotomayor Issues Challenge To a Century of Corporate Law," Wall

II. Why Is Entity Choice Important?

A. The Significance of Entity Choice

The choice of entity is not necessarily controlled by federal tax planning elements, but they are always important to be analyzed in this process. The number of federal tax elements which are important in the choice of a particular entity through which to conduct business and investment activities is substantial. The prominence of specific elements of these various types of business organizations can vary significantly in differing situations. Those tax elements might include:

1) Income recognition upon asset transfers in the organization process.
2) Capital structure elements, including the division between debt and equity, the opportunity to have multiple classes of ownership interests, and limitations on the types of owners.

> *Example: In Taproot Administrative Services Inc. v. Commissioner, 133 T.C. ___, No. 9 (Sept. 29, 2009) The Tax Court held that a Roth individual retirement account (IRA) is not an eligible shareholder of an S corporation and, therefore, a corporation whose sole shareholder is a Roth IRA must be taxed as a C corporation. The Tax Court identified its rationale that traditional IRAs are not eligible S corporation shareholders because the beneficiary of a traditional IRA is not taxed currently on the IRA's share of the S corporation's income where the beneficiaries of the permissible S corporation shareholder trusts listed in Code §1361(c)(2)(A) are taxed currently on the trust's share of such income. The opinion further specified that because the tax-free accrual of income and gains is one of the*

Street Journal, September 17, 2009, p. A19, cl. 4. Justice Sotomayor suggested that "the court should reconsider the 19th century rulings that first afforded corporations the same rights flesh-and-blood people have." She was quoted as stating that judges "created corporations as persons, gave birth to corporations as persons" and "[t]here could be an argument made that that was the court's error to start with .. [by imbuing] a creature of state law with human characteristics." Therafter, Justice Ruth Bader Ginsburg was quoted as continuing: "A corporation, after all, is not endowed by its creator with inalienable rights."

> *cornerstones of traditional and Roth IRAs, it would make no sense to treat IRAs as grantor trusts thereby ignoring one of their quintessential benefits. Then, using a statutory analysis, the court observed: "To begin with, IRAs are not explicitly listed in section 1361 as eligible S corporation shareholders. ... Had Congress intended to render IRAs eligible S corporation shareholders, it could have done so explicitly, as it has in the limited case of banks desiring to elect S status."*

3) Income taxation of the entity's income, whether at the entity level, after distribution or merely attribution to the owners.
4) Flexibility to allocate income to owners in variance from their equity interests.
5) Effects of distributing cash, property and entity ownership units to the owners.
6) The transfer or termination of a particular owner's interest in the entity.
7) The taxable termination of the enterprise, including a complete liquidation.
8) The (anticipated) tax-free disposition of all the interests in the entity.

In the tax context additional elements for consideration can include compensation arrangements, employment tax issues, and the impact of transnational aspects.

The choice of entity is not necessarily controlled by federal tax considerations and can be significantly impacted by such other elements as:

1) Business risk allocation.
2) Protection (e.g., in creditors' rights legislation) against liabilities, particularly for the owners of the various types of equity interests in the enterprise.
3) State tax applicability to some entities, but not to others.
4) Exposure to litigation, applicable court procedures and risks in arbitration and litigation.
5) Particularly in the closely held entity ownership context, the complexities in transferring ownership, including in the estate planning context, and the potential for reducing federal estate tax values through valuation discounts and similar arrangements.
6) Fiduciary obligations (e.g., care and loyalty) among the owners of the enterprise, and to others.

7) The capability to raise capital.
8) The continuity of the life of the enterprise.
9) Recognition of the legal status of the entity in other jurisdictions.
10) Capability to participate in business combinations and conversions.
11) The cost for the formation of the entity and the continuing costs for its administration and management.

B. What is an "Entity" (for Federal Tax Purposes)?

A discussion of entity choice necessitates that one actually knows what is an "entity" for federal tax purposes. Reg. §301.7701-1(a) specifies that the Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. "Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law." Reg. §301.7701-1(a)(2) provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants "carry on a trade, business, financial operation, or venture and divide the profits therefrom." This regulation notes that, for example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.[4]

Reg. §301.7701-2(a) provides little further help when specifying that "...a *business entity* is any entity recognized for federal tax purposes (including an entity with a

[4] This regulation continues: "nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops they do not "necessarily" create a separate entity for federal tax purposes. Note the discussion below at Segment III F of this paper concerning various alternatives to an "entity" which may be useful in particularized investment situations.

single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code." This "definition" does not help us much other than to tell us that trusts are not business entities for federal tax purposes.

C. Current Entity Usage - IRS Statistics Comparing Choices

When in 1997 the "check-the-box" rules were finalized many practitioners anticipated the eventual demise of the S corporation, with the substitute being the limited liability company.[5]

---

[5] See Staff of the Joint Committee on Taxation, "Review of Selected Entity Classification and Partnership Tax Issues," JCS-6-97 (April 8, 1997), where (p. 23) the report noting the issue of "whether there is a continuing need in the tax law for parallel pass-through systems for general business activities...Although S corporations (and their shareholders generally are treated similarly to partnership (and their partners), significant differences exist, some of which favor S corporations while others favor partnerships." Further, the report states (at p. 24) that "[i]f an LLC can provide limited liability to all owners and achieve pass-through status as a partnership under the check-the-box regulations (or under the Service's prior revenue rulings on LLCs), the need for S corporations could be questioned. Particularly in light of the growing use of LLCs, it could be argued that the greet flexibility of the partnership tax rules outweigh the principal advantage of S corporation: relative simplicity. Thus, it is argued that the rules for S corporation could be repealed without detriment to taxpayers. Others say the continued existence of subchapter S is worthwhile. A corporate charter is a prerequisite imposed by regulators for some trades or businesses (e.g., for depository institutions or to hold certain licenses), and LLCs may not meet such regulatory requirements. Moreover, the corporate form is a familiar, time-tested format, while the LLC form is new and unfamiliar (particularly where a business undertakes interstate commerce). Subshapter S supporters further point out that the rules of subchapter S are much simpler than the rules of subchapter K....Others point to specific advantages of subchapter S over the partnership tax rules (primarily the ability to convert from C to S corporation status generally without current corporate tax on appreciation, the availability of the tax-free reorganization rules for business combinations and reorganizations). At least under LLC interests are as easily issued in capital markets as traditional corporate stock, the S corporation may continue to be an attractive vehicle in which to start a business, if it is anticipated that it will later go public. Finally, any repeal of subchapter S would require rules providing for the treatment of existing S corporations."

This anticipated decline of the S corporation has not occurred.[6] The number of entities taxed as S corporations still exceeds the number of entities taxed as partnerships for federal tax purposes. The most recent statistics available show that the number of S corporations increased by 5.1 percent to 3.9 million for the tax year 2006, so that S corporation represent nearly two-thirds of all U.S. corporations.[7] The number of shareholders in S corporations also increased by 5.1 percent to 6.7 million. The total net income (less deficits) of S corporations increased 7.0 percent to $386.2 billion.

The number of business tax returns filed for the fiscal year 2008 were as follows:[8]

1) Partnerships - 3.307 million
2) S corporations - 4.440 million
3) C (or other) corporations - 2.538 million[9]

Consequently, although more corporations existed than partnerships for tax purposes, most of the entities were conduit organizations.

D. The Federal Tax "Check the Box" Regime

The choice of an entity is often significantly influenced by the "check-the-box" or choice of entity rules. Tax practitioners are quite familiar with these rules that a business entity organized under a federal or state statute will be a *per se* corporation for federal tax purposes if the state statute refers to the entity as incorporated as a

---

[6] Remembering the Mark Twain quotation after hearing that his obituary had been published in the New York Journal: "The reports of my death are greatly exaggerated."

[7] See IR-2009-77, August 25, 2009, "Summer 2009 Statistics of Income Bulletin Now Available."

[8] See IRS, Statistics of Income, "Table 2. Number of Returns Filed, by Type of Return, Fiscal Years 2007 and 2008."

[9] This number includes tax returns for REMICs, cooperatives, foreign corporations, REITs, RICs and miscellaneous other corporate organizations.

corporation, body corporate, or body politic or as an "association."[10] Certain foreign entities specifically identified in the tax regulations will be similarly treated as corporations for federal tax purposes.[11] A business entity not so classified under these rules can elect its classification for federal tax purposes.[12] An "eligible entity" with (1) at least two members can elect to be classified as either an association (and, therefore, a corporation) or a partnership and (2) a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. Certain default classification rules apply to any eligible entity that does not make the election.[13]

The check-the-box system has had both successes and failure since implementation in 1997, and remains under stress.[14] The international components of this system are under attack by the Obama Administration as constituting a frustration of the Subpart F/deferral system of taxing the indirectly received foreign income of U.S. corporations. In the domestic environment the check-the-box system has adjusted to those taxpayers wanting to change federal tax status of an entity because of the changing tax rate relationships between corporate taxation and individual taxation, or for other reasons.[15] And, with federal income tax rate changes for individuals

---

[10] Reg. §301.7701-2(b)(1) & (2).

[11] Reg. §301.7701-2(b)(8).

[12] Reg. §301.7701-3(a).

[13] Reg. §301.7701-3(b).

[14] See Field, "Checking in on 'Check-the-Box,'" Loyola of Los Angeles Law Review, Vol. 42, p. 451, Winter, 2009. At page 470 the author notes that between 1997 and 2007 over 326,000 check-the-box elections were filed with the Service. At page 489 (fn. 205) the author indicates that of a total of 97,922 elections made by foreign entities, 62,218 such elections were made to classify entities as disregarded.

