



2006

# Paradise Kept: A Rule-Based Approach to the Analysis of Transactions Involving Disregarded Entities

Alice G. Abreu

Follow this and additional works at: <https://scholar.smu.edu/smulr>

---

## Recommended Citation

Alice G. Abreu, *Paradise Kept: A Rule-Based Approach to the Analysis of Transactions Involving Disregarded Entities*, 59 SMU L. Rev. 491 (2006)

<https://scholar.smu.edu/smulr/vol59/iss2/5>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

# PARADISE KEPT: A RULE-BASED APPROACH TO THE ANALYSIS OF TRANSACTIONS INVOLVING DISREGARDED ENTITIES

Alice G. Abreu\*

In the beginning, the Check-the-Box Regulations created Disregarded Entities.<sup>1</sup> And the Entities were without form, and empty. And the Regulations said, let the light of the Code shine through the Entities; and it did, and the law was clear, and it was good, and taxpayers were happy.<sup>2</sup> And the Regulations blessed the Entities, and they were fruitful, and they multiplied.

**L**IKE the story of Genesis, the story of disregarded entities begins simply and elegantly. Disregarded entities, single member limited liability companies whose separate legal existence is ignored for all purposes under the Internal Revenue Code, were created by the Check-the-Box regulations.<sup>3</sup> Their creation was a logical consequence of the ap-

---

\* Professor of Law, Temple University Beasley School of Law, (Visiting Professor of Law, Harvard Law School Spring '06). I am honored to have been invited to participate in this Symposium celebrating the work of Charles O. Galvin, a scholar whose work I've admired. Some of Professor Galvin's most widely circulated work cites administrability gains in supporting changes to existing law. Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 TAX NOTES 1413 (1991); Charles O. Galvin, *Burying the Estate Tax: Keeping Ghouls Out of the Cemetery: A Reply to Professor Smith*, 56 TAX NOTES 951 (1991); Charles O. Galvin, *Estate Tax Foe Offers Simple Suggestion*, 76 TAX NOTES 555 (1997). This piece is the beginning of what I hope will be a fuller study of administrability as an independent value in tax policy. I thank Professor Galvin for having the foresight to consider the value of administrability even before the Code became the increasingly unadministrable monster that it is today. I also want to thank Jack Cummings, Rick Greenstein, Marty McMahon, and Andrea Monroe for insightful and prompt comments on a prior draft, although they do not necessarily agree with my conclusions and are not responsible for any errors, omissions, or misguided analysis. Meagan Horn (Harvard, '06), Dawn Moehn (Temple '06), and Nordia Morris (Harvard '07) provided valuable research assistance. A summer grant from Temple Law School provided financial support for the project. Special thanks to Chris Hanna for inviting me to participate and for his unending grace and patience.

1. Treas. Reg. §§ 301.7701-1 to .7701-3 (as amended in 1999). These regulations were proposed in May 1996, adopted in December 1996, became effective in January 1997, and were amended in November 1999.

2. The forgoing was adapted liberally from the First book of Moses. *Genesis* 1:1 (King James).

3. The Code itself provides for other disregarded entities, for example, a qualified real estate investment trust ("REIT") subsidiary under § 856(i) and a qualified Subchapter S subsidiary under §1361(b)(3) ("Q-Sub"). I.R.C. §§ 856(i), 1361(b)(3) (West 2006). Those disregarded entities differ from Check-the-Box disregarded entities because they are statu-

proach the Treasury adopted in those regulations.<sup>4</sup> Like the God described in Genesis, who gave humans dominion over other creatures, the Treasury, through the Check-the-Box regulations gave taxpayers dominion over the tax treatment of limited liability companies. Taxpayers could enjoy the benefits of entity status for substantive law purposes, but could choose a different characterization for federal tax purposes. Taxpayers could even choose to disregard the existence of the entity completely for tax purposes, so that the tax law would apply as if the entity did not exist. For taxpayers, this was the Garden of Eden.

In Genesis, the Garden of Eden is paradise for only two chapters. By the third chapter the serpent has made its appearance, the apple has been bitten, and paradise is lost. In the world created by the Check-the-Box regulations, the serpent has made its appearance and the apple has been nibbled at, but paradise is not yet lost. This article urges the Internal Revenue Service ("Service") to stop nibbling, so that paradise is not only regained but retained.

That the serpent of substance would invade the formalistic world of the Check-the-Box regulations was perhaps inevitable. Although the Treasury and the Service tried to end uncertainty over entity classification with the promulgation of the Check-the-Box regulations, the Service soon discovered that although the regulations put an end to some questions, they opened the door to others. The Service began issuing private letter rulings ("PLRs") on disregarded entities in late in 1997<sup>5</sup> and by

---

torily created and must also satisfy specific statutory requirements to be disregarded, which ensure that they are treated as part of the parent entity and limit their versatility. For example, although both a qualified REIT subsidiary and a Q-Sub must be 100% owned by a REIT or a subchapter S corporation, respectively, any taxpayer can own a Check-the-Box disregarded entity. There may also be state tax differences. For additional information regarding the differences between the Check-the-Box disregarded entities and other disregarded entities in the Code, see David S. Miller, *The Strange Materialization of the Tax Nothing*, 87 TAX NOTES 685 (2000).

4. The Check-the-Box regulations established a system under which all domestic unincorporated entities would be treated as partnerships unless they elected otherwise. Partnerships are pass-through entities, and since single-members LLCs could not be treated as partnerships, by devising the disregarded entity, the Treasury and the Service came up with the next best thing: pass-through taxation to the single LLC owner. Part II describes the development of the Check-the-Box regulations and the disregarded entity in detail. Foreign entities are also subject to the Check-the-Box regulations, but the regulations operate differently in the international context. I will restrict my analysis to the domestic treatment of disregarded entities in this paper, both because that suffices to illustrate my point and because the international application of the concept implicates different policy considerations.

5. The earliest ruling that mentions disregarded entities is I.R.S. Priv. Ltr. Rul. 97-32-030 (May 15, 1997). There, the question was whether, after a parent corporation that wholly owned the stock of several subsidiaries—two of which were the sole partners in a partnership—made an S election for itself and elected to treat the subsidiaries as Qualified Subchapter S Subsidiaries, which are disregarded entities, the partnership would be treated as having a single owner and would cease to be a partnership. The Service concluded that the partnership became a disregarded entity. In 1998, the Service issued a PLR to a foreign entity allowing it to have an extension of time to file. I.R.S. Priv. Ltr. Rul. 98-46-018 (Nov. 13, 1998). The Service, however, does not seem to have issued rulings in matters other than extensions until 1999, when it issued the bankruptcy remote rulings discussed *infra* note 124 and accompanying text. The nearly two-year lag between adoption of the

December 2005 had issued nearly 1,000 such rulings.<sup>6</sup> Although many of these rulings involved ministerial matters such as requests for extensions of time in which to file elections, others involved foundational issues such as whether an LLC with two legal owners should be treated as a disregarded entity because of limitations on the rights of one of the owners.<sup>7</sup> Still others involved situations where truly disregarding the separate existence of the single-member LLC would lead to a substantively incorrect result.<sup>8</sup> Despite the apparent clarity of the rule set forth in the Check-the-Box regulations, the Service sometimes found the lure of substantive accuracy too strong to resist. It began to issue PLRs that looked to substance to determine whether an LLC would be treated as having a single member and otherwise retreated from the mandate of the regulations to disregard the separate existence of such entities.<sup>9</sup>

The Service's inability to resist the lure of substance is understandable. At least since Mrs. Gregory lost her case before the Supreme Court in 1935, the primacy of substance has been a bedrock tenet of tax adjudication.<sup>10</sup> Nevertheless, by looking to substance, the Service has departed from the rule-based approach that produced the Check-the-Box regulations.<sup>11</sup> To look to substance is to apply a standard: substantively similar transactions ought to be taxed similarly. While that is often an unassailable goal, in this case, its costs are too great.

When deciding whether to disregard an entity for the purpose of determining the tax consequences of business transactions, the Service should abandon the goal of substantive accuracy. Substantive accuracy is unachievable in a system of elective classification. Elective classification necessarily produces a system in which substantively identical organizations are treated differently for tax purposes. The Treasury and the Service necessarily abandoned all attempts at classifying unincorporated entities by reference to substance when they promulgated the Check-the-Box regulations letting taxpayers choose the classification of unincorporated entities. The Service should resist the temptation to reintroduce substantive analysis. Instead, the Service should now focus on achieving the primary objective of the regulations: administrability. Adminis-

---

Check-the-Box regulations and the issuance of a number of non-extension PLRs is probably attributable to the time it took for tax planners (other than the advisors to the taxpayers in I.R.S. Priv. Ltr. Rul. 97-32-030) to begin using such entities, thereby discovering unanswered questions on which guidance was necessary.

6. A LEXIS-NEXIS search conducted in February 2006 turned up 971 PLRs and technical advice memoranda that contained the words "disregarded entity" or "entity that is disregarded."

7. See *infra* note 123 and generally Part B.

8. See *infra* note 173 and accompanying text.

9. See *infra* Part II.A.1.

10. Gregory v. Helvering, 293 U.S. 465 (1935).

11. Government officials acknowledge that they have found it difficult to reconcile the Check-the-Box regulations with the substantive application of the tax law and that their application of those regulations has been inconsistent. See Kenneth A. Gary, *Treasury, IRS Seek Comments on Disregarded Entity Treatment*, TAX NOTES TODAY, Oct. 14, 2004, LEXIS, 2004 TNT 199-1.

trability is the god that the Treasury and the Service purport to have been worshiping by issuing the Check-the-Box regulations, and administrability should therefore drive the application of those regulations.

Instead of the ad hoc, sometimes-rule, sometimes-standard approach the Service is currently taking, or an always-rule, or always-standard, approach that has the beauty of consistency, this article proposes a bifurcated analysis. The proposed analysis distinguishes between situations in which the characterization of an entity is important ex-ante, where knowing whether the entity will be disregarded would allow both taxpayers and the Service to predict accurately the tax consequences of particular transactions, and situations where the characterization is relevant only ex-post, where an event that is not susceptible of planning has already occurred.

The proposed analysis would use a rule to determine the characterization of an entity where characterization of the entity will affect the treatment of business transactions in which the entity engages. In such situations it is desirable to have a rule so that taxpayers, who can elect the tax characterization of an entity, can predict with certainty the results of their election. Certainty is the great virtue of rules and certainty breeds administrability. It was a quest for certainty and administrability that drove the promulgation of the Check-the-Box regulations allowing taxpayer choice, so a rule-based approach follows from the *raison d'être* of the regulations. Although consistent application of a rule can produce substantively inaccurate results in some cases, inaccuracy is least troubling when the classification is not only elective in the first instance, but where that election can be changed by taxpayer action. Consistent application of a rule will allow taxpayers to decide whether to make or change an election with maximum information.

There are other situations that do not involve the tax treatment of business transactions but rather involve either the act of payment of tax or the breakdown of the relationship between the entity and the government. Such a breakdown occurs when the government seeks to assess or collect payment of a tax liability. When it comes to assessment, collection, and payment, the reasons for disregarding the separate existence of the entity—allowing taxpayers to enjoy pass-through treatment of the tax consequences of transactions—are not present. In those situations, the objective should be to ensure that the government is able to collect what is lawfully due it. In matters involving assessment, collection, and payment, the rule should not apply. A disregarded entity should be treated as the taxpayer with respect to tax liability attributable to its economic activity.

In developing the proposed analysis, I have drawn on scholarship that examines the application of rules and standards in a variety of legal contexts.<sup>12</sup> I have chosen to do that not only because many of the insights

---

12. FREDERICK SCHAUER, *PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND IN LIFE* (1991); Colin S. Diver, *The Opti-*

developed in that scholarship apply in tax, but because by doing so I hope to make that literature more prominent in tax scholarship generally. The increasing difficulty of administering the tax system suggests that policy-makers should think more deeply about the tradeoff between equity and administrability. Disregarded entities can help to explore that tradeoff because they are the culmination of more than half a century of struggle with entity classification and represent one resolution of it. In addition, the pattern of the struggle between equity and administrability in entity classification follows that evident in other areas of the law. In *Crystals and Mud in Property Law*, Carol Rose described a process in which rules are promulgated in areas where frequent application demands certainty, but that very frequency creates exceptions and nuanced analysis, which converts the rule into a standard, and the cycle begins anew.<sup>13</sup> The tax law on entity classification follows this pattern precisely.

The crisp, clear edges of the crystalline rule set forth in the Check-the-Box regulations have already begun to blur and the rule-to-standard, crystal-to-mud pattern is in danger of being repeated. In the future the Service will come under additional pressure to take a bite from the apple of substance and revert to using a standard, as it copes with questions such as the application of § 108 to discharges of disregarded entity debt<sup>14</sup> and the application of the Check-the-Box regulations to single-shareholder corporations that are administratively dissolved, thus becoming non-corporate entities under state law.<sup>15</sup> If the Service bows to the pressure to look at substance, the Check-the-Box regulations will not only have failed to achieve their objective of simplification, but the Service will have exacerbated complexity by introducing a new set of variables. Paradise will be lost. The Service can prevent that result by adopting the analysis proposed here.

Parts I and II of this article will track the development of the Check-the-Box regulations. They will show the evolution of the law on entity classification from an apparently crystalline rule contained in the statute to the mud of the standards created by judicial decisions. Those decisions were followed by regulatory attempts to introduce crystalline rules, only to have those rules converted to muddy standards, eventually culminating in the attempt to restore crystalline order through the adoption of the Check-the-Box regulations.<sup>16</sup> Part III will then explain how the Service has deviated from the rule-based approach of the Check-the-Box regulations in issuing guidance on the tax treatment of various transactions in-

---

*mal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. J. 557 (1992); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988); For a compendium of the scholarship on rules and standards, from an economic perspective, see Kaplow, *supra*.

13. See *supra* note 2.

14. See *infra* Part III.E.1.

15. See *id.*

16. The reference to crystals and mud is drawn from Carol Rose's work. See generally Rose, *supra* note 12.

volving disregarded entities. Part IV will discuss why the rule-based approach of the regulations is apt for purposes of *ex ante*, but not *ex post*, determinations. Finally, Part V will conclude by suggesting how the Service and Treasury might reconsider their position on the Check-the-Box regulations and on the guidance the Service has issued.

## I. ENTITY CLASSIFICATION BEFORE THE CHECK-THE-BOX REGULATIONS

### A. THE SUPREME COURT CASES: TAXING LIKES ALIKE

Entity classification under the Internal Revenue Code (“Code”)<sup>17</sup> has a long and tortured history. The Code provides that “the term ‘corporation’ includes associations, joint-stock companies, and insurance companies.”<sup>18</sup> It is the word “association” that caused the uncertainties that ultimately led to the promulgation of the Check-the-Box regulations. By providing that “associations” could be corporations for tax purposes, Congress suggested that an unincorporated entity could be treated as a corporation under the Code.<sup>19</sup> The obvious question that followed was which unincorporated associations should be treated as corporations for tax purposes?

Before the issuance of the Check-the-Box regulations, the determination of whether an entity was an association taxable as a corporation depended on the application of six separate factors that required a detailed examination of the powers, composition, and governance structure of the entity.<sup>20</sup> These factors were derived from Supreme Court case law that interpreted the meaning of the word “corporation” in the Code. The

---

17. All references to the “Code” are to the Internal Revenue Code of 1986, as amended through December, 2005.

18. I.R.C. § 7701(a)(3) (2005).

19. The Congressional intention to treat all non-partnership business entities alike, regardless of their formal status as corporations, dates back to 1894, when the statutory language was even more explicit. Section 32 of the Revenue Act of 1894, which was found to impose an unconstitutional direct tax in *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429 (1895), also imposed a tax on the “net profits or income” of “corporations, companies, or associations doing business for profit in the United States, no matter how created and organized, but not including partnerships.” *Id.* at 676 n.2. Income tax legislation before that time had not imposed a tax on entities by broad type but had instead taxed specific industries or trades. See Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 438 n.5 (1995).