[15] Note from the Field article (fn. 14) Appendix A (article, p. 525) that during the early 2000s the number of (particularly) domestic check-the-box elections increased (to a peak in excess of 45,000 for the year 2006) but has subsequently declined.

possibly on the near term horizon these perspectives could adjust again.[16]

E. The Timeliness of Making the Entity Choice

A business entity that is not classified as a corporation for federal tax purposes will be an "eligible entity" which can elect its classification for federal tax rules, making that election consistent with the rules specified in Reg. §301.7701-3. Default rules provide for the tax classification of an eligible entity if no election is made, particularly:

1) A domestic eligible entity is (a) a partnership if it has two or more members or (b) is disregarded as an entity separate from its owner if it has a single owner.

2) A foreign eligible entity will be classified (a) as a partnership if it has two or more members and at least one members does not have limited liability, (b) as an association if all members have limited liability, or (c) as a disregarded entity separate from its owner if it has a single owner that does not have limited liability.

Often an alternative status is desired but the parties do not make an election timely to avoid the applicability of a default rule. The Service has adopted a quite liberal position concerning remedying this failure to make a timely entity classification election. In Rev. Proc. 2009-41, 2009-39 IRB 439 (superseding Rev. Proc. 2002-59, 2002-2 CB 615) the Service has extended late entity classification relief to both initial entity classification elections and changes in entity classification elections. The filing time can be as late as three years and 25 days after the requested effective date of entity classification. This Revenue Procedure was effective on September 28, 2009. At the taxpayer's election this can apply to entity classification relief requests presently before the Service (and this could possible allow the taxpayer to obtain a refund of the private letter ruling user fee).

[16] See at Appendix A an historical summary of the relationship of federal corporate and individual income tax rates.

III. What are the Available "Entity Choices"?

A. The Usual Suspects for Entity Choice

When examining entity choices the traditional options are identified as:

1) C corporations,[17]
2) S corporations,[18]
3) general partnerships,
4) limited partnerships, and
5) limited liability companies.[19]

These might be organized as domestic entities (i.e., under the laws of a state of the United States or the district of Columbia) or as a foreign entity (i.e., under the laws of a jurisdiction outside the United States).

Of course, for individuals the sole proprietorship is also a fundamental alternative. An individual or a business enterprise might (as noted in greater detail below) have an interest in a limited liability company treated as a conduit for federal tax purposes and that entity would be a "disregarded entity" or a "tax nothing" for federal tax

---

[17] Under local law the business organization code provisions may enable greater flexibility for shareholders in the management of a "close corporation." See Texas Business Organizations Code §§3.008, 21.703, 21.713. But, these provisions will have no impact on the classification for federal tax purposes of the entity either as a type of corporation ("C" or "S") or in distinguishing a corporation from a partnership.

[18] For a comparison between partnerships and S corporations see Schwidetzky, "Integrating Subchapters K and S," Tax Lawyer, Vol. 62, No. 3, p. 749 (Spring 2009).

[19] Although the LLC is often treated as a partnership for federal tax purposes for local business law purposes the owners of the LLC re ordinarily called "members." The management of the LLC occurs under a "company agreement" (which is similar to a limited partnership agreement). The business affairs of an LLC may be conducted by a designated "manager."

purposes.[20] That disregarded entity status could arise by reason of a statutory dissolution under state business organization laws.[21]

In the business context terminology which is often used to describe a cooperative business project is "joint venture." However, the business-deal parties (not tax lawyers) often do not differentiate whether this joint undertaking is organized in corporate, partnership, limited liability company, or merely a contractual format. So this situation can present a challenge of assuring the correct identification of the tax status of the entity.

B. Some Current Issues Concerning Tax Differences in Entity Choice

The usual perspective of tax planners is that corporations are to be placed in one column and partnerships and LLCs are together in the other column. Tax planners do recognize the differences between C corporations and S corporations, including that for tax purposes an S corporation, to be eligible for that status, must:
i) be a domestic corporation.
ii) have no more than 100 shareholders (but liberal rules apply in determining this limit).

---

[20] Note in this context Rev. Rul. 2004-77, 2004-2 CB 119, where the Service indicated that if an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is disregarded as an entity separate from its owner or an association taxable as a corporation.

[21] A corporation can become a disregarded entity upon the corporation's dissolution, including a dissolution which occurs when a corporation is administratively dissolved by its state of incorporation for the failure to file appropriate reports or pay necessary franchise taxes. In CCA 200852001 under applicable community property laws a husband and wife were equal shareholders of a corporation which was administratively dissolved. The Chief Counsel's office advised that the corporation should be treated as a disregarded entity, owned by the husband and wife as the sole proprietors of the business. The Chief Counsel's office noted that ordinarily this entity would then be treated as a partnership because it had two members but in this situation would be treated as a disregarded entity because it was owned by the husband and wife solely as community property (citing Rev. Proc. 2002-69, 2002-2 CB 831).

iii) have no more than one class of stock.[22]
iv) have no shareholders other than individuals who are residents or citizens of the United States and certain trusts, estates or exempt organizations.

The S corporation may have a C corporation as a subsidiary even if the S corporation owns 80 percent or more the C corporation. An S corporation may own a qualified Subchapter S subsidiary, i.e., a "QSSS" (a domestic corporation owned 100 percent by the S corporation and for which an election is made).[23]

Tax planners often equate S corporation status and partnership/LLC status as basically tax equivalent, but many important differences must be identified in these contexts. This paper cannot detail all those differences, but some important differentiating issues are identified here:

1) Corporation vs. Partnership

- The tax basis for the partner in his partnership interest includes his allocated portion of partnership recourse and nonrecourse debt. Availability of tax basis is particularly relevant when the entity is experiencing losses (e.g., during the 2008-2009 economic downturn) since this basis allows the flow-through to the owners of

---

[22] This causes a concern that debt may be treated as a second class of stock. Occasionally the roles might be reversed, IRS asserting that only one class of stock exists and the shareholders asserting that a second class of stock exists, thereby causing a termination of the S corporation election and, thereby, avoiding shareholder level taxation of corporate income except for actual distributions. See, e.g., Minton v. Commr., 562 F3d 730 (5th Cir. 2009) where younger family member shareholders asserted that monthly distributions to parent shareholders who were relinquishing their shareholder interests constituted a payment for a second class of stock . Counsel advised the younger shareholder that the corporation was no longer a pass-through entity and the younger shareholder claimed that undistributed corporate level income was taxable at the corporate level. However, IRS was successful in asserting that the monthly distributions to the retiring older generation shareholders did not constitute a second class of stock.

[23] A QSSS is not treated as a corporation separate from the parent S corporation, and all the assets, liabilities, items of income, deduction and credits as treated as directly attributable to the S corporation.

the allocable losses. In the S corporation context this tax basis is ordinarily only available to the extent of the actual cash (or other property) infusion into the corporation by the shareholder. Debt of the corporation guaranteed by the shareholder is not sufficient to create additional tax basis.

2) General Partnership vs. Limited Partnership vs. Limited Liability Company

• Code §469(h)(1) (the "passive loss" rules) provides that a taxpayer shall be treated as materially participating in an activity (enabling greater deductibility) only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous and substantial. Code §469(h)(2) provides that, except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer "materially participates." Reg. §1.469-5T(a) provides that material participation in an activity only occurs if the individual (when a limited partner) participates in the activity for more than 500 hours during the year. In Garnett v. Commissioner, 132 T.C. ___, No. 19 (2009) the Tax Court observed that limited liability companies are hybrids of corporate and partnership forms of business. In the LLC members can participate in management and still have limited liability. The IRS asserted that limited liability should be the sole consideration of whether limited partner status existed to trigger the material participation rule. However, the Tax Court held that the taxpayer held an ownership interest as a general partner in an LLC for purposes of these regulations.[24]

Similarly, in Thompson v. United States, 87 Fed. Cl. 728 (7-28-2009), 104 AFTR 2d (RIA) 5381, an individual owned an LLC mostly directly and a small proportion indirectly (through a wholly owed S corporation). The court was requested to determine whether the owner held a limited partnership interest for purposes of applying the passive loss rules. The Court of Claims cited Reg. §1.469-5T(e)(3) that a "partnership interest shall be treated as a limited partnership interest if the liability of the holder of such interest of the partnership is limited, under the law of the state in which the partnership is organized." The court held that the literal language of the

[24] This position was followed in Hegarty v. Commissioner, TC Summary Opinion 2009-153.

regulations requires that the ownership interest be in a business entity that is a partnership under state law, not merely be taxed as such under the Internal Revenue Code. The court observed that "an LLC is not a partnership." It noted that an LLC is not "substantially equivalent" to a limited partnership. "... unlike a limited partnership, an LLC allows all members to participate in the business while retaining limited liability."

C. Special Entity Structures Under State Business Organization Laws

Over the years for various reasons other options have evolved under state law business organization statutes, including such entities as:
1) Limited liability partnerships[25]
2) Limited liability limited partnerships
3) Professional limited liability companies
4) Small business corporations
Each has unique purposes, sometimes for tax planning purposes, but often to achieve limitation of liability objectives.

D. Special Entity Structures Described in the Code

Special types of structures have been identified for various federal tax requirements, including:

1) The publicly traded partnership - treated as a corporation although organized under state law in a partnership form.[26] Numerous exceptions make this a viable alternative

---

[25] In this format the individual liability of partners for obligations of the partnership is limited, except to the extent that those obligations are attributable to the fault of the particular partner. The Texas LLP statutes require that an LLP must include in its name the words "limited liability partnership" or an abbreviation, i.e., "LLP." See Texas Business Organizations Code, §5.063.