20. Treas. Reg. § 301.7701-2(a)(1), (2) (1960); T.D. 6503, 1960-2 C.B. 409. These regulations, generally known as the “*Kintner* Regulations” because their issuance followed the government’s defeat in *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), provide that the six characteristics are as follows: (1) associates; (2) an objective to carry on business and to distribute the resulting profits; (3) continuity of life; (4) *Kintner* centralized management; (5) limited liability; and (6) free transferability of interests. The *Kintner* regulations provided that those characteristics common to both the entity in question and corporations (like associates and the intent to carry on business for profit in the case of a partnership) were to be ignored and that classification depended on whether the entity had more than half of the remaining corporate characteristics. Treas. Reg. § 301.7701-2(a)(2) (1960); T.D. 6503, 1060-2 C.B. 409. In the case of partnerships, that meant that if the partnership had three of the remaining four characteristics, it would be classified as an association and taxable as a corporation. *Id.*

analysis was designed to classify as associations, taxable as corporations, those entities that resembled corporations.<sup>21</sup> Such an analysis rested on a standard—the corporation—and sought to treat as corporations only those entities that resembled corporations.

The Supreme Court began to explore the question of which associations would be taxable as corporations in 1911,<sup>22</sup> a scant two years after the adoption of the first constitutional corporate income tax<sup>23</sup> and two years before the ratification of the Sixteenth Amendment and enactment of the first constitutional federal income tax. Section 38 of the Corporation Tax Law of 1909 imposed a tax on “every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares . . . .”<sup>24</sup> Having decided that the Corporation Tax Law was constitutional in *Flint v. Stone Tracy Co.*,<sup>25</sup> the Court in *Eliot v. Freeman* had to decide whether real estate trusts would be subject to the corporate income tax.<sup>26</sup> The analysis the Court adopted in *Freeman* to determine which unincorporated entities would be subject to the corporate income tax was founded on the analysis the Court had just developed in *Stone Tracy* to conclude that the tax itself was constitutional. It reflected the standard-based approach that began with *Stone Tracy* and that would dominate entity classification for the next eighty-five years.

*Freeman*<sup>27</sup> and *Stone Tracy*<sup>28</sup> were decided on the same day in unanimous opinions written by the same Justice,<sup>29</sup> so it is not surprising that the Court used the same type of analysis in both decisions.<sup>30</sup> To decide whether the corporate income tax was constitutional in *Stone Tracy*, the Court had to determine whether the tax was a direct tax, which must be

21. The test was known as the “resemblance test.” For a detailed description of the test and an explanation of its historical development and application, see generally Hobbs, *supra* note 19.

22. See *Eliot v. Freeman*, 220 U.S. 178, 185-86 (1911).

23. Payne-Aldrich Tariff Act of Aug. 5, 1909, Pub. L. No. 61-5, ch. 6, 36 Stat. 11 (1909). The word “association” made its first appearance in the Revenue Act of 1894. Hobbs, *supra* note 19, at 439.

24. *Id.* § 38, 36 Stat. at 112.

25. 220 U.S. 107 (1911). In *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), the Court overruled *National League of Cities v. Usery*, 426 U.S. 833 (1976), a case in which the Court had applied a Commerce Clause analysis like the one it applied in *Stone Tracy* to uphold the Corporation Tax Law against a commerce clause challenge. Although Shepard’s lists *Stone Tracy* as being overruled by *Garcia*, I believe that conclusion goes too far. In *Garcia*, the Court only overruled a case that had employed a test similar to that employed in *Stone Tracy*. The Court did not overrule *Stone Tracy* directly. Nothing in *Garcia* suggests that the Court would hold the corporate income tax to be unconstitutional, a conclusion that is implied by listing *Stone Tracy* as overruled. I have therefore declined to describe *Stone Tracy* as overruled.

26. 220 U.S. at 184.

27. 220 U.S. 178.

28. 220 U.S. 107.

29. Both opinions were written by Mr. Justice Day, and both opinions were unanimous.

30. *Freeman* was argued on January 19, 1911 and decided on March 13, 1911. *Freeman*, 220 U.S. at 178. *Stone Tracy* was first argued on March 17 and 18, 1910, was reargued on January 17, 18, and 19, 1911, and was also decided on March 13, 1911. *Stone Tracy*, 220 U.S. at 107.



apportioned, or an indirect excise that was constitutionally permissible even if not apportioned.<sup>31</sup> Although much about the Court's decision in *Stone Tracy* has been roundly criticized,<sup>32</sup> my purpose here is not to pass judgment on the Court's analysis but rather to examine its analytical approach. In *Stone Tracy*, the Court found that the tax was an excise on doing business in corporate form and was therefore not a direct tax.<sup>33</sup> Crucial to its finding that the tax was an excise tax was the Court's conclusion that the subject of the tax was the doing of business in a particular form and the levy was therefore a tax imposed on the privilege of doing business in that form.<sup>34</sup> That form was the corporation, but that conclusion did not end the inquiry. The Court also had to show that the tax did not violate the Uniformity Clause.<sup>35</sup>

The Court concluded that the tax did not violate the Uniformity Clause, because the tax applied only to businesses conducted in a particular form; that form gave those businesses advantages and attributes that were not available to businesses conducted in other forms and therefore made those other businesses distinguishable. As the Court explained:

The thing taxed is not the mere dealing in merchandise in which the actual transactions may be the same, whether conducted by individuals or corporations, but the tax is laid upon the privileges which exist in conducting business with the advantages which inhere in the corporate capacity of those taxed, and which are not enjoyed by private firms or individuals. These advantages are obvious, and have led to

---

31. Apportionment is required by Article I of the Constitution. U.S. CONST. art. I, §§ 2, cl. 3, 9, cl. 4.

32. See *infra* note 33.

33. This conclusion has been soundly and frequently criticized, and the case referred to as "infamous." See, e.g., Hobbs, *supra* note 19, at 456. Calvin Johnson has observed that,

After *Pollock* and before the Amendment, the Supreme Court had retreated to a more flexible, functional definition of "direct tax," much like the one that had prevailed before *Pollock*, so that only the income tax remained at issue. The Sixteenth Amendment only governed income taxes, not because it was meant to preserve some area of non-income taxes in which apportionment was thought to be of continued constitutional value, but because apportionment seemed to have been otherwise sufficiently nullified by judicial doctrine, except for the income tax.

Calvin H. Johnson, *Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution*, 7 WM. & MARY BILL RTS. J. 1, 27 (1998). See also Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2376 n.236 (1997) (quoting JOHN STEELE GORDON, *HAMILTON'S BLESSING: THE EXTRAORDINARY LIFE AND TIMES OF OUR NATIONAL DEBT* 86, 97 (1997), "One can hardly help admiring the legal artistry of [Chief Justice] Taft's deft end run around an inconvenient phrase in the Constitution.").

34. *Stone Tracy*, 220 U.S. at 150. Hobbs explains that President Taft explicitly proposed an income tax to "protect the integrity of the Court" by allowing them to uphold the constitutionality of that tax without having to overrule *Pollock* and to "spare the Court from having to reconsider the income tax issue until after Congress and the states contemplated a Constitutional amendment." Hobbs, *supra* note 19, at 454-55 (footnotes omitted).

35. The Uniformity Clause provides that "The Congress shall have Power To lay and collect Taxes, Duties, Imposts, and Excises, to pay the Debts and Provide for the Common Defense and General Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States." U.S. CONST., art. 1, § 8, cl. 1.

the formation of such companies in nearly all branches of trade. The continuity of the business, without interruption by death or dissolution, the transfer of property interests by the disposition of shares of stock, the advantages of business controlled and managed by corporate directors, the general absence of individual liability, these and other things inhere in the advantages of business thus conducted, which do not exist when the same business is conducted by private individuals or partnerships. It is this distinctive privilege which is the subject of taxation, not the mere buying or selling or handling of goods which may be the same, whether done by corporations or individuals.<sup>36</sup>

As the forgoing passage reveals, in deciding the Uniformity Clause issue, the Court in *Stone Tracy* used four characteristics of the corporate form (continuity of life, transferability of interests, centralized management, and limited liability) both to identify and to limit the kinds of businesses that were to be subject to the tax. Not coincidentally, those are the characteristics on which the bulk of modern analysis has proceeded. Out of the six characteristics of the corporate form, only those four can distinguish between corporations and unincorporated associations that more closely resemble partnerships than corporations.<sup>37</sup> In *Stone Tracy*, the Court not only established the constitutionality of the corporate income tax but also provided the foundation for the standard-based analysis that persisted until the promulgation of the Check-the-Box regulations.

The Court returned to that analysis in *Freeman*. In that case the question was whether trusts would be subject to the corporate income tax, which by its terms applied to “corporations and joint-stock associations [that] are now or hereafter organized under the laws of the United States,”<sup>38</sup> and the Court interpreted that language to include only entities organized under a state statute. As the Court explained,

It was the purpose of the act to treat corporations and joint stock companies, similarly organized, in the same way, and assess them upon the facility in doing business which is substantially the same in both forms of organization. Joint stock organizations are not infrequently organized under the statute laws of a State, deriving therefrom, in large measure, the characteristics of a corporation.<sup>39</sup>

The Court concluded that since the trusts in question were not organized under a state statute, they did not derive any benefit from the statutory laws of the state and were therefore not subject to the tax.<sup>40</sup> To underscore the difference between the entities described in the tax law, which derived from a statute “some quality or benefit not existing at the com-

---

36. *Stone Tracy*, 220 U.S. at 161-62.

37. See *supra* note 20. The other two hallmarks, associates and an objective to carry on business for profit were common to both corporations and partnerships and so were not factored into the analysis. *Stone Tracy*, 220 U.S. at 161-62. See also *supra* n.20.

38. *Eliot v. Freeman*, 220 U.S. 178, 178, 185 (1911).

39. *Id.* at 185-186.

40. *Id.* at 187.

mon law," and the trusts at issue in the case the Court pointed out that "[t]hese trusts do not have perpetual succession, but end with lives in being and twenty years thereafter."<sup>41</sup>

Subsequent early cases followed a similar approach. In *Crocker v. Malley*,<sup>42</sup> the Court again had to rule on the application of the corporate income tax imposed by the 1913 Act to a trust.<sup>43</sup> That legislation imposed a tax on "every corporation, joint stock company or association, and every insurance company, organized in the United States, no matter how created or organized, not including partnerships."<sup>44</sup> In concluding that the trust in question was not subject to the tax, Justice Holmes applied a standards-based analysis and explained,

[I]f we assume that the words "no matter how created or organized" apply to "association" and not only to "insurance company," still it would be a wide departure from normal usage to call the beneficiaries here a joint-stock association when they are admitted not to be partners in any sense, and when they have no joint action or interest and no control over the fund.<sup>45</sup>

Four years later, in *Hecht v. Malley*,<sup>46</sup> the Court had to make a similar decision under the Revenue Act of 1916<sup>47</sup> and the Revenue Act of 1918.<sup>48</sup> The Court found that the trusts in question were not subject to tax under the 1916 Act because they did not derive authority from any state statutory enactment, but were subject to tax under the 1918 Act.<sup>49</sup> The reason for the difference in result was the difference in the language of the two statutes. Unlike the 1916 and previous Acts, the 1918 Act imposed a tax on corporations and then defined corporations to include "associations, joint-stock companies, and insurance companies."<sup>50</sup> The change in the language from the 1916 and prior Acts to the 1918 Act<sup>51</sup> showed that Congress intended "to extend the tax from one imposed solely upon organizations exercising statutory privileges, as theretofore, to include also organizations exercising the privilege of doing business as associations at the common law."<sup>52</sup> Freed from the constraint of the statutory link, the Court turned to the dictionary to uncover the meaning of

---

41. *Id.*

42. 249 U.S. 223 (1919).

43. *See* Revenue Act of 1913, Pub. L. No. 63-16, § II(G)(a), 38 Stat. 114, 172.

44. *Id.*

45. *Crocker*, 249 U.S. at 223.

46. 265 U.S. 144 (1924).

47. Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 789.

48. Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057 (1919).

49. *Hecht*, 265 U.S. at 154-47.

50. Revenue Act of 1918 ch. 18, 40 Stat. at 1058.

51. As described by Professor Hobbs, that change involved the provision of a definitional section in the 1918 Act which changed the placement of a comma, so that the statute went from applying to "corporations, joint-stock companies or associations, . . ." to "the term 'corporation' includes associations, joint-stock companies, . . ." thus indicating that the term "association" was not to be limited to entities that resembled joint-stock companies. *See* Hobbs, *supra* note 19, at 439.

52. *Hecht*, 265 U.S. at 155.

the term “association” and decide whether the trusts were associations within the meaning of the 1918 Act. The Court consulted three dictionaries and cited three definitions of the term “association” that shared one common characteristic: they defined association by reference to corporations, using the corporation as a standard against which the entity in question was to be measured.<sup>53</sup> Although the specifics of the analysis had changed as a result of the change in the statutory language, the method of analysis—determining whether the entity to be classified shared the important characteristics of the referenced entity—had not. The Court concluded that

[W]hen the nature of the three trusts here involved is considered, as the petitioners are not merely trustees for collecting funds and paying them over, but are associated together in much the same manner as the directors in a corporation for the purpose of carrying on business enterprises, the trusts are to be deemed associations within the meaning of the Act of 1918.<sup>54</sup>

As before, the Court was using a standard—the corporation—to determine the coverage of the statute.

Although the statutory formulation has remained essentially unchanged since 1918, the Court needed to continue to construe the meaning of the term “association.” That, of course, is one of the problems with standards: they require a nuanced analysis that makes it difficult to predict the outcome of any given case. Nevertheless, the Court continued to apply a standard-based analysis. In *Morrissey v. Commissioner*,<sup>55</sup> the Court acknowledged this difficulty and tried to provide a more definitive formulation.<sup>56</sup> It therefore concluded that “[t]he inclusion of associations with corporations implies resemblance; but it is resemblance and not identity. The resemblance points to features distinguishing associations from partnerships as well as from ordinary trusts.”<sup>57</sup> The analysis had

---

53. The three definitions were: (1) “a term ‘used throughout the United States to signify a body of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise.’” *Id.* at 157 (quoting 1 BENJAMIN ABBOTT DICTIONARY OF TERMS AND PHRASES USED IN AMERICAN OR ENGLISH JURISPRUDENCE 101 (1879); 1 JOHN BOUVIER, A LAW DICTIONARY 269 (Rawle’s 3d Rev.); 3 AMERICAN & ENGLISH ENCYCLOPEDIA LAW 162” (2d ed.)); (2) “‘In the United States, as distinguished from a corporation, a body of persons organized, for the prosecution of some purpose, without a charter, but having the general form and mode of procedure of a corporation.’” *Id.* (quoting WEBSTER’S NEW INTERNATIONAL DICTIONARY); (3) “[U.S.] An organized but unchartered body analogous to but distinguished from a corporation.” *Id.* (quoting THE PRACTICAL STANDARD DICTIONARY OF THE ENGLISH LANGUAGE).

54. *Id.* at 161.

55. 296 U.S. 344 (1935).

56. The Court observed that “[w]hile it is impossible in the nature of things to translate the statutory concept of ‘association’ into a particularity of detail that would fix the status of every sort of enterprise or organization which ingenuity may create, the recurring disputes emphasize the need of a further examination of the congressional intent.” *Id.* at 356.

57. *Id.* The Court employed the same analysis in the three companion cases that it decided at the same time it decided *Morrissey*. See *Swanson v. Comm’r*, 296 U.S. 362, 365

become more refined with each successive case, but the standard-based approach, with its emphasis on discerning similarities so that likes could be taxed alike, and equity and theoretical purity thus achieved, became more entrenched.<sup>58</sup> Regulations adopted after *Morrissey* generally followed the analysis developed in that case, adopting the so-called resemblance test and thus enshrining the standard-based approach in the regulatory framework.

#### B. THE *KINTNER* REGULATIONS: RESULT-ORIENTED DRAFTING LEADS TO INCREASING FORMALISM

*Morrissey* marked the end of the Supreme Court's involvement with the definition of the term 'association', but the law on the subject did not stand still. Although corporate status brought with it the imposition of an undesirable entity level tax, it also had significant benefits, particularly with respect to tax-qualified pension plans.<sup>59</sup> Before the advent of the professional corporation, unincorporated groups of professionals wanted to be classified as associations (taxable as corporations) for federal income tax purposes so that they could establish pension plans under terms then available only to corporations.<sup>60</sup> After the government lost in court under the then-existing regulations (which had adopted the post-*Morrissey* resemblance test) in *Kintner v. United States*,<sup>61</sup> where the court held that an unincorporated organization with unlimited life and centralized management would be taxable as a corporation, the Treasury amended those regulations to make classification as an association more difficult.<sup>62</sup> The resulting regulations, which became known as the *Kintner* regula-

(1935); *Helvering v. Combs*, 296 U.S. 365, 368 (1935); *Helvering v. Coleman-Gilbert Assocs.*, 296 U.S. 369, 372 (1935).

58. The Court was not deciding these entity classification cases in a vacuum. The Treasury Department had issued regulations interpreting the various provisions of the different statutes and the Court had these formulations before it. But since the regulations could not apply unless they were valid in each case, the Court was not just enforcing a regulatory provision but was passing on the validity of that regulatory construction. For a detailed analysis of the regulatory evolution, see Hobbs, *supra* note 19, at 468-81.

59. See Hobbs, *supra* note 19, at 482-91.

60. *Id.*

61. 107 F. Supp. 976 (D. Mont. 1952), *aff'd*, 216 F.2d 418 (9th Cir. 1954).

62. In *Kintner*, under the regulations then applicable, the district court observed that "If an organization is not interrupted by the death of a member or by a change in ownership of a participating interest during the agreed period of its existence, and its management is centralized in one or more persons in their representative capacities, such an organization is an association, taxable as a corporation." *Id.* at 979 (quoting Treas. Reg. § 29.3797-4 (1949)). The court concluded that since the organization in question satisfied those two requirements, it would be treated as a corporation for federal income tax purposes. Under the amended regulations an organization had to have more corporate than non-corporate characteristics. See Hobbs, *supra* note 19, at 486 (noting that under the amended regulations three of four factors must be met); see also Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 217 (2004) (noting that three of four factors must be met). As Professor Victor Fleisher has observed, "the Court [in *Morrissey*] never intended a mechanical application of its enumerated factors." Victor E. Fleisher, *If It Looks Like a Duck: Corporate Resemblance and Check-the-Box*, 96 COLUM. L. REV. 518, 525-26 (1996), reprinted in TAX NOTES TODAY, Apr. 19, 1996, LEXIS, 96 TNT 78-26 at para. 13. In *Morrissey* itself the Court observed that,

tions, retained the resemblance test, but modified its application to make it less likely that unincorporated organizations would be classified as associations.<sup>63</sup>

To make corporate status more difficult to attain, the *Kintner* regulations replaced the general weighing of factors to determine corporate resemblance with a numerical requirement. An organization had to have three of the four corporate characteristics to be classified as an association taxable as a corporation.<sup>64</sup> The addition of a quantitative measure made the test more rule-like<sup>65</sup> and subjected the new regulations to criticism on the ground that they departed from the Supreme Court-sanctioned *Morrissey* approach.<sup>66</sup> Still, the nominal use of the resemblance test suggested that the regulations sought to tax as corporations only those entities that resembled corporations in some meaningful way, and that only the determination of what was meaningful had changed. To that extent the *Kintner* regulations continued to reflect a standard-based approach, albeit one that was tending toward a rule.<sup>67</sup>

The term embraces associations as they may exist at common law. We have already referred to the definitions, quoted in that case, showing the ordinary meaning of the term as applicable to a body of persons united without a charter "but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise." These definitions, while helpful, are not to be pressed so far as to make mere formal procedure a controlling test. The provision itself negatives such a construction. Thus unincorporated joint-stock companies have generally been regarded as bearing the closest resemblance to corporations. But, in the revenue acts, associations are mentioned separately and are not to be treated as limited to "joint-stock companies," although belonging to the same group. While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive.

*Morrissey*, 296 U.S. at 358 (citations omitted).

Polsky has also noted that the Court did not particularly give weight to any of the factors, "appearing to use an overall facts and circumstances test. Nor did the Court provide any guidance regarding the degree of corporate similarity necessary in order for an entity to be considered an association." Polsky, *supra* at 216.

63. Hobbs, *supra* note 19, at 486. See Treas. Reg. §301.7701-2(a)(1)-(3) (1960); T.D. 6503, 1960-2 C.B. 409. See also *supra* note 62.

64. Hobbs, *supra* note 19, at 486. See also *supra* note 62.

65. In *Larson v. Commissioner*, 66 T.C. 159 (1976), the Tax Court noted that "[t]he regulations discuss each major corporate characteristic separately, and each apparently bears equal weight in the final balancing. This apparently mechanical approach may perhaps be explained as an attempt to impart a degree of certainty to a subject otherwise fraught with imponderables."

66. The *Kintner* regulations were criticized as being inconsistent with *Morrissey* insofar as they provided a bright line test. See Polsky, *supra* note 62, at 218.

67. The emphasis on evaluating the existence of corporate characteristics reflected continued reliance on a standard, but the description of each characteristic was becoming more detailed and thus more rule-like. For example, as Hobbs noted, the regulations stated that

"Free transferability of interests" existed under the regulations if members owning substantially all of the interests in the organization had the power to transfer their entire interest to a non-member without consent. If, however, members were only free to transfer their rights to the profits of the enterprise and not their rights to participate in the management of the enterprise, then the corporate characteristic of free transferability did not exist.

Although the advent of the professional corporation and the amendment of the Code to create parity between corporate and noncorporate pension plans made it unlikely that cases like *Kintner* would arise again, neither development put an end to the need to engage in the exercise of entity classification. Beginning in the late 1960s, partnerships became the vehicle of choice for structuring ventures designed to pass significant tax benefits to groups of individuals. Many of these ventures eventually came to be known as tax shelters. The Service initially attempted to thwart the tax objectives of these ventures by seeking to have them classified as corporations for tax purposes.<sup>68</sup> The Service was largely unsuccessful, and the early 1980s saw the development of the Master Limited Partnership ("MLP"), a publicly traded entity that enjoyed limited liability and centralized management but still purported to be a pass-through entity for tax purposes.<sup>69</sup>

The development of MLPs revealed the difficulty of maintaining a standard-based approach while providing certainty in tax administration. Indeed, the Treasury took a number of inconsistent positions during this time,<sup>70</sup> and in 1987 it succeeded in obtaining legislation (codified in § 7704) to tax publicly traded partnerships as corporations, thus ending the need to have regulations of general applicability do the job.<sup>71</sup> The enactment of § 7704 ended the reign of the *Morrissey* resemblance test with respect to publicly traded organizations. Under this provision, publicly traded organizations (with only a very few exceptions)<sup>72</sup> were

---

See Hobbs, *supra* note 19, at 488.

68. See Hobbs, *supra* note 19, at 498-502.

69. Master Limited Partnerships ("MLPs") were limited partnerships whose partnership interests were publicly traded either on an exchange or over the counter. The first MLP appeared in 1981 and the growth of MLPs was substantial over the next few years. J. COMM. ON TAXATION, 100TH CONG., TAX TREATMENT OF MASTER LIMITED PARTNERSHIPS n.11 (Comm. Print 1987), reprinted in *Tax Treatment of Master Limited Partnerships: Joint Committee on Taxation Explains Master Limited Partnerships*, 87 TAX NOTES TODAY, June 30, 1987, LEXIS, 87 TNT 126-3, at n.11. MLPs were popular because they provided pass-through taxation and only one level of tax. Although the natural resource industries were the first to take advantage of the MLP structure, soon, a wide variety of entities requiring capital contributions were utilizing the structure. For example, the Boston Celtics operated as an MLP. See *Finance/New Issues; Celtics Basketball Team Goes Public*, N.Y. TIMES, Dec. 4, 1986, available at <http://query.nytimes.com/gst/fullpage.html?res=9A0DE6DC113FF937A35751C1A960948260>. The Government soon became concerned about the potential erosion of the corporate tax base and the practical difficulties of applying Subchapter K to publicly traded entities that could have a number of partners within the span of a single day. For a more complete discussion on the proposed tax treatment of MLPs, see generally *Tax Treatment of Master Limited Partnerships: Joint Committee on Taxation Explains Master Limited Partnerships*, *supra*.

70. *Tax Treatment of Master Limited Partnerships: Joint Committee on Taxation Explains Master Limited Partnerships*, *supra* note 69; see also Hobbs, *supra* note 19, at 498-502. Treasury even proposed regulations that would have treated an entity as a corporation if it all of its members enjoyed limited liability. For further description of the proposed regulations and their fate, as well as some of the inconsistent positions the IRS took during this time, see *infra* note 81.

71. Revenue Act of 1987, Pub. L. No. 100-203, § 10211(c), 101 Stat. 1330, 1330-403; see Hobbs, *supra* note 19, at 503-511.

72. If ninety percent of a publicly traded partnership's income is "qualifying income" for the current taxable year and each preceding taxable year the partnership was a publicly

treated as corporations, whether they resembled corporations in any other way or not. Section 7704 provided a rule. Use of a standard in that area became history.

### C. THE LIMITED LIABILITY COMPANY: TRENDSETTING ON THE RANGE

Despite the enactment of § 7704, the passage of the Tax Reform Act of 1986 put additional pressure on the entity classification issue; some of the changes wrought by that legislation, most notably the repeal of the *General Utilities* doctrine,<sup>73</sup> made many taxpayers want to do business through an entity that provided the benefits of limited liability but would be treated for tax purposes as a partnership.<sup>74</sup> This contributed signifi-

---

traded partnership, then § 7704(a) will not apply (the partnership will not be a per se corporation) unless the partnership could qualify as regulated investment company (with some qualifications). "Qualifying income" is income from interest, dividends, real property rents, gain from the sale or other disposition of real property, income and gains 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), any gain from the sale or disposition of a capital asset, and in some circumstances, the income and gains from commodities or futures, forwards, and options with respect to commodities.

73. *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200 (1935). In *General Utilities*, the Court held that a corporation's distribution of shares of stock of a different corporation as a dividend to its shareholders would not result in gain at the corporate level. The Court found that the transaction did not constitute a sale and noted that assets were not used to discharge indebtedness. *Id.* at 206. Over time, the case was interpreted to mean that there would be no corporate level tax on corporate distributions of appreciated property and was extended by statute to cover certain liquidating sales of property. See Boyd C. Randall & Dave N. Stewart, *Corporate Distributions: Handling Liabilities in Excess of the Fair Market Value of Property Remains Unresolved*, 19 J. OF CORP. TAX'N 55 (1992). However, the *General Utilities* doctrine was repealed by the Tax Reform Act of 1986. After the repeal, gain was recognized

by a corporation on (1) a liquidating distribution of its property as if the property had been sold at its fair market value to the distributee; (2) a liquidating sale of its property; and (3) a nonliquidating distribution of its property as if the property had been sold at its fair market value to the distributee.

*Id.* See I.R.C. §§ 311, 336 (2005).

74. See George R. Goodman, *Corporate and Partnership M&A Tax Laws: Is it Time to Merge Subchapters C and K?*, 95 TAX NOTES 1497, 1497 (2002). See also Richard M. Lipton, Phillip M. Brunson & Stefan F. Tucker, *Critical Partnership Tax Issues—An Overview*, 1186 PLI/CORP 343, 377 (June 2000). With the repeal of *General Utilities*, and the inversion of tax rates resulting from the Tax Reform Act of 1986, the pass-through status of partnerships became markedly more valuable. However, before the existence of LLCs, a partnership could achieve limited liability for its partners only by becoming a Limited Partnership. The problem was that a limited partner could not be a working partner (for example, a partner in a law firm) without becoming liable for the liabilities of the partnership. In cases where limited partners did not want to be involved in management, the technique of creating a limited partnership with a corporate general partner did not achieve the same objective as incorporation, because the corporate general partner had to be adequately capitalized if it was to be respected in that capacity, thus preventing the full insulation of significant assets from liability for partnership debts. Treas. Reg. § 301.7701-2(d) (1995). The issuance of Rev. Rul. 88-76, which classified a Wyoming LLC as a partnership for federal tax purposes, resulted in a dramatic increase in the number of LLCs formed. See Philip F. Postlewaite & John S. Pennell, *JCT's Partnership Tax Proposals: 'Houston, We Have a Problem,'* 76 TAX NOTES 527, 29 (1997) (stating that Rev. Rul. 88-76 "opened the



cantly to the increase in popularity of the Limited Liability Company ("LLC"), an entity first created by a 1977 Wyoming statute,<sup>75</sup> and made it necessary for the Treasury to reconsider its approach to the entity classification question.

Under the *Kintner* regulations, as then in effect, an entity would be classified as a corporation if it more closely resembled a corporation than any other form of business organization, but the regulations also provided that such resemblance could not exist unless the organization had more corporate than non-corporate characteristics.<sup>76</sup> If an LLC had limited liability and centralized management, but lacked continuity of life and free transferability of interests, it could not be classified as a corporation under the *Kintner* regulations. The drafters of the 1977 Wyoming LLC statute were undoubtedly aware of this, and the statute provided for the dissolution of an LLC after the expiration of a set period, with the unanimous consent of the members, or upon the death, retirement, resignation, insanity, bankruptcy, or expulsion of a member.<sup>77</sup> In addition, the statute provided that an assignee of an interest in an LLC could not become a full member without the unanimous consent of the other members, thus preventing the LLC from enjoying free transferability of interests.<sup>78</sup>

The absence of two out of the four relevant corporate characteristics was sufficient for the Service to conclude that the LLCs created under the Wyoming statute would not be classified as associations, taxable as corporations, without detracting from the attractiveness of that form of organization for closely held businesses. The statute provided for flexibility with respect to the existence of centralized management,<sup>79</sup> and the areas where it differed from the corporate form, limited life and restrictions on transferability, were not significant in most closely held businesses. In most such businesses, the continuity of the enterprise depends on the involvement of one or more key individuals anyway, and it is not usually in their self-interest to allow the free transferability of interests that could bring uncongenial individuals into the organization. Thus, the Wyoming LLC statute gave most closely held businesses the corporate characteristics they craved—the flexibility to enjoy centralized management and management by equity holders without relinquishing limitation of liability<sup>80</sup>—while at the same time providing partnership treatment for federal

---

floodgates" and increased the use of the LLC "exponentially"). See also, Robert B. Keatinge, *New Gang in Town*, 4 APR BUS. L. TODAY 5 (1995) (noting that by 1994, forty-five states had enacted LLC statutes).