[26] See Code §7704 which specifies that certain publicly traded partnerships are treated as corporations for federal tax purposes. The term "publicly traded partnership" means any partnership if (i) interest in such partnership are traded on an established securities market, or (ii) interests in the partnership are readily tradable on a secondary market. See Livingstone and

in certain important industries.[27]
2) Regulated investment companies.[28]
3) Real estate investment trusts.[29]
4) Real estate mortgage investment conduits.[30]
5) Financial asset securitization investment trusts.[31]

Omer, "Publicly Traded Partnerships, Tax Cost, and Choice of Entity," 2009 TNT 141-11, July 6, 2009.

[27] Exceptions from this categorization exist where the partnership has the requisite portion of "qualifying income' such as interest and dividends (making it the equivalent of a regulated investment company) or rents (making it the equivalent of a REIT). A further exception is available when the partnership's income and gains are derived from the exploration, development, mining or production, processing, refining transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), or industrial source carbon dioxide, or the transportation of other fuels. See Code §7704(d)(1)(E). This exception enables a vast segment of the energy industry to utilize the partnership (or LLC) form. The Service regularly issues private letter rulings concerning whether certain activities qualify within this exception. For example, in Priv. Ltr. Rul. 200927002 the Service ruled that income derived by a publicly traded partnership in the production of asphalt and earned from the marketing of produced asphalt would constitute qualifying income under IRC § 7704(d)(1)(E). In Priv. Ltr. Rul. 200919019 a publicly traded gas partnership's income from interest rate swaps entered into for the purposes of managing risk of the movement of interest rates on its borrowed funds was qualifying income for purposes of these rules. In Priv. Ltr. Rul. 200909006 income derived from collecting and licensing seismic data to oil and gas producers was qualifying income for this purpose.

[28] See Internal Revenue Code, Subchapter M, Part I, concerning regulated investment companies (Code §§851-855).

[29] See Internal Revenue Code, Subchapter M, Part II, concerning real estate investment trusts (Code §§856-859).

[30] See Internal Revenue Code, Subchapter M, Part IV, concerning real estate mortgage investment conduits (Code §§860A-860G).

[31] See Internal Revenue Code, Subchapter M, formerly Part V, concerning financial asset securitization investment trusts (former Code §§860H-860L). This entity structure was eliminated in the American Jobs Creation Act of 2004, P.L. 108-357, §835(a).

6) Cooperatives.[32]
7) Personal service corporation.[33]

Obviously each of these entities has a special purpose for federal tax.[34]

E. New Variations on the Entity Choice Theme

1. Identifying the New "Guys on the Block"

Inventiveness always flourishes in considering possible variations to accommodate special objectives in structuring business and investment organizations. Presently at least two new choices have achieved some notoriety:

1) The series limited liability company (or "cell" companies); and,
2) The low profit limited liability company

The "series limited liability company" is examined separately in Part IV below.

2. The "L3C" - a "Low Profit Limited Liability Company"

The low profit limited liability company (know as the "L3C") is a state law authorized entity which has attributes of both "for profit" and "non-profit" organizations. Some background is necessary. In the private charitable foundation environment a foundation encounters penalties if it acquires investments which are treated as jeopardizing the financial stability of the foundation. An exception does exist for the

---

[32] See Internal Revenue Code, Subchapter T (Code §§1381-1388).

[33] A personal service corporation is taxed at a flat rate of 35 percent on its taxable income, not having the availability of a lower rate for its first layer of income. Code §11(b)(2). A personal service corporation is one substantially all of the stock of which is held by employees or retired employees or by their estates or by certain persons who acquired the stock from a deceased employee and who have held the stock for two years or less. See Code §448(d)(2).

[34] Most of these specialized entities are not eligible for the benefits of the check-the-box regulations. See Reg. §301.7701-1(b).

private charitable foundation where the investment is a "program related investment." The requirements for such investments are (1) that the primary purpose of the investment be to further charity; (2) that no significant objective of the investment is to produce income; and (3) no lobbying activity purpose exists. [35] An objective for this entity is apparently to provide an alternative source of low cost financing when market financing is not available but an incentive exists to provide support for the proposed endeavors.

Under state law an entity has been developed which does not have as its primary purpose the maximized production of income.[36] Rather, its objective is to provide funding in an environment where low return capital is essential. However, the "L3C" cannot qualify as a Code §501(c)(3) organization for federal tax purposes.[37]

The Service has not provided any guidance concerning the federal tax aspects of these organizations and, consequently, their potential for effective utilization remains in doubt.[38] Similarly, since few jurisdictions have authorized this new entity their recognition in other jurisdictions would presently appear to be problematical.

---

[35] See Code §4944(c).

[36] Vermont was the first state to authorize the "L3C" in 2008. See Vt. State. Tit 11, Ch. 21, Section 3001 (27). Other states which have authorized the formation of such an entity under their business organization laws include Michigan, Utah, Wyoming and Illinois.

[37] See 2009 TNT 130-10, "Attorney Describes IRS Guidance on Foundations' Investments in LLCs," July 08, 2009, providing a letter from Marcus Owens of Caplin & Drysdale, noting an IRS official's comments to the contrary, has pointed to evidence of published guidance on the tax consequences of private foundations' investments in limited liability companies. He observed that by enacting legislation that recognizes the low-profit limited liability company, states are creating a business form with an identifiable designation -- "L3C" -- that signals to regulators and investors that the entity is organized and operated to accomplish charitable or educational purposes.

[38] Note that the ABA Tax Section has suggested to the Service that it provide safe-harbor guidance for private foundation program related investments into low profit limited liability companies ("L3Cs") in states that have adopted the L3C form. 2009 TNT 110-21, "ABA Tax Section Members Recommend Projects for IRS Guidance Priority List," June 11, 2009.

F. Not Forgetting About Numerous Other Options

1. Other Entity Choice Possibilities

The premise of this discussion is that the taxpayer owners will want to utilize some entity that will have continuing utility for implementing numerous business and investment objectives as the enterprise evolves over time. However, tax planners should not overlook that numerous other structures exist in the Internal Revenue Code which actually might be more useful when implementing specific projects. Many of these might be relevant in both the business and the investment context as alternative arrangements for completing investments. This segment identifies and examines many single purposes entities and other arrangements (perhaps "quasi-entities) which facilitate the separate identification of ownership groupings.

2. Trusts

Although not available for the management of an active business enterprise the use of a trust can often facilitate a variety of investment objectives. The options in this context are numerous.[39] In the business and investment context the advisor should not overlook the many possibilities which exist in the trust context, often to facilitate ownership arrangements which may be parallel to business endeavors. Examples include the following:[40]

a) Personal wealth/family asset trusts whether (i) revocable/grantor trusts or (ii) irrevocable trusts, including both simple trusts and complex (e.g., discretionary

---

[39] Flexibility concerning the management of trusts may be greater than various business entity forms; rights of creditors may be more restricted under local law to pursue trust assets. The court jurisdiction may be more favorable to trusts than to business entities. However, trusts established by agreement rather than under a testamentary instrument may be subject to the same court jurisdiction as business entities, dependent upon local court procedures.

[40] During periods of quite low interest rates (reflected in the Code § 7520 applicable federal rate) income deflection to family members can be accentuated through various arrangements because the imputed interest cost is reduced.

income distribution trusts).

b) The grantor retained annuity trust (GRAT) or grantor retained unitrust (GRUT). These are arrangements to bifurcate the ownership of an investment asset with the grantor retaining the immediate portion and another party receiving the remaining portion after the lapse of a specified term.

c) Split interest charitable transfers, such as a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT) whereby charity receives (eventually) property after the expiration of one or several lives, or a specified term, but in the interim the property is available for private beneficiaries. The timing of the charitable ownership can be reversed, with the charity being the owner of the lead interest with private beneficiaries (e.g., children or trusts for children and grandchildren) being the owners of the remainder interest . This is represented by the charitable lead annuity trust (CLAT) or the charitable lead unitrust (CLUT).

d) Grantor trusts used as investment vehicles to enable numerous owners to held small percentages of various properties. These could include (i) oil and gas royalty trusts, and (ii) equipment leasing trusts (e.g., the syndicated ownership of a wide-bodied aircraft subject to a lease to an airline company)

An overarching consideration in this context is that the "trust" must only be used as a passive vehicle for protecting or conserving the trust property, and are not the active managers of a business enterprise. Reg. §301.7701-4(a) (concerning "ordinary trusts") specifies that an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

In contrast, Reg. §301.7701-4(b) (concerning "business trusts") specifies that there are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. The fact that any organization is technically created in the trust form by conveying title to property to trustees for the benefit of persons designed as beneficiaries will not change the real character of the organization (for federal tax purposes) if the organization is more property classified as a business entity under Reg. §301.7701-2. Note that this classification will enable either corporate or partnership status, dependent upon the application of the rules in that provision, rather than the trust being irrevocably classified as a corporation for federal tax purposes.

3. Agency

An agent can act on behalf of its principal with or without separate entity status existing, depending on the circumstances. In Commissioner v. Bollinger, 485 U.S. 340 (1988), the Supreme Court clarified that a corporation could be treated under factors enumerated in that situation as an agent of its parent even if it did not deal with its parent at arm's length and did not receive an agency fee. The Court held that a wholly owned, title-holding nominee corporation formed solely to obtain financing for apartment complexes developed by several partnerships was the partnerships' agent. Accordingly, the Court found the nominee corporation should be ignored for tax purposes (at least as to the financing activities for the principal). The nominee in the Bollinger situation: (1) held title as the partnerships' agent for the purpose of securing financing; (2) conveyed, assigned, or encumbered the property and disbursed the proceeds thereof as directed by the partnerships; (3) was not obligated to maintain the property or to assume liability by reason of execution of the notes to the lenders; and (4) was indemnified by the partnerships from any liability it might sustain as the agent and nominee of the partnership. The court reasoned, in ruling for the taxpayer, that an agency relationship is established if a writing identifies the principal-agency relationship, the corporation actually functions as an agent, and the corporation is held out as the agent (and not the principal) in all third party dealings.

For an example of the tax importance of agency status in the inbound tax context, see IRS Generic Legal Advice, AM 2009-011, Sept 22, 2009 (identified from Tax Analysts website), where the Service concluded that interest income earned by a foreign corporation with respect to loans originated by an agent in the United States was treated as "effectively connected income" in the United States to the foreign corporation. Differentiation between dependent and independent status of the agent was regarded as irrelevant. The activities of the agent were attributable to the foreign corporation for determining trade or business within the United States (thereby causing U.S. income tax jurisdiction to exist on the business income realized in the United States. The Service noted that in similar circumstances, courts have found an agency relationship to exist in fact and have attributed the activities of the U.S. agent to the foreign principal in determining whether the foreign principal conducted considerable, continuous, and regular activity within the United States. See Inverworld, Inc. v. Commissioner, T.C. Memo. 1996-301 (finding that the activities of a U.S. corporation, although nominally an independent contractor and not an agent, were attributed to a foreign corporation where the activities of the U.S. corporation were in fact those of an agent).

A nominee other than a dummy corporation can be used and be treated as not an entity for federal tax purposes. The nominee may be an individual or some noncorporate entity. The particular facts and circumstances often determine whether the other person or entity is a separate income tax reporting entity for federal tax purposes or is merely a nominee for federal tax purposes.[41] Observe that local law business organization rules have counterpart provisions dealing with whether a court will "pierce the corporate veil" or "disregard the corporate entity."[42]

---

[41] Note from Rev. Rul. 2004-86, 2004-2 CB 191, that the IRS distinguished the Bollinger decision in ruling that a Delaware Statutory Trust was not an agent for trust beneficiaries.

[42] For example, the Texas Business Organizations Code, §21.223, specifies that no shareholder, or affiliate of the shareholder or the corporation, may be held liable for (1) any contractual obligation of the corporation on the basis that the shareholder or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetuate a fraud or a similar theory, unless it is shown that the shareholder used the corporation for the

4. Contractual Structures

Business transactions might be conducted merely through specific contractual arrangements which, however, could constitute an effective substitute for the use of an "entity" as described for federal tax purposes. These might include:

a) Sales contracts, including on a deferred basis (with potential installment sales treatment available for federal income tax purposes).
b) Licensing arrangements, perhaps on a royalty basis which is for a limited period or for a period co-extensive with the life of the asset being licensed.[43]
c) Lease of tangible property, including machinery and equipment (e.g., airplanes) and real property. Remember particularly in this context the decision in the Frank Lyon case where the Supreme Court determined that a lease transaction was to be respected even though the lessee bank has options to purchase the property at a very low price relative to the anticipated salvage value of the property and the lessee owned the land on which the building was located.[44]
d) Cost-sharing agreements.[45]

5. Traditional Property Ownership Arrangements

Traditionally when the ownership (particularly of real estate) involves a number of

---

purposes of perpetuating, and did perpetuate, an actual fraud, primarily for the person benefit of the shareholder or affiliate or (ii) any obligation (whether contractual, tort or other) on the basis that the corporation failed to observe any corporate formality (e.g., maintaining separate offices and employees, keeping separate books, holding regular meetings of shareholders and board of directors, keeping written minutes of such meetings, etc.

[43] Note that for licensing transactions between related parties the Service has finalized the Section 482 intangibles licensing regulations. Reg. §1.482-9, 74 Fed. Reg. 38,830 (Aug. 4, 2009), reflected changes proposed in Notice 2007-5, 2007-1 C.B. 269.

[44] Frank Lyon Co. v. United States, 435 U.S. 561 (1978).

[45] Planning possibilities can be discerned from the cost-sharing Section 482 temporary regulations, Reg. 1.482-7T, T.D. 9441, 2009-7 I.R.B. 240 (Feb. 17, 2009).

owners this ownership might be held in a partnership or a limited liability company to avoid local property ownership title complications. However, this ownership could preclude the availability of "like-kind" exchange treatment under Code § 1031 were an interest in the property sold to be transferred without required gain recognition. The response has been the evolution of the tenant-in-common arrangement (or"TIC") under which each of the co-owners must hold title to the property as a tenant-in-common as determined under local property law concepts. The use of the TIC has received much greater usage in recent years when the objective is to implement a Code §1031 like-kind exchange involving a portion of a property having significant value. Of course, the technical, legal property ownership might itself be held by a disregarded entity, or by an agent so as to avoid property title complications (but that holder can not be an entity as recognized under local law).

In Rev. Proc. 2002-22, 2002-1 CB 733, the Service specified those conditions under which it would consider a request for a private letter ruling that an undivided fractional interest in rental real property is not to be treated as an interest in a business entity for federal tax purposes. This revenue procedure applies to the co-ownership of rental real property (other than mineral interests as defined in Code §614) in an arrangements classified under local law as a tenancy-in-common. Conditions for the issuance of a private letter ruling under this procedure include:

1) Each of the owners must hold title to the property (directly or through a disregarded entity) as a tenant in common under local law.
2) The number of co-owners must be limited to no more than 35 persons.
3) The co-ownership arrangement can not be treated as an entity.
4) The co-owners may enter into a limited co-ownership agreement that is "running with the land."
5) The co-owners must retain the right to approve certain actions such as the sale or other disposition of the property.
6) Each co-owner must have the right to transfer, partition and encumber the co-owner's undivided interest in the property without the agreement or approval of any person.
7) If the property is sold any debt secured by a blanket lien must be satisfied and the remaining sales proceeds distributed to the co-owners.

8) Each co-owner must share in all revenues generated by the property and all costs associated with the property in proportion to the co-owner's undivided interest in the property.
9) The activities of the co-owners must be limited to those customarily limited to those performed in the maintenance and repair of rental real property, and not constitute business activities (e.g., as evidenced by the rental of rooms).

The Service has periodically issued private letter rulings in response to requests which comply with these guidelines. These guidelines can probably be relied upon in constructing similar arrangements to assure that TIC status exists even without the receipt of an IRS private letter ruling.

6. Financial Instruments

Financial instruments can be used to shift risk, change income character, transfer certain attributes from one party to another, and for multiple other purposes. These can include debt instruments, hedges, repos, and notional principle contracts.

Debt instruments often face the challenge that they are not debt but, rather constitute equity. The objectives on the taxpayer's side concerning the tax classification of this instrument can often be muddled. The corporation may want debt status for the instrument so that the interest paid is deductible to the payor. The shareholder may want equity status because, as an individual, he/she will be entitled to a 15 percent tax rate (at least through 2010). A corporate shareholder may want dividend classification to enable the dividends received deduction. But, in some situations this loan or stock investment transaction might be an alternative to the creation of an "entity" for federal tax purposes.

IV. More Detailed Examination of the "Series LLC" or "Cell" Company Structure

A. State Law Considerations

1. Legislative Enactments

A variant of the LLC structure now gaining legislative attention and being enacted is the "series LLC." At least eight states have adopted this concept: Delaware, Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas[46] and Utah. This structure raises a vast array of federal tax and other questions, many of which are only beginning to be understood and few issues have been definitively answered.

2. State Series LLC Legislative Enactments

In the next segment below an ABA Section of Taxation presentation to the Service concerning the federal tax treatment of series LLCs is noted. That paper has an Appendix A which includes a chart identifying (for seven states, not including Texas) the answers to the following business organization-type questions:

1) May each series may have a separate business purposes or investment objective? Answer: yes.
2) May each series have separate members, managers and limited liability company interests? Answer: yes.
3) May each series have separate rights, powers or duties with respect to specified property, obligations or profits and losses associated with specified property or obligations? Answer: yes.
4) Are the debts, liabilities, obligations and expenses of a particular series enforceable only against the assets of such series? Answer: yes.
5) Does each series have the power to contract, hold title to assets, and grant liens and security interests in its own name? Answer: Some yes, mostly no.
6) Is each series a separate state law entity? Answer: no, except elective in one

---

[46] See Texas Business Organizations Code, Title 3 (Limited Liability Companies), Subchapter M, Section 101, enacted by S.B. 1442, effective September 1, 2009.

situation.

7) Does state law impose recordkeeping and notice requirements of the series company? Answer: yes.

These questions (and answers) provide a basic identification of the structure of the Series LLC under applicable state law.

3. The Delaware "Series" Provision

The leading state for the authorization of the Series LLC is Delaware. Under the Delaware Limited Liability Company Act a "Series" may have the following characteristics:[47]

1) Each Series may have a separate business purpose or investment objective;

2) Each Series may have separate members, managers, and limited liability company interests;

3) Each Series may have separate rights, powers or duties with respect to specified property, obligations or profits and losses associated with specified property or obligations;

4) The debts, liabilities, obligations and expenses of a particular Series may be enforceable only against the assets of such Series;

5) Each Series has the power to, in its own name, contract, hold title to assets, and grant liens and security interests.