75. WYO. STAT. ANN. § 17-15-122 (1977). Wyoming was the first state to enact an LLC statute.

76. Treas. Reg. §§ 301.7701-1 to -11 (1960); T.D. 6503, 1960-2 C.B. 409. See also *supra* notes 62-64 and accompanying text for an explanation of the *Kintner* regulations.

77. § 17-15-107(a).

78. § 17-15-122.

79. See Hobbs, *supra* note 19, at 487.

80. Under the Uniform Limited Partnership act ("ULPA"), if a limited partner is involved in management he/she relinquishes the benefit of limited liability. Thus, limited partnerships are not nearly as attractive as LLCs, and LPs also need a general partner with unlimited, or at least expanded liability (in the case of a corporate general partner, as the

income tax purposes.

Recognizing that this result followed from the *Kintner* regulations, the Treasury and the Service considered amending those regulations to prevent characterization of LLCs as partnerships. In 1980 the Treasury even proposed regulations that would have classified an entity as an association if its members enjoyed limited liability.<sup>81</sup> Perhaps because of its experience with the *Kintner* regulations, which had provided partnership treatment for organizations that the Treasury believed should be taxed as corporations because of their mechanical application, the Treasury was hesitant to adopt a rule-based, single-factor test, and it withdrew the proposed amendments roughly two years after announcing them.<sup>82</sup> At the same time, the IRS announced that it would “undertake a study of the rules for entity classification with a special focus on the significance of the characteristic of limited liability.”<sup>83</sup>

Taxpayers’ dreams came true in 1988 with the issuance of Rev. Rul. 88-76 where the Service concluded that the Wyoming limited liability company would be treated as a partnership.<sup>84</sup> Rather than changing the regulations (as it had after losing *Kintner*) the government simply applied the regulations as written and confirmed the result that the drafters of the Wyoming (and other) LLC statutes had concluded would follow there-

---

regulations provided that a corporate general partner would not be treated as having full liability unless it was adequately capitalized). Treas. Reg. § 301.7701-2(d) (1995).

81. Prop. Treas. Reg. § 301.7701-2(a)(2), 45 Fed. Reg. 75,709 (Nov. 17, 1980), provided that “an organization will be classified as an association if under local law no member of the organization is personally liable for debts of the organization.” *Id.* at 75,710. Under this formulation, only one corporate characteristic was important: the existence of limited liability. By so circumscribing the analysis, the Treasury was moving from the standard-based approach of the resemblance test as formulated in *Morrissey* and the regulations promulgated thereafter to a rule-based approach where only one thing—easily ascertained by reference to state law—was determinative. The Treasury eventually withdrew the proposed regulation and explained the withdrawal as being in response to comments received; the only comment publicly available through *Tax Notes* is one by Richard Cohen, who objected to the proposed regulations precisely on the ground that by making only one factor determinative, the proposed regulation contravened case law. Richard G. Cohen, *New York Attorney Comments that the Proposed Single Factor Test for Limited Liability Companies Is Inappropriate*, 17 TAX NOTES 757 (1982). On November 18, 1980, the Service had issued a PLR concluding that a Wyoming LLC would be taxed as a partnership. I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980). Nearly two years after the release of the proposed amendment to the regulations, the Service issued another PLR in which it came to a conclusion consistent with the proposed amendment, but inconsistent with its conclusion in I.R.S. Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980). In I.R.S. Priv. Ltr. Rul. 83-04-138 (Oct. 29, 1982), the Service concluded that a Wyoming LLC was an association taxable as a corporation. See Hobbs, *supra* note 19, at 514-515. Under the *Kintner* regulations it was possible to conclude that a limited partnership did not enjoy limited liability even if the only general partner was a corporation, because the regulations treated a corporate general partner as having personal liability for the debts of the partnership if the corporate general partner was adequately capitalized. Treas. Reg. § 301.7701(d)(2) (1995).

82. I.R.S. Announcement 83-4, 1983-2, I.R.B. 31 (Jan. 10, 1983). In 1983 Treasury also took the position that MLPs should not be classified as associations on the basis of the existence of limited liability alone. See Hobbs, *supra* note 19, at 515, n.514.

83. I.R.S. Announcement 83-4, 1983-2 I.R.B. 31.

84. Rev. Rul. 88-76, 1988-2 C.B. 360.

from.<sup>85</sup>

What happened next was not surprising: every other state in the union eventually adopted LLC legislation, preventing Wyoming from becoming the Delaware of LLCs and allowing all taxpayers to partake of this new and very useful form of business organization.<sup>86</sup> Together with the earlier enactment of § 7704 in 1986, this resulted in a system in which all publicly traded organizations were subject to the corporate income tax as a result of § 7704, but non-publicly traded organizations were necessarily subject to the corporate income tax only if they chose to be organized as corporations. If they wanted limited liability and chose to be organized as LLCs they could effectively choose whether or not to be taxed as corporations by choosing how many corporate characteristics to adopt.<sup>87</sup> The development of the LLC, coupled with the structure of the formalistic, numbers-based test of the *Kintner* regulations, resulted in a corporate tax system that was, at least for newly created entities that were not publicly traded, essentially elective. Taxpayers that wanted to avoid classification of an entity as an association taxable as a corporation could do so virtually at will simply by including certain provisions in the terms of the LLC operating agreement. Because providing terms that would either allow or

---

85. Although commentators have speculated on the reasons for the Treasury's change of heart, it is impossible to know for certain what factors combined to produce that result. Some have speculated that the Treasury wanted Congress to act and perhaps thought that, given the Congressional foray into classification questions with the enactment of I.R.C. § 7704, Congress might be willing to do so again. See Hobbs, *supra* note 19, at 515; see also Robert B. Keatinge, *supra* note 74 (noting that Rev. Rul. 88-76 was issued after eight years of study, and "marked a significant shift in the IRS' policy with respect to entities in which the liability of the owners is limited to the owners' investment."). Others have more informally suggested that the change might have been attributable to the change in administrations following the 1980 election of Ronald Reagan.

86. Before the issuance of Rev. Rul. 88-76 only two states, Wyoming and Florida, which enacted LLC legislation in 1982, had LLC statutes. Susan Pace Hamill, *The Taxation of Domestic Limited Liability Companies and Limited Partnerships: A Case for Eliminating the Partnership Classification Regulations*, 73 WASH. U. L.Q. 565, 566 n.4 (1995). In 1990, two additional states (Colorado and Kansas) enacted LLC statutes and in 1991 four more (Nevada, Texas, Utah and Virginia) joined the club. *Id.* The movement then seemed to spread eastward and in 1992, ten more states, including Delaware, passed LLC legislation. *Id.* The number grew the following year, with eighteen more states enacting LLC legislation, and by the close of 1994, nearly all states had LLC statutes and those that had not yet adopted them had them pending. *Id.* By 1997, when the Check-the-Box regulations became effective, all states had LLC legislation. Scott D. Smith, *What are States Doing on the Check-the-Box Regs?*, TAX NOTES TODAY 159-41, Aug. 18, 1997, LEXIS, 97 TNT 159-41. Thus, the issuance of Rev. Rul. 88-76 led to a phenomenon not unlike that which has resulted in the incorporation of many corporations in Delaware and which economists have dubbed a race to the bottom, although that view has been questioned. See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 553-55 (2002).

87. In 1995, the Service issued Rev. Proc. 95-10, 1995-1 C.B. 501, providing the conditions under which it would issue a ruling that an LLC would be treated as a partnership for tax purposes. The existence of a procedure specifically dealing with LLC ruling requests suggests that the Service was receiving such requests in numbers high enough to justify implementing procedures for standardizing the process. Rev. Proc. 95-10 did not apply to single-member entities, however; section 4.01 thereof specifically provided that "[t]he Service will consider a ruling request that relates to classification of an LLC as a partnership for federal tax purposes only if the LLC has at least two members . . ."

prevent classification as an association had little non-tax significance, the decision to be structured in a way that would result in classification as an association depended only on whether the taxpayer wanted the corporate tax, and Subchapter C of the Code, to apply.<sup>88</sup>

The essentially elective system that resulted after the issuance of Rev. Rul. 88-76 was theoretically unjustifiable in light of *Morrissey*. In *Morrissey*, the Court had provided for corporate taxation of entities that resembled corporations; equity would be achieved because the tax law would treat as corporations all entities that shared significant corporate characteristics. Likes would be treated alike. In the nearly thirty years that elapsed between the issuance of the *Kintner* regulations and the issuance of Rev. Rul. 88-72, the government had moved away from the resemblance test so much that equal treatment of entities that closely resembled one another had become impossible.<sup>89</sup> Entities that were essentially alike were treated differently if there were minor differences in their organizational documents—differences that had little effect upon the operation of the entity or the legal relationship between its members.

## II. THE CHECK-THE-BOX REGULATIONS

### A. PROPOSING AN ELECTIVE SYSTEM

Having made an incremental journey to an essentially elective system of entity classification, after the issuance of Rev. Rul. 88-76 the Treasury and the Service were faced with a dilemma: the Service could continue to issue private letter rulings applying the *Kintner* regulations to comfort skittish taxpayers on the classification of their LLCs,<sup>90</sup> or the Treasury could change the regulations so that taxpayers could easily make that determination for themselves, thus improving the administration of the tax

---

88. See NYSBA Tax Section, *Report on the 'Check-the-Box' Entity Classification System Proposed in NOTICE 95-14*, TAX NOTES TODAY, Aug. 30, 1995, LEXIS, 95 TNT 173-64; ABA Section of Taxation, *Comments on NOTICE 95-14*, 1995-14 I.R.B. 7, *Proposed Revisions to the Entity Classification Rules*, TAX NOTES TODAY, July 17, 1995 LEXIS, 95 TNT 145-25.

89. Professor Victor Fleischer has argued that in combination with I.R.C. § 7704(b), the Check-the-Box regulations implement the *Morrissey* resemblance test because they produce a regime in which all entities that resemble corporations are treated as corporations (§ 7704), and all other unincorporated organizations are treated as partnerships. See Fleischer, *supra* note 62, at 524. The only significant difference between the Check-the-Box regulations and the *Kintner* regulations is that the former make access to capital markets—being publicly traded—the only test of corporate resemblance, whereas the latter took four factors into account. In effect, Professor Fleischer argues, the combination of the Check-the-Box regulations and § 7704 provides for only one test of corporate resemblance: access to capital markets. *Id.* at 542. While I think that Professor Fleischer's observation is astute, I disagree with his conclusion that the Check-the-Box regulations return us to *Morrissey*. The ability to elect corporate status (and some LLCs actually make such an election) creates a situation in which entities are treated as corporations for tax purposes even if they do not resemble corporations in the way Professor Fleischer deems primarily important because they are not publicly traded. It is the elective nature of the regulations that separates substance from taxation, and fundamentally distinguishes the Check-the-Box regulations from the corporate resemblance test of *Morrissey*.

90. See note 92 *infra*.

system. In 1995, the Treasury and the Service chose the latter course. In Notice 95-14,<sup>91</sup> the Treasury and the Service explained that:

The existing classification regulations are based on the historical differences under local law between partnerships and corporations. However, many states recently have revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships. . . .

One consequence of the narrowing of the differences under local law between corporations and partnerships is that taxpayers can achieve partnership tax classification for a non-publicly traded organization that in all meaningful respects, is virtually indistinguishable from a corporation. Taxpayers and the Service, however, continue to expend considerable resources in determining the proper classification of domestic unincorporated business organizations. For example, since the issuance of Rev. Rul. 88-76, the Service has issued seventeen revenue rulings analyzing individual state limited liability company statutes, and has issued several revenue procedures and numerous letter rulings relating to classification of various unincorporated organizations under the classification regulations. In addition, small unincorporated organizations may not have sufficient resources and expertise to apply the current classification regulations to achieve the tax classification they desire.<sup>92</sup>

---

91. I.R.S. Notice 95-14, 1995-14 I.R.B. 7.

92. *Id.* As Michael Thomson, Treasury Acting Deputy Tax Legislative Counsel is reported to have said at a May 11, 1995 lunch meeting of the District of Columbia Bar Tax Section,

It's a resource allocation question. . . . Too many resources have been wasted both by the IRS and the private sector in resolving classification issues, even though in the end the taxpayer gets the desired status . . . . Classification becomes a very intricate game that if you have counsel you get out of the maze and you're home free. In this context, allowing taxpayers a simple choice causes little if any substantive change. . . .

Rod Garcia, *Treasury Officials Discuss Entity Choice of Tax Status*, TAX NOTES TODAY, May 12, 1995, LEXIS, 95 TNT 93-4. During the hearings on the Check-the-Box proposal, Susan Pace Hamill, then an Assistant Professor of Law at the University of Alabama School of Law but, previously in Branch I of Passthroughs, observed that there had been "approximately 900 Private Letter Rulings issued in classification, as well as countless telephone advice and other informal activity upon the government to help taxpayers out." I.R.S., *Unofficial Transcript of July 20 IRS Hearing on Entity Classifications*, TAX NOTES TODAY, July 20, 1995, LEXIS, 95 TNT 144-27 [hereinafter *July 20 Unofficial Transcript*]; see also Sheryl Stratton, *IRS Proposes "Check the Box" Partnership Classification Procedure*, TAX NOTES TODAY, Mar. 30, 1995, LEXIS, 95 TNT 62-3 (describing the proposal as "part of the IRS's attempt to engage in 'consensual rulemaking' promoted by the Clinton administration's regulatory reform initiative.").

Notice 95-14 was the Treasury Department's response to "President Clinton's vow to restore common sense to government regulations." See Fleischer, *supra* note 62, at 518 (citing Department of the Treasury, *Treasury's Summary Report on President's Regulatory Reform Initiatives*, TAX NOTES TODAY, Sept. 11, 1995, LEXIS, 95 TNT 176-33 and Rick Wartzman, *Clinton Directs Agencies To Identify Burdensome Rules*, WALL ST. J., Feb. 22, 1995, at B12); Susan Pace Hamill, *A Case for Eliminating the Partnership Classification Regulations*, TAX NOTES TODAY, July 17, 1995, LEXIS, 95 TNT 141-65.

The Treasury and the Service therefore proposed to amend the *Kintner* regulations "to allow taxpayers to elect to treat domestic unincorporated business organizations as partnerships or as corporations for federal tax purposes."<sup>93</sup>

The reaction of tax professionals to Notice 95-14 was overwhelmingly positive.<sup>94</sup> Practitioners generally applauded the administrative convenience wrought by the advent of clear rules and urged prompt adoption of the proposed system as well as its extension to the international area.

### 1. *The Problem of Single Member LLCs*

The elective approach suggested in Notice 95-14 by its terms would have applied only to organizations with two or more associates.<sup>95</sup> Notice 95-14 did not address the classification of single member LLCs. The government's unwillingness to extend the elective treatment proposed in Notice 95-14 to single member entities reflected longstanding ambivalence over the treatment of such entities.<sup>96</sup> Although the Service had previously taken the position that a single member entity could not be a partnership,<sup>97</sup> it had taken varying positions on what such an entity could be.

In at least two cases and several PLRs, the Service had taken the position that a single member entity (a trust with a single beneficiary) en-

---

93. I.R.S. Notice 95-14, 1995-14 I.R.B. 7. In Notice 95-14, the Treasury and the Service also said that they were considering providing elective treatment for foreign entities. *Id.* The system that applies in the case of foreign entities differs from that applicable to domestic entities and is generally beyond the scope of this article.

94. Commentators noted that although the then-current system was essentially elective, significant resources were devoted to ensuring that an entity met the arbitrary and arcane requirements of the *Kintner* regulations. Many believed that the regime advocated in Notice 95-14 would largely simplify the classification regime without materially changing the overall substantive results. Others observed that the elective approach advocated by Notice 95-14 provided more equitable results, noting that the then-current system was largely elective for only for those with an extensive knowledge of the tax law. *See* ABA Section of Taxation, *supra* note 88; *see also* Fleischer, *supra* note 62, at n.7; I.R.S., *supra*, note 92; NYSBA Tax Section, *supra* note 88. *But see* Aaron Brooks, *Chuck the Box: Proposed Entity Classification Regulations Bring Bad Policy*, TAX NOTES TODAY, Mar. 18, 1996, LEXIS, 95 TNT 57-114 (arguing that entity classification was not mere formalism and should not become formalistic; a formalistic system such as Check-the-Box would be horizontally inequitable because it would tax similar entities dissimilarly).

95. *See supra* note 94.

96. Treasury was concerned about the consequences of treating single-member LLCs as pass-throughs. For example, at a meeting of the New York State Bar Association Tax Section on January 23, 1995, Deputy Tax Legislative Counsel Michael Thomson is reported to have observed that, "We still have reservations about having an entity that is a nothing for tax purposes." Lee A. Sheppard, *NYSBA Tax Section Checks Out Check-the-Box*, TAX NOTES TODAY, Jan. 25, 1996, LEXIS, 26 TNT 17-3.

97. *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,395, 1985 IRS GCM LEXIS 72 (Aug. 5, 1985) (stating "we believe that no single-member organization possesses associates in the partnership sense and that an organization with only a single-member cannot be a partnership."). The Government continued to take this position after issuing Notice 95-14. Before the hearings on Notice 95-14 were held, Deputy Tax Legislative Counsel Michael Thomson reportedly did "not view single-member LLCs as partnerships." Rod Garcia, *Service LLC Check-the-Box Hearing Set for Thursday*, TAX NOTES TODAY, July 19, 1995, LEXIS, 95 TNT 140-6. This position is consistent with that reflected in Rev. Proc. 95-10, 1995-1 C.B. 501, in which the IRS refused to consider ruling that an LLC with fewer than two members was a partnership.

gaged in business could be said to have associates and thus be an association for tax purposes.<sup>98</sup> Although such an organization could not be a partnership because it did not have associates "in the partnership sense,"<sup>99</sup> that conclusion did not end the inquiry. In evaluating whether the organization had associates for purposes of determining whether it was an association, both the Service and the courts concluded that the relevant inquiry was whether the organization was engaged in business for profit. If it was, the organization would more closely resemble a corporation than a trust, such as an ancestral trust. A trust engaged in business was therefore held to be an association even though it had only one beneficiary.<sup>100</sup>

The foregoing analysis followed from applying the *Kintner* regulations, under which the characteristics common to the two organizations being compared were disregarded and only those characteristics not usually common to both organizations were considered. Since corporations and trusts both had centralization of management, limited liability, and free transferability of interests, the question came down to whether trusts also had associates and an objective to carry on a business for profit. The Service and the courts concluded that trusts possessing associates and an objective to carry on business for profit would be taxable as associations. The existence of associates and an objective to carry on a business for profit prevented them from being taxed as trusts.

General Counsel Memorandum ("GCM") 39,395 presented a somewhat more complicated situation.<sup>101</sup> There, the Service again concluded that the trust in question had associates because it had an objective to carry on business and could not be treated as a trust. However, when the Service examined whether the other four corporate characteristics were present, it concluded that only two out of the four existed; therefore the trust could not be treated as an association for tax purposes. Since the trust could not be treated as a partnership because of the Service's posi-

---

98. *Lombard Trs., Ltd. v. Comm'r*, 136 F.2d 22 (9th Cir. 1943); *Hynes v. Comm'r*, 74 T.C. 1266 (1983) (treating trusts as associations taxable as corporations). Quoting *Morrissey v. Commissioner*, 296 U.S. 344, 357 (1935), the Tax Court noted that "the ultimate test is resemblance and not identity" to corporate form," and concluded that a trust with a single beneficiary could be taxable as an association because the beneficiary bore the same relationship to the trust as a single shareholder would to a corporation. *Hynes*, 74 T.C. at 1279-1280. Because Treas. Reg. § 3017701-4(b) (1960) distinguishes between trusts created to protect or conserve property for beneficiaries and other arrangements, once it is clear that the trust has not been established for the former purpose it is impossible to conclude that it is a trust for tax purposes. See I.R.S. Priv. Ltr. Rul. 88-52-017 (Sept. 27, 1988); *Business Trust Will Be Taxed as Either an Association or a Partnership*, TAX NOTES TODAY, Jan. 4, 1989, LEXIS, 89 TNT 3-41; I.R.S. Priv. Ltr. Rul. 85-52-010 (Sept. 25, 1985); I.R.S. Priv. Ltr. Rul. 85-33-003 (May 7, 1985). The Service cited *Hynes* as authority for its conclusion in these letter rulings, observing that: "under *Hynes* a single-member organization can be treated as having associates for purposes of determining if it is an association, no single-member organization possesses associates in the partnership sense and an organization with only a single-member cannot be a partnership." I.R.S. Priv. Ltr. Rul. 85-33-003 (May 7, 1985).

99. See I.R.S. Priv. Ltr. Rul. 85-33-003 (May 7, 1985).

100. See *Lombard Trs., Ltd.*, 136 F.2d at 22; *Hynes*, 74 T.C. at 1266.

101. I.R.S. Gen. Couns. Mem. 39,395 (Aug. 5, 1985).

tion that despite the existence of associates for association purposes “no single-member organization possesses associates in the partnership sense,” the Service concluded that the organization “should be treated as \* \* \* making investments through an agent (the trustee).”<sup>102</sup> Presumably, the omitted information represented by the asterisks was the identity of the beneficiary, so that the trust was treated as an agent of the beneficiary. In coming to this conclusion, the Service was treating the trust as a pass-through that was not a partnership and also presumably not a grantor trust. The seeds of the disregarded entity were planted. A trust with a single beneficiary could now be either an association or an agent that was not a separate taxpayer.

After Notice 95-14 was issued, it became clear that the Treasury was going to have to take a position on the treatment of single-member entities.<sup>103</sup> Although single-member LLCs were not authorized under all of the state LLC statutes existing at that time, they were permitted under some state statutes; it was easy to imagine that single-member LLCs would eventually be permitted everywhere if such entities received favorable tax treatment, just as LLCs had become universally available once the Service began to issue favorable rulings.<sup>104</sup> Tax professionals also recognized the need to address the question of how to treat single member LLCs, and wasted little time publicly urging inclusion of single member LLCs in the forthcoming guidance, although there was some disagreement on just how such entities ought to be treated. Some commentators suggested an expansion of the definition of partnership to include such entities, while others preferred treating such entities as proprietorships or branches.<sup>105</sup> Although the Treasury did not waver in its position

---

102. *Id.*

103. Sheryl Stratton, *IRS Set to Address LLC Problems, Official Tells AICPA Panel*, TAX NOTES TODAY, June 8, 1995, LEXIS, 95 TNT 111-12 (stating that “[Diana K. Miosi, senior technician reviewer in the office of the Assistant Chief Counsel (Passthrough and Special Industries)] fended off the usual unremitting questions on the Service’s prohibition against single-member LLCs by stating that no final decisions resolving the issue will be made until after the July 20 hearing on the ‘check the box’ proposal . . . ‘We are still figuring out what position to take,’ she offered. ‘We are aware that the issue is not going away.’”).

104. That is precisely what happened. See Smith, *supra* note 86, providing background and authority for the growth of state LLC statutes that permit single-member LLCs.

105. See, e.g., Rod Garcia, *Single-Member LLCs: Basic Entities Raise Complex Problems*, TAX NOTES TODAY, July 13, 1995, LEXIS, 95 TNT 136-6; Garcia, *supra* note 92; *July 20 Unofficial Transcript*, *supra* note 92; Richard M. Leder, *Association of the Bar of the City of New York Favors Extending Check-the-Box Election to Single Member Entities, Foreign Organizations*, TAX NOTES TODAY, Aug. 24, 1995, LEXIS, 95 TNT 166-43 (urging pass-through treatment for tax purposes but not branch treatment (preserving entity treatment) where such treatment for partnership attributes was appropriate to prevent taxpayers from having a choice of branch or partnership treatment); Alvin D. Lurie, *Lurie Says ‘Check-the-Box’ Entity Classification Procedure Should be Extended to One-Member Entities*, TAX NOTES TODAY, June 15, 1995, LEXIS, 95 TNT 116-46 (urging elective classification for single-member entities); David S. Neufeld, *Association Says Check-the-Box Proposal Should Apply to Unincorporated Entities*, TAX NOTES TODAY, July 6, 1995, LEXIS, 95 TNT 147-44 (urging treatment as proprietorship or branch); New York State Society of Certified Public Accountants, *New York State CPAs Say Time Is Now for Guidance on Classification of Single Member Organizations*, TAX NOTES TODAY, Sept. 1,



that a single-member entity could not be a partnership, statements by Treasury officials suggested that the rationale of GCM 39,395 was apparently taking root and that the Treasury was considering treating single member entities as sole proprietorships.<sup>106</sup>

## B. THE PROPOSED CHECK-THE-BOX REGULATIONS

Following hearings held on July 20, 1995,<sup>107</sup> the Treasury issued proposed Check-the-Box regulations on May 9, 1996,<sup>108</sup> and held hearings on the proposed regulations on August 21, 1996.<sup>109</sup> The proposed regulations did precisely what Notice 95-14 said they would do. They replaced the standard-based, indeterminate system of the *Kintner* regulations with a binary system of classification in which entities are classified either as corporations, which are separate taxpayers subject to an entity-level tax, or as pass-through entities whose activities are taxed to their owners, but which are not subject to any entity-level tax. Under the Check-the-Box regulations, the classification of an entity depends only on the answer to two questions, each of which can only be answered "yes" or "no." The first question is whether the entity was incorporated under state law. If

---

1995, LEXIS, 95 TNT 179-21 (acknowledging the possibility of taxing single-member LLCs as proprietorships but urging taxation as partnerships on the ground of simplicity); Daniel Shefter, *Check the Box Partnership Classification: A Legitimate Exercise in Tax Simplification*, TAX NOTES TODAY, Apr. 13, 1995, LEXIS, 95 TNT 72-44; Seth M. Zachary & Andrew M. Short, *Attorneys Say Check-the-Box Proposal Should Include Single Owner Organizations, Unincorporated foreign Entities*, TAX NOTES TODAY July 13, 1995, LEXIS, 95 TNT 140-57 (no specific recommendation on how single-member entities should be treated).

106. Before the hearings on Notice 95-14 were held, Deputy Tax Legislative Counsel Michael Thomson reportedly did "not view single-member LLCs as partnerships. However, he [had] not necessarily dismissed the possibility that one-member LLCs can merit treatment as sole proprietorships for tax purposes." Garcia, *supra* note 97. This position is consistent with that reflected in Rev. Proc. 95-10, 1995-1 C.B. 501, in which the IRS refused to consider ruling that an LLC with fewer than two members was a partnership.

107. Fourteen speakers were scheduled to testify at the Hearings, but only thirteen appeared. Although most of the testimony concerned extending the Check-the-Box regime to foreign entities, the four speakers who addressed the issues raised by single-member entities all supported the extension of the Check-the-Box regime to such entities. *July 20 Unofficial Transcript*, *supra* note 92.

108. Prop. Treas. Reg. § 301.7701, 61 Fed. Reg. 21,989 (May 13, 1996), reprinted in *Proposed "Check-the-Box" Regs Issued: Special Rules Provided for Foreign Entities, Single-Member Entities*, TAX NOTES TODAY, May 9, 1996, LEXIS, 96 TNT 93-1.

109. The testimony at the hearings was generally positive, with the majority of comments being requests for clarity in very specific areas. Most commentators noted that the regulations would substantially reduce the level of resources then devoted to entity classification issues as well as provide a more equitable result for all taxpayers. However, there was much concern surrounding the definition of "limited liability," and whether a single-member LLC should be recognized for federal tax purposes. Some argued that if those entities were not recognized, the compliance issues would simply shift from the government to the fifty states, as each state would adopt its own rules regarding such entities; they therefore argued that single-member LLCs should automatically be classified as corporations. Other commentators felt that the disregarded entity classification was acceptable, although still others wished there were more specific rules regarding the operation and ownership of such entities. I.R.S. *Unofficial Transcript of IRS Hearing on Check-the-Box Regs.*, TAX NOTES TODAY, Aug. 21, 1996, LEXIS, 96 TNT 167-53 [hereinafter *IRS Hearing*].

the answer is “yes”, the entity will be treated as a corporation for federal tax purposes and will therefore be subject to an entity level tax—end of story. However, if the answer to that first question is ‘no’ (because the entity is not incorporated under state law), there is a second question. The second question is whether the entity has elected to be treated as a corporation for federal income tax purposes. If the answer to that second question is ‘no’ (because the entity has made no election), then the entity will be treated as a partnership if it has multiple owners.

The Check-the-Box regulations thus provided an elective regime under which unincorporated organizations with more than one member would be treated as partnerships unless they elected to be treated as corporations.<sup>110</sup> But the proposed regulations went further than Notice 95-14 by also providing that a single member unincorporated organization (an LLC) that did not elect to be treated as a corporation would be disregarded as an entity separate from its owner.<sup>111</sup> Thus, the disregarded entity was conceived.

Tax professionals again generally praised the Treasury’s decision to create the disregarded entity,<sup>112</sup> although some were quick to point out that treating a disregarded entity as a tax-nothing would sometimes provide a very different result than treating it as a partnership.<sup>113</sup>

---

110. Prop. Treas. Reg. § 301.7701-2, 61 Fed. Reg. 21,989.

111. In the Supplementary Information, the Treasury reiterated its long-standing position that because “a fundamental characteristic of a partnership is the presence of associates, an entity with a single owner cannot conduct business as a partnership.” *Id.* at 21,991. It went on to explain that

the proposed regulations permit a business entity with a single owner that is not required to be classified as a corporation to elect to be classified as an association or to have the organization disregarded as an entity separate from its owner (in which case the business activity is treated for federal tax purposes in the same manner as if it were conducted as a sole proprietorship, branch, or division of the organization’s owner).

*Id.* at 21,991-92.

112. Sheryl Stratton, *ABA Tax Section Meeting: Government Gets Accolades for Check-the-Box Rules*, TAX NOTES TODAY, May 13, 1996, LEXIS, 96 TNT 94-4. One notable dissenting voice was Glenn L. Rigby of the California Franchise Tax Board, who objected to disregarding the separate existence of single-member entities on the ground that in states like California, which follow federal entity classification for many state purposes but which also impose an entity level tax on entities that enjoy limited liability, single-member LLCs would benefit from anomalous treatment that would allow them to enjoy the benefits of limited liability without having to pay an entity level tax. California’s Franchise Tax Board later issued Notice 96-5, refusing to incorporate the federal entity classification and issued a regulation adopting the *Kintner* regulations’ approach to entity classification for California state tax purposes. Amy Hamilton, *Check-the-Box Chaos? The State Tax Treatment Factor*, TAX NOTES TODAY, May 29, 1997, LEXIS, 97 TNT 103-1; Glenn L. Rigby, *California Franchise Board Opposes Single-Member Business Entity Election*, TAX NOTES TODAY, Aug. 21, 1996, LEXIS, 96 TNT 164-23. California has now enacted a statutory provision whereby entities will be classified for state purposes in the same way they entity are classified for federal purposes: CAL. REV. & TAX. CODE § 23038(b)(2)(B) (West 2006).