Note that, in addition to series limited liability companies and series trusts, Delaware also permits the formation of series limited partnerships.[48]

4. The Texas Enactment

A series LLC provision is now included in the Texas Business Organizations Code. Title 3, Limited Liability Companies, Chapter 101, Limited Liability Companies,

---

[47] Del. Code Ann. Title 12, §3806(b).

[48] See Del. Code Ann., tit. 6, §17-218.

Subchapter M, was enacted in 2009.[49] This legislation provides for a series LLC regime similar to that enacted by other states.[50]

---

[49] Texas S.B. 1442, Section 45. Section 74 of this act provides for a September 1, 2009 effective date.

[50] Note the following excerpts from this statute: Sec. 101.601. SERIES OF MEMBERS, MANAGERS, MEMBERSHIP INTERESTS, OR ASSETS. (a) Authorizes a company agreement to establish or provide for the establishment of one or more designated series of members, managers, membership interests, or assets that has separate rights, powers, or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations or has a separate business purpose or investment objective.
(b) Authorizes a series established in accordance with Subsection (a) to carry on any business, purpose, or activity, whether or not for profit, that is not prohibited by Section 2.003.
Sec. 101.602. ENFORCEABILITY OF OBLIGATIONS AND EXPENSES OF SERIES AGAINST ASSETS. (a) Requires that, notwithstanding any other provision of this chapter or any other law, but subject to Subsection (b) and any other provision of this subchapter:
(1) the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to a particular series be enforceable against the assets of that series only, and not be enforceable against the assets of the limited liability company generally or any other series; and
(2) none of the debts, liabilities, obligations, and expenses incurred, contracted for, or otherwise existing with respect to the limited liability company generally or any other series be enforceable against the assets of a particular series.
(b) Provides that Subsection (a) applies only if the records maintained for that particular series account for the assets associated with that series separately from the other assets of the company or any other series, the company agreement contains a statement to the effect of the limitations provided in Subsection (a), and the company's certificate of formation contains a notice of the limitations provided in Subsection (a).
Sec. 101.603. ASSETS OF SERIES. (a) Authorizes assets associated with a series to be held directly or indirectly, including being held in the name of the series, in the name of the limited liability company, through a nominee, or otherwise.
(b) Provides that if the records of a series are maintained in a manner so that the assets of the series can be reasonably identified by specific listing, category, type, quantity, or computational or allocational formula or procedure, including a percentage or share of any assets, or by any other method in which the identity of the assets can be objectively determined, the records are considered to satisfy the requirements of Section 101.602(b)(1).

B. Federal Income Tax Considerations

1. Prior Specialized IRS Guidance

Rev. Rul. 2008-8, 2008-1 CB 340, addresses whether certain arrangements constitute insurance premiums for federal income tax deduction purposes. The "insurance" coverage in this Revenue Ruling is described as provided through a "Protected Cell Company" structure utilizing cells which, although not treated as separate entities for state law purposes, separately account for their own income, expense, assets, liabilities and capital. As noted above, various states now do permit the formation of entities that have business units with characteristics like the cells discussed in the Revenue Ruling. For example, some states permit the formation of business or statutory trusts with so-called "series" having separate business purposes or investment objectives. States have also started adopting statutes that permit limited liability companies to be divided into series having separate business purposes or investment objectives. In Notice 2008-19, 2008-1 C.B. 336, the Service did provide guidance and requested comments on the standards for determining whether an arrangement between a participant and cell of a protected cell company is "insurance" for income tax purposes and whether amounts paid to the cell are deductible as insurance premiums under Code §162. In this Notice the Service further requested comments on guidance concerning segregated arrangements that do not involve insurance.

2. Examining the Fundamental Questions

Many questions exist concerning the tax status of these segregated arrangements which are permitted to exist within the structure of one LLC.[51] Particularly, no authority exists concerning whether a particular "series" of a limited liability company itself constitutes an entity for federal tax purposes that is separate from any other series of the same limited liability company for purposes of Reg.§301.7701-2(a). The

[51] An IRS representative to consult concerning federal tax questions about the Series LLC format has been identified as being Steve Frost, Senior Counsel, Office of Tax Policy, U.S. Department of the Treasury.

ABA Section of Taxation paper has identified to the Internal Revenue Service certain of these fundamental questions needing to be addressed by the Service.[52] Excerpts from the Executive Summary of this presentation might best identify the fundamental "choice of entity" questions in this context:

> *We recommend that the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") issue guidance confirming that each Series of an LLC is a separate "business entity" for purposes of Regulation section 301.7701-2(a), assuming that certain minimum requirements are met. In order to be treated as a separate business entity, the Series must (i) be formed under a statute having characteristics such as those contained in the Delaware Series Provision of the Delaware LLC Act, and (ii) satisfy applicable record keeping and notice requirements so that the liabilities of a particular Series may only be enforceable against that Series' assets.*
>
> *We further recommend that the characterization of the LLC itself for federal tax purposes depend upon whether the LLC satisfies the minimum requirements to be a business entity that is separate from its Series. Unless the LLC has assets and liabilities that are not associated with one or more of its Series, the LLC has no separate existence and should be treated as transparent or as a nominee. If the LLC has separate assets (including holding the economic interest in one or more of its Series) and satisfies applicable record keeping and notice requirements so that the liabilities of the LLC may only be enforced against the LLC's assets, the LLC should be characterized as a separate business entity.*
>
> *By recognizing each Series and the LLC as a separate "business entity" under Regulation section 301.7701-2(a), each Series' and the LLC's classification for federal tax purposes would be independently determined. As long as the LLC*

---

[52] See a January 5, 2009 letter to Douglas Shulman, Commissioner of the Internal Revenue Service, from William J. Wilkins, Chair, Section of Taxation, American Bar Association. See "ABA Members Request Guidance on Series LLCs," 2009 TNT 2-56, January 6, 2009. This letter also includes a useful Appendix B which has a selective bibliography of articles on series limited liability companies.

> *is not required to be classified as a corporation under Regulation section 301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8), each Series and the LLC would be a separate "eligible entity" within the meaning of Regulation section 301.7701-3(a). If a Series or the LLC has at least two members, such Series or the LLC would be classified as a partnership unless it elects to be classified as an association taxable as a corporation under Regulation section 301.7701-2(b)(2). If a Series or the LLC has a single member, such Series or the LLC would be disregarded as an entity separate from its single member unless it elects to be classified as an association taxable as a corporation under Regulation section 301.7701-2(b)(2).*
>
> *We recognize that the approach we are recommending may not be consistent with how some taxpayers are currently treating series limited liability companies that they are using for their business affairs. We believe that any guidance should be applied prospectively, except that existing series limited liability companies should be allowed to rely on the guidance if they (i) are formed under a statute having characteristics such as those contained in the Delaware Series Provision, (ii) satisfy applicable record keeping and notice requirements, and (iii) have been consistent in their treatment of the arrangement in accordance with the guidance. The classification of other existing series limited liability companies should be based upon the authority that currently exists concerning the classification of series limited liability companies and business trusts and whether taxpayers have been consistent in their treatment of such arrangements for federal tax purposes.*

This ABA Section of Taxation paper provides various examples with quite useful analyses concerning th multitude of issues presented in this context.[53]

The Service has issued at least one private letter ruling concluding that each series of a limited liability company (here identified as a trust portfolio) should be treated as

---

[53] These examples address the fundamental questions in various factual situations: investment funds, an operating company, and a real estate development company.

a separate eligible entity for federal income tax purposes.[54] Further, the Service has issued rulings holding that each series of a business trust is treated as a separate business entity for federal income tax purposes.[55] However, fundamentally the serious issues concerning classification and tax treatment of series LLCs remain unresolved.

These important questions include:

1. Is each series a separate business entity for purposes of Reg. §301.7701-2(a)?
2. How are tax returns to be filed?
3. Does a tax liquidation event occur if one of the series is terminated?
4. What tax consequences occur when properties are transferred between series companies?
5. What are the tax consequences of contributions into a series in exchange for an interest in the series?
6. Is an exchange of an interest in one series for an interest in another series of the same LLC a gain realization and gain recognition event?

V. Federal Tax Effects Upon Structuring & Restructuring Entities

A. The Basics in Structuring, Operating and Terminating Entities

As noted at the beginning of this analysis, a multiplicity of factors relevant during the entire life cycle of an entity must be examined in making a judgment about the best business entity to choose. These are considerations concerning in the utilization of the entity from its "cradle" to its "grave." That is, the analysis must include an "exit strategy" in addition to the front-end considerations.

These various elements include:
1) Formation - including the method of formation, owner eligibility, capital structure, an the method for designating status.
2) The operational phase - including determining the taxable income (or operating

---

[54] PLR 200803004.

[55] PLRs 200809012, 9703002 and 9703016.

losses), allocation of income (and losses), income characterization, tax elections and the impact and effect of statutory elections.
3) Compensation arrangements - including reasonable compensation amounts, allocation of compensation, retirement benefits and fringe benefits.
4) Transactions with the owners - including distributions of cash, distributions of property, the purchase of the owner's interest, property sales to the entity by the owner, and property sales by the owner to the entity.
5) Termination of the entity or the owner's interest - including the tax effect of a sale of an entity interest by the owner to a third person, or the effect of the death of an owner, liquidating distributions, including the effect to the distributor and the recipient, and entity reorganizations.
6) The possible impact of the alternative minimum tax.