113. See, e.g., Michael L. Schler, *Initial Thoughts on the Proposed “Check-the-Box” Regulations*, TAX NOTES TODAY, June 17, 1996, LEXIS, 96 TNT 118-79.

#### D. THE CHECK-THE BOX REGULATIONS BECOME FINAL

On December 17, 1996, the Check-the-Box regulations became final, and the disregarded entity was born.<sup>114</sup> Like the proposed regulations, the final regulations provided that a single member unincorporated entity that did not elect to be treated as a corporation for federal tax purposes would be disregarded as an entity separate from its owner for such purposes.<sup>115</sup> The idea was simple and elegant. In promulgating the Check-the-Box regulations and creating the disregarded entity, the Treasury and the Service intended to convert the mud of entity classification into a crystal—bright lines, sharp edges and distinct shapes.<sup>116</sup> For a while, they succeeded.

### III. THE RULING DELUGE BEGINS

Despite the crystalline beauty of a rule, the siren call of the equity that can be achieved by the application of a nuanced standard is hard to ignore. In the case of disregarded entities, the Service publicly resisted the call, but in private guidance, it quickly found the lure of substance too strong to resist.

#### A. EARLY REVENUE RULINGS—CRYSTAL CLEAR

In its first published rulings the Service did just what the Check-the-Box rules mandated: The Service analyzed transactions as if the disregarded entity did not exist. In the first ruling, Revenue Ruling 99-5, the Service ruled that when a single owner LLC acquired an additional owner it became a partnership, and confirmed that the manner in which the acquisition occurred would determine the tax consequences.<sup>117</sup> If the new owner dealt directly with the single owner, the new owner was treated as

---

114. The regulations became effective on January 1, 1997. Although their validity has been questioned and debated, it has thus far been judicially upheld. *Litriello v. United States*, No. 3:04CV-143-H, 2005 U.S. Dist. LEXIS 9813 (W.D. Ky. May 18, 2005), *reh'g denied*, 2005 U.S. Dist. LEXIS 15950 (W.D. Ky. Aug. 3, 2005). See Polksy *supra* note 62; see also J. COMM. ON TAXATION, 105TH CONG., REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES 13-17 (Comm. Print 1997); Gregg Polsky, *Point: Treasury Should Not Have Promulgated the Check-the-Box Regulations*, 23 ABA TAX SEC. NEWSQUARTERLY 14 (2004); MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS para. 3.08 (3d ed. 1997); Dougan et al., "Check The Box"—Looking Under The Lid, 75 TAX NOTES 1141, 1143-1144, (1997); George Mundstock, A UNIFIED APPROACH TO SUBCHAPTERS K & S, 11 n.33 (2002) (these last three authorities were cited by Judge Halpern in *Dover Corp. v. Commissioner*, 122 T.C. 324, 331 n.7 (2004)); but see Jasper L. Cummings, Jr., *Counterpoint: Treasury Acted Properly in Issuing the Check-the-Box Regulations*, 23 ABA TAX SEC. NEWSQUARTERLY 15 (2004).

115. Although the final regulations were not identical to the proposed regulations, many of the changes were definitional or ministerial, rather than substantive. Notable substantive changes included fleshing out the portion of the regulations describing wholly owned entities, probably in response to the call by practitioners for more explanation surrounding these entities. See *IRS Hearings, supra* note 109.

116. See generally Rose, *supra* note 12.

117. Rev. Rul. 99-5, 1999-1 C.B. 34.

acquiring assets from the old owner.<sup>118</sup> When the single owner transfers part of her interest in the LLC to the new owner, the LLC is a single member entity and does not exist separately from its owner. For tax purposes, the single owner can only be transferring the assets represented by that interest because for tax purposes the entity does not exist. Once the transferee holds an interest in the entity, the entity has two owners and can no longer be disregarded. If no election is made, the entity will therefore have become a partnership.<sup>119</sup>

The analysis in the first situation in Revenue Ruling 99-5 was crystalline and pure, and the analysis in the second situation was almost likewise. In the second situation, the new owner did not deal with the old single owner but instead dealt directly with the entity: the new owner transferred money directly to the LLC in exchange for a 50% interest in the LLC.<sup>120</sup> The Service concluded that when the LLC received the money from the new owner the LLC became a partnership. It therefore treated both the new owner and the old owner as if they had made contributions to a partnership in exchange for a partnership interest.<sup>121</sup> The

---

118. In Rev. Rul. 99-5, 1991-1 C.B. 34, the Service described the tax consequences of two transactions whereby a single-member entity acquires more than one owner and thus ceases to be a disregarded entity and becomes a partnership. In the first situation, *A*, the owner of an LLC which was a disregarded entity for tax purposes, sells half of his interest in the LLC to *B*, an unrelated third party, for \$5,000, and the two continue to operate the LLC. The Service concludes that *A*'s sale of half of his interest in the LLC to *B* will be treated as a sale of 50% of each of the LLC's assets to *B*. The result of this portion of the transaction is that *A* recognizes gain or loss as a result of the deemed sale. The Service then concludes that immediately after the deemed sale of 50% of the LLC's assets by *A* to *B*, both *A* and *B* are treated as contributing their shares of the LLC's assets to a partnership in exchange for partnership interests. The result of this portion of the transaction is that no gain or loss is recognized to either *A* or *B* as a result of § 721, and *A*'s basis in his partnership interest is the same as his basis in the half of the LLC's assets he is treated as contributing to the partnership as a result of § 722. *B*'s basis in his partnership interest is also the same as his basis in the half of the LLC's assets he is treated as contributing to the partnership, but since he was treated as having bought the assets for \$5,000, he has a \$5,000 (cost) basis in his partnership interest.

119. See *id.*

120. In the second situation, the new owner contributed \$10,000 to the LLC in exchange for a 50% ownership interest in the entity, which had assets worth \$5,000. Since the new owner's contribution transformed the LLC into a partnership, the new owner was treated as making a contribution to the partnership in exchange for a partnership interest, and the old single owner was treated as having contributed the assets of the LLC to a partnership. Consequently, neither the old single owner nor the new owner will recognize gain or loss as a result of § 721. *A*, the old single owner, will have a basis in his partnership interest that is the same as his basis in the LLC's assets, and *B*, the new owner, will have a basis in his partnership interest of \$10,000 under § 722.

121. Although the Service reached the correct result in the second situation of Rev. Rul. 99-5, there is arguably one way in which the Service might have made its analysis even clearer. What makes the second situation in Rev. Rul. 99-5 so interesting is that the LLC is a disregarded entity until the instant that it acquires a second owner, at which time it becomes a partnership. At that moment, it is transformed. The analytical question is how that transformation should be characterized. One possibility is simply to say that the new owner's contribution effects the transformation. The conceptual problem with that (concededly not a large one) is that one could wonder how the new owner can make a contribution that has such transformative tax effect when the entity to which the contribution is made did not exist for tax purposes at the time of the contribution. In other words, if the entity is disregarded, why not treat the new owner as transferring property to the old

Service's conclusions in both situations produced clear results that followed directly from the application of the Check-the-Box regulations.

#### B. THE BANKRUPTCY REMOTE RULINGS—PRIVATE MUD

The first difficult issue that the Service ruled on privately required it to determine whether an entity had more than one owner. In the Preamble to the Check-the-Box regulations, the Treasury had made it clear that no attribution rules applied for that purpose, thus apparently confirming that in this area of the law, form would be king.<sup>122</sup> Nevertheless, the Treasury was soon asked to determine whether a corporation holding a legal interest in an LLC, but not entitled to share in the profits of the LLC, would be treated as an owner for purposes of determining whether the LLC had more than one owner and therefore could not be treated as a disregarded entity.

These ruling requests were motivated by transactions in which parties seeking to engage in § 1031 like-kind exchanges needed to satisfy the lender's insistence that the replacement property be placed in a bankruptcy remote entity that would allow the lender to control the circumstances under which the owner could file for bankruptcy.<sup>123</sup> In the typical ruling request, the taxpayer established an LLC in which the taxpayer would be one member and a corporation wholly owned by the taxpayer, described in at least one of the rulings as "Member 2," would be another member.<sup>124</sup> The board of directors of the corporate member would include at least one representative of the lender. The LLC agreement provided that all of the decisions of the LLC would be made by the taxpayer except that for so long as any amounts were due to the lender,

---

owner? Of course, the reason to eschew that analysis is that the end result is that the entity has the money contributed by the new owner and another transaction would have to be constructed to account for the end result of the transaction. However, a second possible analysis would treat the two owners as individually agreeing to form a partnership, and then treat the old single owner as making a constructive contribution to the partnership simultaneously with the new owner's actual contribution of cash. While this latter analysis produces the same result as the Service's instant transformation analysis, the analysis I suggest is slightly more satisfying because it avoids the conceptual question whether a transfer to a disregarded entity can be regarded just long enough to result in the creation of a partnership.

122. The Preamble provides that "[t]he fact that some or all of the owners of an organization are under common control does not require the common parent to be treated as the sole owner." T.D. 8697, 1997-1 C.B. 11, 215.

123. The creation of a bankruptcy remote entity was necessary because simply providing in the loan agreement that the trust would refrain from filing for bankruptcy protection would not have achieved the desired effect. As a matter of public policy, courts will not enforce a promise not to file for bankruptcy made by a party that is otherwise eligible to file. Such a contractual obligation is considered repugnant to the purpose of the Bankruptcy Act. See *In re Weitzen*, 3 F. Supp. 698, 698-99 (S.D.N.Y. 1933); see also *In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995); *In re Wheeler*, 122 B.R. 645, 648 (Bankr. D.R.I. 1991); *In re George*, 15 B.R. 247, 248-49 (Bankr. N.D. Ohio 1981). Of course, by ruling in a manner that facilitates the use of such entities, the Service is allowing the Check-the-Box regulations to be used to circumvent settled bankruptcy policy. That is yet another reason for the Service to change its position in these situations.

124. See e.g., I.R.S. Priv. Ltr. Ruls. 1999-15-030 (Jan. 12, 1999); 1999-14-006 (Dec. 23, 1998); 1999-11-033 (Dec. 18, 1998).

any decision to file for bankruptcy or take similar action would require the approval of the corporate member, whose board of directors had to agree unanimously.<sup>125</sup> Because the LLC could not file for bankruptcy without the approval of the corporate member and because that approval had to be unanimous, the lender would be able to block any such action by simply instructing its representative on the corporate member's board of directors to refrain from voting to approve such action.

Deciding that the LLC had a single member was crucial to the transaction. If the LLC had a single member, the LLC would be a disregarded entity and a transfer of the replacement property to it would be treated as a transfer to its owner, thus qualifying the transfer for § 1031 treatment. If the LLC had more than one member, the LLC would not be disregarded and a transfer of the property to it would not qualify for § 1031 treatment because the replacement property would be received by a taxpayer other than the taxpayer who owned the transferred property.

Although the Service could have simply counted the number of owners the LLC had and concluded that the LLC had more than one owner, thus preventing it from being treated as a disregarded entity, it did not do that. Apparently forgetting that by promulgating the Check-the-Box regulations it had sought to adopt a rule to provide clarity and certainty, the Service instead reverted to the *Morrissey*-like standard-based analysis in which it analyzed the substantive attributes of the entity in order to determine its characterization. In contravention of the rule-based approach of the Check-the-Box regulations, the Service reasoned as follows:

Since LLC is a domestic eligible entity and you have represented that it will not file an election to be treated as a corporation, its federal tax classification depends upon the number of members of LLC. The cases of *Commissioner v. Tower*,<sup>126</sup> and *Commissioner v. Culbertson*,<sup>127</sup> provide general principles regarding the determination of whether individuals have joined together as partners in a partnership. The primary inquiry is whether the parties had the intent to join together to operate a business and share in its profits and losses.

---

125. For example, I.R.S. Priv. Ltr. Rul. 1999-11-033 (Dec. 18, 1998) explained that the taxpayer had represented that,

[F]or so long as the loan from Lender is, [sic] outstanding without the approval of Member 2 (whose Board of Directors vote must be unanimous) the LLC may not: (1) file or consent to the filing of a bankruptcy or insolvency petition or otherwise institute insolvency proceedings; (2) dissolve, liquidate, merge, consolidate, or sell substantially all of its assets; (3) engage in any business activity other than those specified in its Certificate of Formation; (4) borrow money or incur indebtedness other than the normal trade accounts payable and any other indebtedness expressly permitted by the documents evidencing and securing the loan from Lender; (5) take or permit any action that would violate any provision of any of the documents evidencing or securing the loan from Lender; (6) amend the Certificate of Formation concerning any of the aforesaid items; or (7) amend any provision of the Agreement concerning any of the aforesaid items. With respect to items 2 and 7, the LLC must have the prior written consent of the Lender.

126. 327 U.S. 280 (1946).

127. 337 U.S. 733 (1949).

The inquiry is essentially factual and all relevant facts and circumstances must be examined. Furthermore, it is federal, not state, law that controls for income tax purposes, regardless of how the parties are treated under state law.<sup>128</sup>

The problem with this reasoning is that it conflates the question of the number of members with the question whether the entity should be treated as a partnership. Because the Check-the-Box regulations aim to treat as a partnership any unincorporated domestic entity that has more than one member (unless a contrary election is made), the crystalline structure of those regulations should have precluded an examination of the question whether a particular multi-member entity will be classified as a partnership under those regulations. Nothing in either the letter or the spirit of the Check-the-Box regulations ties the determination of the number of owners of an entity to the question of whether the entity ought to be treated as a partnership. Indeed, just the opposite is true. In promulgating the Check-the-Box regulations, the Treasury set out to eradicate the notion that the characterization of an entity should be related, in any way, to its attributes. By making classification elective for entities other than those incorporated under state law (for which the statutory language provided no alternative) the Treasury eliminated any connection between the attributes of an entity and its federal tax classification. The Service's analysis in PLR 1999-11-033 and others of its ilk ignore the elimination of that connection.<sup>129</sup>

Suggesting that the Service should apply the Check-the-Box regulations in a rule-like manner eschewing consideration of the question whether an entity ought to be treated as a partnership when determining how many members it has does not lead to a conclusion that it should abandon all attempts at substantive analysis in this area. The point is one about the ordering of the analysis. The Check-the-Box regulations should determine the initial classification of an entity for federal tax purposes: corporation, partnership, or no separate entity at all. Once that determination has been made, the tax law will apply to that entity just as it did before the advent of the Check-the-Box regulations. Therefore, if

---

128. I.R.S. Priv. Ltr. Rul. 1999-11-033.

129. See *supra* note 128 and accompanying text. Although the question is crucial in the § 1031/bankruptcy remote context addressed in the rulings described in the text, that is not the only situation in which it arises or in which the Service has addressed it, consistently looking to substance to make the determination. For example, in Chief Couns. Adv. Mem. 2005-01-001, 2004 I.R.S. CCA LEXIS 41 the Service was faced with an LLC that lacked articles of organization or ownership documents and whose owner and authorized representative provided inconsistent information on the question whether the LLC had one or more owners. As it had in the bankruptcy remote context, the Service took the position that the question of ownership required "an analysis of who has the benefits and burdens and control of the entity" and would be "dependent on the facts and circumstances of each case." It cited *Grodts & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237-1228 (1981), a case in which the Tax Court analyzed the substance of a transaction to determine ownership. In concluding that it lacked sufficient evidence to determine how many owners the LLC had, the Service refused to employ suggested objective tests, such as whether only one person had reported all of the income and expenses of the LLC on his return, insisting instead on a substantively-based determination.

the Service wishes to apply a non-Check-the-Box-based doctrine to transactions in which the entity engages, and, for example, refuse to recognize a family limited partnership<sup>130</sup> or give effect to a transaction involving an entity that has elected to be treated as a corporation, as the Court did in *Gregory*,<sup>131</sup> nothing in the analysis I am suggesting prevents that.