The objective of this paper does not include an elaboration of all these various elements. Many of these various considerations have not been subject to significant changes in recent federal tax legislation. These elements can be ascertained from various sources.[56] However, at the edges these considerations could be impacted if the tax rate for corporate dividends received by individuals is increased to 35 percent (upon the expiration of the "Bush tax cuts") or to an even greater rate (e.g., 39.6 percent, remembering the Clinton era). This process of entity choice could also be impacted if legislation were enacted to treat the receipt of various partnership interests as constituting the receipt of immediate gross income.

B. The Tax Rules Applicable Upon Restructuring Entity Status

For various reasons the owners of an enterprise (often closely-held) may decide to change the legal status of the entity from a partnership to a corporation, from a corporation to a partnership, or implement other variations. This might be sought to be accomplished because of a greater potential under local law to limit the liabilities of the enterprise and its owners. This reduction of liability exposure might include state income taxes (e.g., a limited liability company or a partnership might not be subject to the state income tax, but a corporation might be subject to tax). However,

[56] See, e.g., Streng, "Choice of Entity," Tax Management Portfolio No. 700-2nd (2007).

for federal tax purposes this change in status may be accomplished merely by making the appropriate election under the check-the-box rules (assuming an entity eligible to make the election).

The choice of entity regulations (Reg.§301.7701-3(g)) provide for the following federal tax treatment to apply upon elective changes in federal tax classification occurring:

1) If an eligible entity classified as a partnership elects to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association and immediately thereafter the partnership liquidates by distributing the stock of the association to it partners.[57]
2) If an eligible entity classified as an association elects to be classified as a partnership the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.[58]
3) If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.[59]
4) If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.[60]

The regulations further indicate that "[t]he tax treatment of a change in the

[57] Reg. §301.7701-3(g)(1)(i).

[58] Reg. §301.7701-3(g)(1)(ii).

[59] Reg. §301.7701-3(g)(1)(iii).

[60] Reg. §301.7701-3(g)(1)(iv).

classification of an entity for federal tax purposes by election ... is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine."[61] These regulations only state the basic principles and refinements in particular situations are identified in various IRS rulings.

C. Planning Possibilities When Changing Corporation Status

1. Conversion from Partnership to Corporation

A partnership might converts to a corporation under either (1) check-the-box election (Reg. § 301.7701-3(c)(1)(i)) or (2) under a state law formless conversion statute with the objective making the S corporation election. Previously issued Rev. Rul. 2004-59, 2004-1 CB 1050, provides that the conversion of a partnership into a state law corporation under a state law formless conversion statute is treated in the same way as if the entity had made an election to be treated as an association under Reg. § 301.7701-3(c)(1)(i).

As specified in Rev. Rul. 2009-15, 2009-21 IRB 1035, this new corporation is eligible to make an S election effective for the corporation's first tax year. In each situation the partnership is deemed to have distributed its assets and liabilities to the corporation and immediately thereafter liquidated by transferring the stock to the partners (who are then the shareholders). The corporation, with the consent of the shareholders, can then make the S corporation election, to be effective as of the beginning of that first year. This treatment will be available even if the S corporation election in not made until some time after the effective date of this change in entity status (if made on or before the 15th day of the third month of that tax year).

2. Conversion from Corporation to Partnership Only for State Law Purposes

For state law purposes a corporation may wish to convert to partnership status but wish to retain corporate law status for federal tax purposes. As noted earlier, to

---

[61] Reg. §301.7701-3(g)(2).

convert from corporate status to partnership status for federal tax purposes triggers liquidation treatment, but the entity may only wish to change for state law taxation purposes.[62] This can be accomplished pursuant to an arrangement treated as a tax-free reorganization for federal tax purposes.[63]

D. Status Changes for Foreign Organized Entities

When ownership changes are made in the legal status of a foreign entity and its assets the concern can exist that this change will produce capital gain which, in turn will be treated as foreign personal holding company income, therefore Subpart F income and then being required to be included in the U.S. shareholders' income currently.

An example of a transaction to facilitate tax deferral in this context is the "check and sell" transaction described in the Dover case.[64] There, the foreign parent corporation decided to "check the box" concerning the status of its wholly owner subsidiary, thereby transforming its federal tax status from a corporation to a "tax nothing." This change in status is a liquidation of a controlled subsidiary into a parent corporation is a Code §332 liquidation, and this status is not altered by Code §367 or its regulations.

---

[62] For example, in Alliance Obstetrics & Gynecology PLC v. Michigan Department of Treasury, Michigan Court of Appeals, 2009 Mich. App. Lexis 1656 (August 4, 2009), the state court determined that a limited liability company qualified for a small business tax credit under the Michigan single business tax even though its elected to be treated as a corporation under the federal check-the-box system. The court noted: [H]ow an entity elects to be classified under the federal 'check-the-box' system does not determine how it will be classified for SBT purposes." The court further observed that"business entities .... that are neither a corporation nor a partnership should not be required to elect a classification inconsistent with its organization under State law."

[63] See, e.g., Priv. Ltr. Rul. 200839017 where the IRS ruled that the conversion of an S corporation to a LLC, followed by an election to be treated as an association taxable as a corporation, will qualify as an F reorganization. The election to be treated as an association taxable as a corporation was to be effective as of the date of the transaction so that the LLC would never exist as a partnership for federal tax purposes.

[64] Dover Corp. v. Commissioner, 122 T.C. 324 (2004).

VI. The Obama Administration Proposals Concerning Cross-Border Foreign Entity Choice

A. The Obama Administration Fiscal Year 2010 Revenue Proposals

The Obama Administration's fiscal year 2010 revenue proposals have various items which (if enacted) could be particularly relevant to making decisions about the choice of an operating entity, including:
1) Expanding the exclusion of gain on the sale of "qualified small business stock."
2) Taxing the carried (i.e., profits) interest in a service partnership as ordinary income.
3) Codifying the "economic substance" doctrine.
4) Repeal the expensing of intangible drilling costs and the 60 month period for the amortization of capitalized intangible drilling costs.
5) Reinstate the 39.6 percent rate as the highest individual income tax rate.
6) Reinstate the limitation on itemized deductions for taxpayers with income over $250,000 (married filing a joint return) and $200,000 (single taxpayer return).
7) Reinstate the personal exemption phase-out for taxpayers with income over $250,000 (married filing a joint return) and $200,000 (single taxpayer return).
8) Impose a 20 percent rate on dividends and capital gains for taxpayers with income over $250,000 (married filing a joint return) and $200,000 (single taxpayer return).
9) Modify the rules on valuation discounts for estate, gift and generation skipping transfer tax purposes.

Probably the most important proposal in the context of entity choice is the proposal to eliminate the availability of the "check-the-box" option in the U.S. ownership of a foreign entity.[65]

B. Foreign Entity Choice - History and Present Law

---

[65] Note, however, from the Wall Street Journal, October 13, 2009, the main headline on page one: "Business Fends Off Tax Hit: Obama Administration Shelves Plan to Change How U.S. Treats Overseas Profits." The first paragraph states: "The Obama Administration has shelved a plan to raise more than $200 billion in new taxes on multinational companies following a blitz of complaints from businesses."

The cross-border impact of the 1997 change to the choice of entity rules has been to enable U.S. multinational corporations to lower their effective rates of tax in high-tax foreign countries by engaging in loan and similar transactions with related enterprises in tax haven jurisdictions. These tax haven jurisdiction entities were treated as separate, legal entities by the high tax foreign jurisdiction, thereby enabling a deductible payment from that jurisdiction to the tax haven entity. However, under the U.S. check-the-box rules the entities in both the high tax and the tax haven jurisdiction can be treated as "disregarded entities" or "tax nothings." This treatment thereby allows the shift of value from the high tax to the tax haven jurisdiction to be treated as a "non-event" for U.S. income tax purposes. Consequently, no income is treated as constructively derived by the taxpayer for U.S. income tax purposes (particularly under the Subpart F purposes) and the only effect has been to enable a reduction of taxes in the foreign high tax jurisdiction.

> *Note: See particularly the charts at pages 12-14 in the Appendix Five materials with "Outbound Cross Border Structures," for diagrams of arrangements to implement this technique.*

This check-the- box limitation effort actually began in 1998, with IRS Notice 98-11, 1998-1 CB 433, which would have minimized the impact of these rules in the Subpart F context, but implementation of this Notice has never been accomplished.[66] In this Notice the Service and the Treasury Department announced that they had become aware of the increased use of certain transactions that utilized "hybrid branches" to (from their perspective) circumvent the purposes of subpart F. The Notice defined a hybrid branch as an entity with a single owner that is treated as a separate entity under the relevant tax laws of a foreign country and as a branch (i.e., disregarded entity) of a CFC that is its sole owner for U.S. tax purposes. In the several transactions described in the Notice a taxpayer utilized a hybrid branch arrangement to make deductible interest payments that reduced the CFC's foreign tax liability and created law-taxed interest income in another entity, without creating Subpart F income.

---

[66] For a description of these developments see Staff of the Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment," JCS-4-09, p. 106, September 2009.