The Check-the-Box regulations should provide a clear first cut at entity classification that answers the question: "For federal tax purposes, what kind of entity are you?" The answer to that question provides a point of departure that is subject to being altered by the application of other doctrines. My point is that there ought to be two separate questions. Question 1 is, under the Check-the-Box regulations what type of organization has been created? That question will arise often and should have a clear, easily applied answer, which the rule of the Check-the-Box regulations can provide. Question 2 is whether, despite the creation of such an organization, long-standing judicial and other doctrines (such as the partnership anti-abuse rule)<sup>132</sup> will preclude giving tax effect to what a taxpayer has done. That second question will arise more infrequently and a desire to retain the ability to ask it does not require muddying the answer to the first question. Concluding that a partnership, rather than a corporation or disregarded entity, has been created under the Check-the-Box regulations should not preclude the application of judicial, regulatory or statutory anti-abuse rules any more than the actual creation of an entity under state law does. That the Check-the-Box regulations answer the question "what is it" need not mean that anti-abuse doctrines do not apply to whatever "it" is or whatever it has done. Using the Check-the-Box regulations to answer that first question, and no other, will allow those regulations to continue to answer that question pristinely in the large number of cases in which they will be called upon to do so. The rest

---

130. "Family partnerships were first used for tax purposes principally to shift income from family members in higher income tax brackets to family members in lower income tax brackets. Later, partnerships became a popular way to transfer wealth to younger family members." See Tax Management Portfolios, *Family Limited Partnerships and Limited Liability Companies* 722, Oct. 18, 2004, at A4. The earliest cases recognized the partnership if the entity was a valid partnership under state law. *Id.* Later cases ignored the partnership if the purpose of the partnership was to shift income from the person entitled to the income to other family members. *Id.* Currently, a person will "be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person." I.R.C. § 704(e)(1) (2005). The regulations further stipulate that there must be a complete transfer to the donee and that the transfer must occur in a bona fide transaction, not a mere sham. Treas. Reg. § 1.704-1(e)(1)(iii) (as amended in 2005). Currently, in determining whether a bona fide transaction exists, "the Tax Court [has] emphasized whether the decedent was on both sides of the transaction; whether he had retained sufficient assets or was, instead, dependent on distributions from the FLP; whether there was a commingling of FLP assets; and whether there was an actual transfer of assets to the FLP." See Susan Simmonds, *Year in Review: IRS Wins Big, Loses Big*, 110 TAX NOTES 39 (2006).

131. *Gregory v. Helvering*, 293 U.S. 465 (1935).

132. Treas. Reg. § 1.701-2 (as amended by T.D. 8592, 1995-1 C.B. 119 in 1995). The Code itself also contains override rules and provides authority for the promulgation of regulations to prevent abuse. See, e.g., I.R.C. § 7701(f), (l).



of the tax law can then apply in the appropriate manner to whatever the organization is.

### C. THE CRYSTALS RETURN, ALBEIT TEMPORARILY.

Despite its analytical misstep in the bankruptcy remote rulings, the Service generally applied the Check-the-Box regulations in a rule-like way in its public guidance, and the Treasury did likewise in issuing regulations. Thus, Treasury Regulation § 1.368-2T provides that a merger of a corporation into a disregarded entity wholly owned by another corporation will be treated as a merger of the merged corporation into the corporate owner of the disregarded entity, and could qualify as a reorganization under § 368(a)(1)(A). Although the Treasury did not reach this conclusion easily, and was initially unwilling truly to disregard the separate existence of a single member LLC, that it reached that conclusion at all is significant.<sup>133</sup> It shows that when forced to focus on the implications of the Check-the-Box regulations, the Treasury is willing to take them to their logical conclusion, and to do so consistently.<sup>134</sup> The Service has

---

133. In the first set of proposed regulations on this subject, the Service took the position that a merger of a single-member LLC into another corporation resulted in the division of the assets held for tax purposes by the owner of the LLC and thus should be tested as a § 355 divisive reorganization because § 355 should provide the only means to effect divisive reorganizations. That first set of proposed regulations also took the position that a merger of a target corporation into a disregarded entity did not qualify as an "A" reorganization because it was not a statutory merger of corporations under state law and because the owner of the LLC is not a "party to a reorganization." These proposed regulations were roundly criticized as being inconsistent with the rationale of the Check-the-Box regulations and meeting all of the substantive requirements for statutory merger treatment. See e.g., Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 34 GA. L. REV. 1523 (2000); Steven A. Bank, *The Runaway "A" Train: Does the IRS Need New Brakes?*, 87 TAX NOTES 553 (2000); Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws*, 77 N.C. L. REV. 1307, 1367 (1999); *Group Criticizes Proposed Regs on Mergers Including DB Regarded Entities*, TAX NOTES TODAY, Aug. 15, 2000, LEXIS, 2005 TNT 158-45; *Members of ABA Tax Section Supplement Comments on Proposed Regs on Mergers Involving Disregarded Entities*, TAX NOTES TODAY, Aug. 2, 2001, LEXIS 2001 TNT 149-27; Nat'l Ass'n of REITS; *Members of ABA Tax Section Suggest Changes to Proposed Regs on Mergers Involving Disregarded Entities*, TAX NOTES TODAY, Oct. 2, 2000, LEXIS, 2000 TNT 208-19.

In a new set of proposed regulations issued on November 13, 2001, the Treasury changed its position on the treatment of the merger of a target into a disregarded entity and generally concluded that such transactions would qualify as "A" reorganizations. It did not change its conclusion that a merger of a disregarded entity into a target corporation would not qualify as an "A" reorganization, but that is reasonable, because disregarding the separate existence of the entity means that the owner's assets are indeed being divided. In January 2003, the Treasury revised the 2001 proposed regulations and issued the revised version as temporary regulations. Temp. Treas. Reg. § 1.368-2T(b) (2003). These temporary regulations retained the same format and general conclusions as the 2001 proposed regulations, but contained additional examples and thus clarified the operation of the regulations. Although the temporary regulations were amended since they were initially issued, the amendments have not changed the fundamental approach, and the regulations were made final on January 26, 2006. T.D. 9242, 2006-7 I.R.B. 422.

134. The Service started applying the revised analysis even before the temporary regulations were issued. The depth of the Service's change of position with respect to its treatment of disregarded entities involved in reorganizations is demonstrated by two PLRs it issued before issuing the temporary regulations. In I.R.S. Priv. Ltr. Rul. 2002-36-005 (May 23, 2002), it ruled that a merger of the parent of an affiliated group into an LLC wholly

done likewise, applying the Check-the-Box regulations in a rule-like way to disregarded entities even in the area of divisive reorganizations.<sup>135</sup>

In Revenue Procedure 2002-69,<sup>136</sup> the Service stayed true to the goal of administrability by concluding that married couples in community property states could choose whether to be treated as one taxpayer or as two taxpayers, so that an LLC in which one or both spouses held an interest

---

owned by the acquiring corporation would be an "A" reorganization. In I.R.S. Priv. Ltr. Rul. 2002-39-022 (June 25, 2002), the Service analyzed a transaction in which two newly created single-member LLCs were disregarded and used to effect a successful split up which qualified under § 355. The transaction included a merger of a subsidiary into the parent's newly created single-member LLC, which was treated as a § 332 liquidation, and the transfer of some businesses into another newly created single-member LLC, followed by the contribution of the interests in the two LLCs to a newly created corporation in exchange for the corporation's stock, which was then distributed to the contributor's shareholders, qualified as a reorganization under § 368(a)(1)(D). For an extensive analysis of the use of disregarded entities in merger and acquisitions see Michele Coad Shahroody & David J. Stalter, *Navigating a One-Way Street: Merging with Disregarded Entities Under the New Temporary Regulations*, BUS. ENTITIES, May/June 2003, at 4; Mark J. Silverman, *Current Developments in Tax-Free and Taxable Acquisitions and Separations*, A.L.I.-A.B.A. CONTINUING LEGAL EDUC. COURSE OF STUDY 787 (2002); Gregory W. Walkauskas, *THE TAX ADVISER* 652 (2002). For some concerns involving the application of the temporary regulations to subsequent asset transfers, particularly transfers to foreign disregarded entities, see Lewis R. Steinberg, *NYSBA Comments on Regs Defining Statutory Merger or Consolidation*, TAX NOTES TODAY, May 27, 2004, LEXIS, 2004 TNT 103-12.

135. In Rev. Rul. 2002-49, 2002-2 C.B. 288, the Service examined a situation where in Year 1 each of two corporations owned a 20% interest in an LLC and others owned the remaining 60%. The LLC owned, leased and managed several commercial office buildings and was taxed as a partnership. In Year 3, one of the corporations, *D*, acquired the interests of the other parties, and the LLC became a disregarded entity. In Year 6, the LLC transferred some of its buildings to a newly created corporation in exchange for all of the new corporation's stock, and then *D* distributed that stock to its shareholders. The Service ruled that the distribution of the new corporation's stock to *D*'s shareholders satisfied the five-year active business requirement of § 355(b). To reach this conclusion, the Service had to treat the business conducted by the LLC when it was a single-member LLC as conducted by *D* because in this situation § 355(b)(1)(A) requires that both the distributing corporation and the controlled corporation be engaged in the conduct of a trade or business actively conducted during the five-year period preceding the distribution. In addition, the Service had to conclude that *D*'s purchase of the other interests in the LLC, which caused the LLC to go from being a partnership to being a disregarded entity, did not result in the acquisition of a new trade or business. The Service's citation to Treas. Reg. § 1.355-3(b)(3)(ii) (as amended in 1986), suggests that it did not regard the acquisition of additional properties by *D* as the acquisition of a new business. See Rev. Rul. 99-6, 1999-1 C.B. 432.

In the second situation, the only difference was that *D* did not start out owning its interest in the LLC in Year 1, but rather acquired it in Year 2 by contributing appreciated securities to the LLC in a transaction that qualified for non-recognition treatment under § 721. In that case the Service concluded that *D* would be treated as having acquired the trade or business in a transaction in which gain or loss was recognized within the five-year pre-distribution period notwithstanding the existence of a § 721 transaction because "had *D* instead directly acquired the trade or business that the [membership] interest represents in exchange for the property *D* contributed to the LLC, such exchange would have been a transaction in which gain or loss was recognized." Rev. Rul. 2002-49, 2002-2 C.B. 288. Although the Service's analysis of this situation looks to the substance of the transaction, that substantive approach did not involve the characterization of the disregarded entity. A number of letter rulings come to favorable conclusions on spin-offs involving disregarded entities. I.R.S. Priv. Ltr. Rul. 2002-34-021 (May 14, 2002); I.R.S. Priv. Ltr. Rul. 2002-30-006 (Apr. 11, 2002); I.R.S. Priv. Ltr. Rul. 2002-28-008 (Apr. 4, 2002); I.R.S. Priv. Ltr. Rul. 2002-14-025 (Jan. 4, 2002).

136. Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

could be treated either as a disregarded entity or as a partnership.<sup>137</sup> Although many questions about the application of the Check-the-Box regulations in community property states remain, for purposes of this discussion Revenue Procedure 2002-69 showed that the Service continued to favor administrability over substantive accuracy.<sup>138</sup>

In Revenue Ruling 2004-77,<sup>139</sup> the Service concluded that an LLC that had two legal owners, a corporation and another LLC wholly owned by the same corporation, was a disregarded entity. It could not be a partnership, because for federal income tax purposes, it only had one owner—the corporation. The LLC that was solely owned by the corporation was disregarded, leaving the first LLC with only one owner for tax purposes—the corporation. This conclusion is not surprising, as it follows directly from the application of the Check-the-Box regulations. If the separate existence of the second LLC is disregarded because it consists only of the corporation, the result is that the only owner of the first LLC is the corporation, thus making it a disregarded entity if it does not make an election to the contrary.

---

137. Ownership of LLCs in community property states presents particularly thorny issues. Even if an LLC owned by one member of a community were designated as separate property, many would not necessarily be so designated, and all LLCs that are community property would have to be treated as partnerships if that treatment depended on the number of individuals having ownership interests under state law. Since *Poe v. Seaborn*, 282 U.S. 101 (1930) gave effect to state community property laws for tax purposes, the Service could not simply ignore the community ownership. Respecting the community ownership would have created a significant disparity between common law property states and community property states, as no entity in which a married person acquired an interest in a community property state could ever be disregarded (if the ownership interest were community property), so disregarded entities would be out of the reach of many, if not most, married people in community property states but would be freely available to married couples in common law property states. The conclusion the Service reached makes disregarded entities available to all married couples. It preserves the element of taxpayer choice so central to the Check-the-Box regulations, while ignoring the substantive reality that two individuals have an ownership interest in the LLC. It uses one rule prompted by concerns over administrability to create another.

138. For example, in I.R.S. Priv. Ltr. Rul. 2003-39-026 (June 23, 2003), the Service addressed a situation involving community property ownership of LLCs as well as layers of disregarded entities. In I.R.S. Priv. Ltr. Rul. 2003-39-026, the Service began by observing that an LLC owned by individual, A, a married individual residing in a community property state, was a disregarded entity, and that S corporations whose stock was owned by the LLC qualified as such. The interesting twist in the ruling is that the married couple then became settlors of a grantor trust that was revocable by either member of the couple, and transferred the LLC interest to the trust. The Service then concluded that “following the transfer of *A and B’s* (emphasis added) ownership interest in LLC to Trust, Trust will be the sole owner of LLC and, therefore LLC will be an eligible entity, disregarded as an entity separate from its owner, unless it elects otherwise.” I.R.S. Priv. Ltr. Rul. 2003-39-06. The Service apparently treated the two individuals as a unit through their ownership in the trust; otherwise, the LLC would have ceased to be a disregarded entity because it would have gone from having one owner, A, to having two, A and B, as settlors of the trust which is itself disregarded because it is a grantor trust. For other questions and an analysis that predates Rev. Rul. 2002-69, see Terence F. Cuff, *Attorney Suggests Issues to be Considered for Future Guidance on Community Property Partnerships*, TAX NOTES TODAY, Sept. 12, 2002, LEXIS, 2002 TNT 177-3. For treatment of community property in like-kind exchanges, see Richard M. Lipton, *The ‘State of the Art’ in Like-Kind Exchanges Revisited*, 98 J. TAX’N 334 (June 2003).

139. Rev. Rul. 2004-77, 2004-31 I.R.B.119.

Private guidance issued during this period also applied the regulations in a rule-like fashion, with results that were in some ways predictable but in other ways startling. The contrasting results reached in a technical advice memorandum (“TAM”) and a PLR issued in 2001 provide a vivid illustration of the consequences of applying the rule-based approach of the Check-the-Box regulations and show that the difference between 100% ownership and 99% ownership matters.<sup>140</sup> In the TAM, the Service ruled that an LLC in which the taxpayer corporation owned a 99% interest, and two of its officers each owned a .5% interest, was a partnership, and that the § 4261 excise tax applied to payments to the LLC.<sup>141</sup> By contrast, in the PLR, the Service ruled that payments from a partnership to a single member LLC of which the partnership was the sole owner would not be subject to the § 4261 excise tax because the single member LLC would be treated as a disregarded entity, with the result that the payments would be treated as if they were made from one division of the taxpayer to another.<sup>142</sup> In addition, payments from each of two other LLCs, of which the partnership was the only member, would not be subject to the § 4261 excise tax because they, too, would be treated as payments made by the taxpayer to itself.