Notice 98-11 describes these transactions as inconsistent with one purpose of Subpart F, i.e., to prevent CFCs (including those engaged in active business) from structuring transactions designed to manipulate the inconsistencies between foreign tax systems to generate inappropriately law or non-taxed income on which U.S. tax might be permanently deterred. Notice 98-11 indicated that IRS and the Treasury Department would issue regulations to address these transaction, as well as certain partnership or trust arrangements raising similar issues. Shortly after the publication of Notice 98-11 the IRS did issue temporary and proposed regulations addressing the transaction described in this Notice.[67] Under these regulations certain payments ("hybrid branch payments") between a CFC and its hybrid branch or between hybrid branches of the CFC were treated as giving rise to Subpart F income. The regulations generally provided that non-Subpart F income of the CFC , in the amount of the hybrid branch payment, would be recharacterized as Subpart F income of the CFC if (1) the hybrid branch payment reduces foreign tax of the payor, (2) the hybrid branch payment would have been foreign personal holding company income (a category of Subpart F income) if made between separate CFCs, and (3) there is a disparity between the effective tax rate on the payment in the hands of the payee and the effective tax rate that would have applied if the income had been taxed in the hands of the payee.[68]

C. The Legislative Proposal to Repeal Foreign Entity Check-the- Box

The Obama Administration's Fiscal Year 2010 budget includes a proposal that a foreign eligible entity may be treated as a "disregarded entity" only if the single owner of the eligible entity is created or organized in, or under the law of, the foreign country in, or under the law of, which the foreign eligible entity is created or

---

[67] T.D. 8767, 1998-1 CB 875, withdrawn T.D. 8827, 1999-2 C.B. 120.

[68] In a further attempt to obtain information about the use by U.S. persons of foreign disregarded entities the Service issued IRS Form 8858, "Information of U.S. Persons With Respect to Foreign Disregarded Entities." The instructions to this form indicate that the failure to file this form can cause Code §6038(a) penalties to be applicable. When releasing this form the Service indicated that the Service "has had significant difficulties administering the relevant provisions of the tax law because the information reporting requirements still date from a time when the substantive entity classification rules did not contemplate disregarded entities." IRS Announcement 2004-2, 2004-1 CB 357.

organized.[69] Stated more understandably, a foreign eligible entity with a single owner that is created or organized in a country other than that of its single owner would be treated as a corporation for federal tax purposes.[70] Except in cases of U.S. tax avoidance the proposal would generally not apply to a first-tier foreign eligible entity wholly owned by a U.S. person. The tax treatment of the conversion to a corporation of a foreign eligible entity treated as a disregarded entity "would be consistent with current Treasury regulations and relevant tax principles."[71] The proposal is to be effective for taxable years beginning after December 31, 2010.

An example in the Obama Administration's May 4, 2009 Press Release helps illustrate its concern with this planning situation:

> ○ *Suppose that a U.S. company invests $10 million to build a new factory in Germany. At the same time, it sets up three new corporations.*[72] *The first is a wholly owned Cayman islands holding company. The second is a corporation in Germany which is owned by the holding company and owns the factory. The third is a Cayman islands subsidiary, also owned by the Cayman islands*

---

[69] See U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," May 2009 (i.e., the "Green Book") (noted as available in Adobe Acrobat format at: *http://treasgov/offices/tax-policy/library/grnbk09.pdf*

[70] This proposal was previously included in the Joint Committee on Taxation's 2005 Options Paper. Under that proposal "an organization must be treated as a corporation for Federal tax purposes if the organization: (1) is a separate business entity organized under foreign law; and (2) has only a single member." See Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05, at 182-185 (2005).

[71] See Staff of the Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment," JCS-4-09, September 2009 (available from the Joint Committee on Taxation website), page 110.

[72] Note inserted by author of this paper: Observe that the use of the term "corporations" is probably imprecise. If corporations are used (which are treated as "per se corporations" for federal tax purposes) this planning would not be available. Presumably these "corporations" are actually organized as "limited liability companies" or LLCs in this context.

holding company.

○ *The Cayman subsidiary makes a loan to the German subsidiary. The interest paid on the loan is income to the Cayman subsidiary and a deductible expense for the German subsidiary. In this way, income is shifted from higher-tax Germany to the no-tax Cayman Islands.*

○ *Under traditional U.S. tax law, this income shift would count as passive income for the U.S. parent - which would have to pay taxes on it. But "check the box" rules allow the firm to make the two subsidiaries disappear - and the income shift with them. As a result, the firm is able to avoid both U.S. taxes and German taxes on its profits.*

Observation: The Obama Administration's projection of a $86.5 revenue pick-up during the period 2011-2019 seems to be optimistic if one considers the planning responses which U.S. multinational corporations might implement in response to this legislation. A major effect of this legislation will be an increase in the tax revenues realized by high-tax foreign countries since the opportunity will have been eliminated to strip earnings from those countries into low tax jurisdictions. Note that the Joint Committee on Taxation estimated the revenue pick-up from this proposal to be approximately $31 billion (about one-third of the U.S. Treasury estimate).[73] Apparently the Obama Administration has subsequently modified its revenue projection on this item to be $36.5 billion.

D. Could this Proposed Change be Accomplished by Regulation?

The assumption is that the requested changes to the check-the-box entity classification rules will be accomplished as part of a tax legislative package. However, if the U.S. Congress is dilatory or reluctant on this issue the Obama Administration might proceed to change these rules by Treasury Regulations. When the check-the-box rules

[73] See Congressional Service Report, "Major Tax Issues in the 111th Congress, Prepared for Members and Committees of Congress," Report R40004, July 21, 2009, electronic citation: 2009 TNT 147-23.

were adopted effective in 1997 court challenges were made that the Treasury Department did not have the authority to issue these regulations, but those challenges were subsequently rejected in several court decisions.[74]

After the 1997 adoption the U.S. Treasury Department realized (which it should have earlier recognized) that its regulatory "plan to facilitate domestic tax efficiencies" could (from its perspective) be "inappropriately exploited" in the foreign entity context. It would seem that, if the Treasury Department could by regulation grant the "whole loaf" for check-the- box entity classification, it should also administratively be able to take back "half the loaf."

VII. "Hybrid Entities" - Exploiting and Limiting Hybridization

An entity can be categorized differently for several purposes. The characterization of the same entity can be different for various objectives, including for (1) federal tax, (2) state business law, (3) state tax law, and (4) foreign country law (whether for foreign country business or tax law).[75] In the cross-national border context further possible alternatives can enable exploiting inconsistencies between national tax entity classification systems. These variables can include:

1) A domestic (i.e., U.S.) corporation which is a "forward hybrid", i.e., transparent for U.S. tax purposes, but treated as a corporation in the foreign jurisdiction.
2) A domestic "reverse hybrid," i.e., treated as a corporation for U.S. federal tax purposes, but being transparent for foreign country purposes.
3) A foreign "forward hybrid", i.e., a foreign organized corporation which is transparent for foreign law purposes but not for U.S. tax law purposes.
4) A foreign "reverse hybrid," i.e., a foreign organized corporation which is treated

---

[74] See Littriello v. United States, 95 AFTR2d 2005-2581 (WD Ky. 2005), aff'd, 484 F3d 372 (6th Cir. 2007), cert. den. 128 S.Ct. 1290 (2008); and, McNamee v. IRS, 488 F3d 100 (2d Cir. 2007).

[75] Note, e.g., the earlier discussion concerning transposing a corporation for state law purposes from a corporation to an unincorporated entity (e.g., an LLC) while retaining its status as a corporation for federal tax purposes.

as a corporate for foreign tax purposes but treated as transparent for U.S. tax purposes.

The use of an entity which is a conduit for one tax purpose and a separate entity for another tax purpose can facilitate significant tax savings in the right planning circumstances. However, the application of rules of limitation (e.g., anti-conduit rules) can restrict these planning opportunities.[76] This hybridization process can become much more intricate, but quite financially beneficial, if successfully achieved when transactions are arranged across national borders. Often these arrangements have as a primary objective the avoidance of withholding tax on payments made from the source jurisdiction.

The Treasury Department has proposed regulations to amend Reg. §1.881-3 (the "anti-conduit regulations") under which, for withholding tax purposes, the Service may disregard the participation of a conduit entity and recharacterize separate financing transactions to which a conduit is a party as a direct financing between the ultimate provider and the ultimate recipient of the financing.[77] These proposed regulations specify that "disregarded entities" (within the meaning of Reg. §301.7701-2) whose separate existence is ignored for most other federal income tax purposes, are treated as "persons" for purposes of these "anti–conduit regulations."[78]

VIII. Entity Choice Impact in the Employment Tax Context

A. Federal Employment Tax Issues

The choice of entity decision can have several impacts in the employment tax context including:

---

[76] See Reg. § 1.894-1(d).

[77] See 73 Fed. Reg. 246 (December 22, 2008).

[78] See New York State Bar Association, Tax Section, "Report on the Application of Anti-Conduit Regulations to Hybrid Entities and Instruments," Report No. 1188 (August 27, 2009), available at www.nysba.org/ at the Tax Section reports.

1) the existence of employment taxes applicable to the owners; and,
2) the allocation of the responsibility for the withholding at source of both income taxes and employment taxes.

B. Employment Tax Liabilities

A sole proprietor will be subject to self-employment tax on his self-employment income. The total tax will be at a rate of 15.3 percent, consisting of (1) a 12.40 percent social security tax (actually its equivalent, a self-employment tax) on income up to $106,800 (during 2009) and (2) a 2.9 percent Medicare tax on all self-employment income (i.e., unlimited as to compensation amount). This Social Security tax base is annually adjusted for inflation. Since this tax (particularly the unlimited 2.9 percent Medicare tax) can produce a significant tax liability the objective often is to avoid employment income inclusion and (in the corporate context) have profits distributed as dividends subject to the 15 percent tax rate. However, at the corporate level this latter strategy will not allow a deduction for salaries paid to the corporate payor.

A similar situation arises in the S corporation context. Shareholders of an S corporation are generally not subject to self-employment tax on their share of the net earnings of trade or business income of the S corporation if reasonable compensation is otherwise paid to the shareholders who are active in the business enterprise. In contrast, net earnings from self-employment do include a distributive share of partnership income, e.g., in a service partnership.[79] However, a limited partner's share of the income of a limited partnership (other than a guaranteed payment for

[79] Reg. §1.1402(a)-2(f) specifies that for the purpose of determining net earnings from self-employment a partnership is one which is recognized as such for federal income tax purposes. For federal income tax purposes the term "partnership" includes not only a partnership as known at common law, but, also, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any trade or business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate or a corporation.

services) is ordinarily not subject to the self-employment tax assessment at source.[80]

C. Employer Identification Numbers

Special rules exist for federal tax employer identification numbers to be used by disregarded entities. A single owner entity that is disregarded as an entity separate from its owner must use its owner's taxpayer identification number for most federal tax purposes. However, for purposes of employment taxes and related reporting requirements applicable to wages paid on or after January 1, 2009 a disregarded entity is to be treated as a separate entity.[81] See Reg. § 301.7701-2(c)(2)(iv)(B) providing that the separate entity is treated as a corporation for purposes of employment taxes and related reporting requirements.[82]

---

[80] Internal Revenue Code §1402(a)(13). Proposed regulations issued in 1997 (and still not finalized in 2009) would specify that an individual is considered to be a limited partner unless the individual (1) has personal liability for the debts or claims against the partnership by reason of being a partner, (2) has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership, or (3) participates in the partnership's trade or business form more than 500 hours during the partnership's taxable year. An individual who is a service partner in a service partnership may not be a limited partner. See Prop. Reg. §1.1402(a)-2(h)(1) & (6), Reg-209824-96, 62 Fed. Reg. 1702 (January 13, 1997).

[81] Similarly, under existing Reg. § 301.7701-2(c)(2)(v), a single-owner eligible entity that is disregarded as an entity separate from its owner for Federal tax purposes is treated as a separate entity for purposes of certain excise taxes reported on Form 720, "Quarterly Federal Excise Tax Return" and other excise tax forms. Although liability for excise taxes is not dependent upon an entity's classification, an entity's classification is relevant for certain tax administration purposes, such as determining the proper location for filing a notice of federal tax lien and the place for hand-carrying a return under Code § 6091. In T.D. 9462, 74 Fed. Reg. 46,903 (September 14, 2009) the Service issued temporary regulations to clarify that these disregarded eligible entities are treated as corporations for excise tax administration purposes.

[82] Reg. § 301.7701-2(c)(2)(iv)(C) provides the following example: LLCA is an eligible entity owned by individual A and is generally disregarded as an entity separate from its owner for federal tax purposes. However, LLCA is treated as an entity separate from its owner for purposes of Subtitle C of the Internal Revenue Code. LLCA is subject to the provision of subtitle C concerning the collection of employment taxes at source, including income tax withholding, FICA taxes and FUTA taxes. In addition, LLCA must file under its own name and employer

Special rules apply when an entity changes its federal tax classification. Any entity that has an employer identification number will retain that EIN if its federal tax classification changes under Reg. §301.7701-3.[83] A single owner entity that is disregarded as an entity separate from its owner under Reg. §301.7701-3 must use its owner's taxpayer identifying number for federal tax purposes.[84] However, if a single owner entity's classification changes so that it is recognized as a separate entity for federal tax purposes, and that entity had an EIN, then the entity must use that EIN and not the taxpayer identification number of the single owner. If the entity did not already have its own employer identification number, then the entity must acquire an EIN and not use the taxpayer identification number of the single owner.[85]

IX. Choice of Entity in the Estate Planning Context

A. Relevance for Making Estate Planning Choices

In the personal wealth transfer context the choice of an appropriate entity can have immense importance. Family members can participate in the ownership of the family investment enterprise. Questions arise about creating senior (i.e., frozen) interests for older generation members and choosing the best vehicle (e.g., S corporation, PL or LLC) to enable governance of the enterprise among the family members. Ultimately the objectives here are often to use the best vehicle to deflect value to younger generation members (and away from the estate of the older generation members for federal estate tax purposes).

B. The Disregarded Entity Valuation Discounts

This planning choice can best be identified by the emphasis on the use of the "family

---

identification number the tax returns for reporting wages and making timely employment tax deposits.

[83] Reg. §301.6109-1(h)(1).

[84] Reg. §301.6109-1(h)(2)(i).

[85] Reg. §301.6109-1(h)(2)(ii).

limited partnership." A common approach for transferring assets in the estate planning context is to utilize a family limited partnership to achieve significant discounts on asset transfers. The business law format for such a family limited partnership is either a limited partnership or, increasingly, a limited liability company. However, the client might ask whether multiple owners are necessary to achieve the valuation discount when making transfers to younger generation members.

In a recent Tax Court decision the use of a single member LLC treated as a disregarded entity was authorized to achieve these benefits. In Suzanne J. Pierre v. Commissioner, 133 T.C. ___, No. 2 (8-24-2009) the taxpayer had received $10 million and wanted to provide for her son and granddaughter. She created a single member LLC under the laws of the state of New York. She then (1) created trusts in the names of her son and granddaughter, (2) transferred assets to the LLC, and (3) gave or sold her interests in the LLC to the trusts. For gift tax reporting purposes a discounted value was used concerning the LLC interest given to the trusts. The Service asserted that the interests transferred to the donees should have been valued by reference to the underlying assets and that gifts were made for interests sold to the trusts to the extent the fair market value of the assets themselves exceed the value of the promissory notes received.

Fundamentally the Service asserted that because the single member LLC was a disregarded entity under the check the box regulations the donor's transfer should have been treated as a transfer of the LLC's underlying assets and that no valuation discounts should be applied. However, the divided Tax Court concluded that the LLC was not a disregarded entity under the check the box rules for the valuation discount rules and, therefore, a discount was available. The scorecard among the judges was (1) a ten member majority opinion, (2) a nine member concurrence, (3) a six member dissent and (4) a three member dissent. Essentially the state law elements determined this result.

X. Tax Procedure and Tax Administration Rules

A. Identifying the Proper Taxpayer

Seldom will the ultimate choice of an identity be impacted by variances in rules concerning tax administration and tax collection, but for some selective clients these matters could be of substantial significance. In tax collection matters taxpayers have unsuccessfully attempted to differentiate themselves from their wholly owned disregarded entity. For example, in Medical Practice Solutions, LLC v. Commissioner,[86] the taxpayer unsuccessfully asserted that the check the box rules were invalid. An LLC had not paid employment taxes. The Service pursued the sole member of the LLC to collect these taxes. The sole member indicated that the member was immunized from this liability because the regulations concerning check-the-box were invalid, but the Tax Court rejected this analysis and authorized the tax liability.

B. Federal Tax Refund Claim Impact of Entity Status Changes

Federal tax status of an entity and its change in status can possibly be of importance in pursuing a federal tax refund claim:

> *In Browning-Ferris Industries, Inc. & Subsidiaries v. United States, 2008 U.S. App. LEXIS 8146; 101 A.F.T.R.2d (RIA) 1770 (2008) the company had won dismissal of its tax refund suit without prejudice on a claim that its conversion, under Delaware law, from corporate form to that of a limited liability company (LLC), had stripped it of its authority to act for the consolidated group of which it was the corporate parent and with which it had filed the underlying tax returns. When the claims court granted dismissal over defendant's objection, defendant appealed. The court reversed and remanded. Though agreeing that an entity that had ceased to exist was not authorized to serve as an consolidated group's agent, the court looked to the law of Delaware, which governed, and concluded that because state law provided that such a conversion did not constitute dissolution of the corporation, the plaintiff in fact had continued to exist after its conversion to LLC form. That meant that a valid*

[86] 132 T.C. ___, No. 7 (2009). See further proceedings in this matter at T. C. Memo. 2009-214 remanding the case to the Appeals Officer after complications arising in the collections process.

demand for a refund had been filed and that the claims court in fact had jurisdiction over the suit. In so ruling, the court specifically found that Reg. §301.7701-3(g)(1)(iii), on which the claims court had relied, did not apply because plaintiff was a corporation, not an "eligible entity" as defined therein.

XI. Concluding Observations

As can be observed from the scope of this paper the impact upon choosing a particular type of entity to be used for business or investment purposes has numerous ramifications. These range from the standard analysis of comparing the net current after tax benefits when comparing all tax liabilities (e.g., federal income tax, employment tax and state tax). But the choice is much larger than merely quantifying this potential current tax cost. For this reasons the full scope of options identified in this paper (not limited to the standard choices) should be examine when planning to implement a business or investment endeavor.

SELECTED BIBLIOGRAPHY FOR THE CHECK-THE-BOX TAX PROPOSALS OF THE OBAMA ADMINISTRATION

1. U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," May 2009 (i.e., the "Green Book") (noted as available in Adobe Acrobat format at: *http://treasgov/offices/tax-policy/library/grnbk09.pdf*

2. Staff of the Joint Committee on Taxation, "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment," JCS-4-09, September 2009 (available from the Joint Committee on Taxation website)

3. Sullivan, "A Simple Overview of the Obama International Tax Proposals," Tax Notes, June 15, 2009, p. 1301

4. Stack, Rolfes, Brady and Bates, "Recent International Tax Proposals Raise Technical Issues," Tax Notes, August 3, 2009, p. 451.

5. Staff of the Joint Committee on Taxation, "Economic Efficiency and Structural Analyses of Alternatives U.S. Tax Policies for Foreign Direct Investment," as prepared for a Senate Finance Committee Hearing on June 26, 2008, JCX-55-08, June 25, 2008.