The difference between the conclusions reached by the Service in the TAM and the PLR follows precisely from an application of the Check-

---

140. A TAM is guidance issued by the Service in response to questions that develop during a proceeding. TAMs are issued only on closed transactions and represent a final determination of the position of the IRS on the correct application of tax law, treaties, revenue rulings and other precedents, but only with respect to the specific issue in the particular case in question. Thus, a TAM is the *ex post* equivalent to the PLR. Nevertheless, this *ex post* versus *ex ante* distinction does not account for the difference in result. See *Understanding IRS Guidance—A Brief Primer*, available at <http://www.irs.gov/irs/article/0,,id=101102,00.html> (for complete definitions of the PLR and TAM).

141. I.R.S. Tech. Adv. Mem. 2001-28-002 (Jan. 2, 2001). Technical advice was apparently sought because § 4282(c) provided that the § 4261 excise tax did not apply to amounts paid between members of an affiliated group under circumstances applicable to the taxpayer corporation and the LLC. If the LLC and the taxpayer corporation had been members of an affiliated group, the tax would not have applied to payments between them. Because the taxpayer corporation owned 99% of the LLC and the other 1% was owned by the taxpayer corporation’s own officers, the taxpayer was apparently taking the position that it ought to be treated as making the payments to a member of an affiliated group. In substance, the taxpayer and the LLC represented the same economic interests. A standard based approach would have resulted in treating the taxpayer and the LLC as members of an affiliated group. Nevertheless, that is not how the Service analyzed the situation.

In I.R.S. Tech. Adv. Mem. 2001-23-002 (June 8, 2001), the Service concluded that the definition of an affiliated group applicable for purposes of § 4282(c) was that found in § 1504. Because the § 1504 definition includes only corporations as members of an affiliated group, the Service had to determine whether the LLC was a corporation for that purpose. *Id.* For that determination, it looked to the Check-the-Box regulations and concluded that the LLC was not a corporation because it had more than one owner and it had not elected to be treated as a corporation for tax purposes. Because it was not a corporation, it could not be a member of an affiliated group and the exception to the application of the § 4261 excise tax did not apply. If ownership of 99% of the LLC had been treated as substantively the same as ownership of 100%, there would have been no need to invoke the affiliated corporation exception because the LLC would have been a disregarded entity and the payments would have been nonexistent for tax purposes (there would have been payments within one entity, the taxpayer corporation and its then single-member LLC).

142. I.R.S. Priv. Ltr. Rul. 2002-03-019 (Oct. 15, 2001).

the-Box regulations. By their terms and design, the Check-the-Box regulations leave no room for determining substantive equivalence. Substantively, the difference between an LLC in which the taxpayer owns 100% of the interest and one in which it owns 99% of the interest is illusory. Indeed, in many areas of the tax law, ownership of 80% of the equity in an entity is statutorily treated the same as ownership of 100% of the equity.<sup>143</sup> Nevertheless, by applying the Check-the-Box regulations in the TAM and the PLR, the Service appropriately avoided a determination of substantive equivalence. By doing so, it remained true to the objective of the Check-the-Box regulations. By eschewing the standard of substantial equivalence it avoided uncertainty.

As often occurs when a standard gives way to a rule, the contrast between the results in the TAM and PLR seem substantively unfair. The two situations are nearly identical, yet they are treated in dramatically different ways. For tax lawyers steeped in doctrines that seek to ensure that similarly situated taxpayers are treated similarly, the differing results in the TAM and PLR can seem almost shocking. Nevertheless, the different results follow from the decision to adopt a rule in the Check-the-Box regulations. The potential inequity of dissimilar treatment for similar situations is ameliorated by the taxpayer's ability to choose the desired characterization given the elective nature of the Check-the-Box regulations.<sup>144</sup> If both taxpayers had elected to have the LLC treated as a corporation for tax purposes, the treatment of the two LLCs would have been identical.

In some ways, the difference in the results reached in the TAM and the PLR is not surprising. Rules always have this effect, which is evident in the application of rules contained in the Code itself.<sup>145</sup> What is perhaps startling here is that the application of the rule produced such a potentially taxpayer friendly result in the PLR, suggesting that taxpayers can manipulate the characterization of their transactions to produce either the result of the TAM—respecting the separate identity of the LLC, or not, as in the PLR. Of course, allowing taxpayers to choose was precisely the point of the Check-the-Box regulations. That is why retaining the rule-based approach of those regulations is so important.

---

143. See, e.g., I.R.C. §§ 246, 332, 368(c), 1504 (2001). Of course, this suggests that when Congress wants to treat less than 100% ownership as equivalent to 100% ownership, it specifically so provides. This is a rule-based area of the law where Congress, and the Treasury through the promulgation of the Check-the-Box regulations, have chosen to eschew determinations of substantive equivalence in favor of the administrative ease of applying a rule.

144. It is interesting to consider the possibility that the TAM and PLR involved the same taxpayer, who restructured its affairs after receiving the TAM and asked for the Service's blessing through the PLR.

145. For example, in *Kamborian v. Commissioner*, 56 T.C. 847 (1971), the court refused to give effect to the acquisition of additional stock by an existing shareholder, leaving the other transferors in a § 351 transaction holding only 77.3% of the stock. The court held that § 351 would not apply to the transaction because the stock held by the transferors was less than the required 80%. Close was not good enough.

The TAM and PLR are not the only private guidance in which the Service has been willing to apply the Check-the-Box regulations linearly even when doing so produced a result very favorable to taxpayers. In I.R.S. PLR 2002-22-026, the Service considered a situation in which an LLC that had two owners redeemed the interest of one of its owners and thus became a disregarded entity.<sup>146</sup> The Service found that the partnership terminated as a result of the redemption, as it should have given previously issued published guidance,<sup>147</sup> but the problem was that the LLC (the partnership) had outstanding liabilities to the entity that became its single owner. The Service therefore had to consider the question whether the termination of the partnership gave rise to discharge of indebtedness income to the LLC. The Service concluded that “[b]ecause a person cannot be both creditor and debtor, LLC’s obligations [to its now-single owner] are cancelled . . . LLC is treated as paying the full issue price of the cancelled out debts. Accordingly, neither LLC nor [its now-single owner] will realize any discharge of indebtedness income . . . upon the termination of the partnership.”<sup>148</sup> The fact that the debt remained outstanding as a matter of state law and might not be repaid, and that the LLC received an amount as a separate entity which it might now fail to repay without tax consequence, did not matter.

The Service has publicly underscored the extent to which it is willing to stand by the rule-based application of the Check-the-Box regulations, even when that approach allows taxpayers to change a result from taxpayer-unfavorable to taxpayer-favorable status, and despite the absence of any substantive change in the underlying relationships. Revenue Ruling 2005-40<sup>149</sup> dramatically illustrates this. In that ruling, the Service examined four situations and was called upon to decide whether in each situation, corporation Y, a corporation unrelated to corporation X, was providing insurance to X.

In the first situation, X carried on a courier transport business and owned a fleet of motor vehicles that it used in that business.<sup>150</sup> It paid Y to insure the risks associated with the motor vehicles based on accepted, arms-length industry rates. Nevertheless, because Y’s only insurance ac-

---

146. I.R.S. Priv. Ltr. Rul. 2002-22-026 (Mar. 1, 2002).

147. This result is mandated by Rev. Rul. 99-6, 1999-1 C.B. 432. In that Ruling, the Service analyzed two situations in which one person purchased all of the interests in a multi-person LLC, causing the LLC to change from a partnership to a disregarded entity. Both situations are analyzed differently from the buyer’s side and the seller’s side. In both situations, the seller(s) are treated as selling a partnership interest, which results in the recognition of capital gain except to the extent of unrealized receivables or inventory items, which are ordinary income. In both situations, from the buyer’s side, the transaction is treated as a partnership liquidation followed by a purchase of the assets distributed in liquidation. The analysis differs because although the seller’s side is straightforward — the seller can be treated as selling a partnership interest because that is what he or she has and the mere act of selling does not change the character of the interest—the buyer cannot be treated as having bought a partnership interest because his purchase causes the entity to cease being a partnership.

148. I.R.S. Priv. Ltr. Rul. 2002-22-026 (Mar. 1, 2002).

149. Rev. Rul. 2005-40, 2005-27 I.R.B. 1.

150. *Id.*

tivity was providing insurance to *X*, the Service found that *X* had shifted its risk but that the risk had not been distributed.<sup>151</sup> Thus, the arrangement was not found to constitute insurance and *Y* was not treated as an insurance company.<sup>152</sup>

In the second situation, the only difference was that *Y* also provided insurance to another unrelated entity. However, since that other insurance accounted for only 10% of *Y*'s business, the Service again found insufficient risk distribution to allow the service provided by *Y*, to qualify as insurance and thus, *Y* was not treated as an insurance company.<sup>153</sup>

The third situation was the same as the first, except that *X* conducted its courier business through twelve separate LLCs of which *X* was the only member.<sup>154</sup> *X* had not made any election under the Check-the-Box regulations, so the LLCs were disregarded entities.<sup>155</sup> Again, the Service found insufficient risk distribution because the two situations were identical for tax purposes, and again, *Y* was not treated as an insurance company.<sup>156</sup>

The fourth situation provides the coup de grace. That situation was the same as the third except that each of the twelve LLCs had elected to be treated as a corporation under the Check-the-Box regulations.<sup>157</sup> In that situation, the Service found sufficient risk distribution because:

[t]he arrangements between *Y* and each LLC . . . shift a risk of loss from each LLC to *Y*. The risks of the LLCs are distributed among the various other LLCs that are insured under similar arrangements. Therefore the arrangements between the 12 LLCs and *Y* constitute insurance for federal income tax purposes.<sup>158</sup>

The effect of this conclusion was that *Y* was treated as an insurance company for federal income tax purposes and the LLCs were able to deduct their payments to *Y* as insurance premiums. The Check-the-Box election—an election that changed nothing about the substance of the transaction and did not alter the distribution of risk in any meaningful substantive manner—nevertheless changed the tax consequences dramatically. Here, tax form mattered.

Despite having completely disregarded substance, the Service came to the correct conclusion in Rev. Rul. 2005-40; having issued the Check-the-Box regulations and created the disregarded entity, and having made the characterization of the entity elective, the Service came to the only conclusion it could. For tax purposes, corporations are different from non-corporate entities; they are separate legal persons and are subject to the

---

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

corporate income tax.<sup>159</sup> Therefore, it could be said that as a matter of substance, an entity that is treated for tax purposes as a corporation is different from a non-corporate entity. The problem is that in this case, as in all cases where taxpayers elect corporate treatment under the Check-the-Box regulations, the differences between corporations and non-corporate entities are illusory for all purposes except the federal income tax. Risk is not spread more widely in the fourth situation than in the third because, as a substantive matter, the pool of risks in the two situations is identical.<sup>160</sup> Only the making of an election that is effective for federal tax purposes distinguishes the two situations by appearing, in the last situation, to lodge the risks with different legal persons. Nevertheless, form appropriately trumps substance, as the rule of the Check-the-Box regulations mandates.

In Revenue Ruling 2003-125,<sup>161</sup> the Service also followed the linear implications of the Check-the-Box regulations to conclude that a Check-the-Box election allowed the sole owner of the entity to take a worthless stock deduction. Revenue Ruling 2003-125 analyzed two situations involving a foreign entity, all of whose interests were held by a U.S. corporation that checked the box to change its classification from a corporation to a disregarded entity.<sup>162</sup> In the first situation, the foreign entity was not insolvent at the time of the elective change in classification even if the determination of insolvency included intangibles, such as goodwill and going concern value.<sup>163</sup> In the second situation, the foreign entity was insolvent at the time of the change if its intangibles were included in the determination of solvency.<sup>164</sup> The Service explained that in an actual liquidation §§ 331 and 332 could not apply if the shareholder received nothing in exchange for its stock, and for that reason, a liquidation of an

---

159. See *Moline Props. v. Comm'r*, 319 U.S. 436 (1943).

160. See Rev. Rul. 2005-40, 2005-27 I.R.B. 1. I am not suggesting that the Service's conclusion that in Situation 4 there is risk shifting and risk distribution is incorrect. Indeed, the conclusion follows from the court's analysis in cases like *Humana Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1980), and *Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835 (6th Cir. 1995) and from the Service's current position with respect to captive insurance companies. See Burgess J.W. Raby & William L. Raby, *Captive Insurance—Some Lights in the Fog*, 97 TAX NOTES 1711 (2002) (citing Rev. Proc. 2002-75, 2002-2 C.B. 997; Rev. Rul. 2002-89, 2002-2 C.B. 984; Rev. Rul. 2002-90, 2002-2 C.B. 985; and Rev. Rul. 2002-91, 2002-2 C.B. 991). What is remarkable about the Service's conclusion is the extent to which, appropriately, it respects the form of the transaction—the existence of a Check-the-Box election. The temptation to be swayed by the substantive identity of Situations 3 and 4 must have been great, as the effects on the parent's balance sheet, assets, and net worth are identical in the two situations. Nevertheless, the Service did precisely what I am suggesting it should always do in situations like this: follow the Check-the-Box regulations to their logical conclusion (no risk shifting and risk distribution in Situation 3) allowing the taxpayer to make a different choice if it doesn't like that result (risk shifting and risk distribution in Situation 4 following a Check-the-Box election).

161. Rev. Rul. 2003-125, 2003-2 C.B. 1243.

162. *Id.*

163. *Id.*

164. *Id.*



insolvent corporation would not be subject to §§ 331 and 332,<sup>165</sup> but would instead produce a worthless security loss under § 165(g)(3)—on the deemed liquidation the shareholder receives no payment for its stock. Following the position set forth in the Check-the-Box regulations, the Service treated the election not to be treated as a corporation, as an actual liquidation. Therefore, where the entity was insolvent, taking into account the intangibles, the change in elective classification resulted in a worthless security deduction under § 165(g)(3).

This ruling is notable because the Service treated a change in elective classification as the occurrence of an actual transaction even though it acknowledged that the change in elective classification had no effect on the treatment of the entity under foreign law.<sup>166</sup> The Service did not

---

165. See REV. RUL. 59-296, 1959-2 C.B. 87 (holding that a liquidation of an insolvent subsidiary into its parent, a bona fide creditor for cash advances that totaled more than the fair market value of the subsidiary's assets, will neither be considered a nontaxable distribution under § 332 nor a tax-free reorganization under § 368). See also *Comm'r v. Spaulding Bakeries, Inc.*, 252 F. 2d 693, 695-98 (2d Cir. 1958); *H.K. Porter Co. v. Comm'r*, 87 T.C. 689, 694-98 (1986) (each holding that § 332 or its predecessor will apply only to the extent that a subsidiary's liquidating distribution was with respect to all of the subsidiary's stock, so that a liquidating distribution made only to the preferred stock held by the parent, with no distribution on the common stock held by the parent, indicates that the company was insolvent at time of liquidation, and thus § 332 did not apply). The Treasury has proposed to extend this net value requirement to other situations. Prop. Treas. Reg. § 1.332-2(b), 70 Fed. Reg. 11,903 (Mar. 10, 2005). The proposed regulations would require that there be an exchange, or in the case of § 332, a distribution, of positive net value in order for §§ 351, 368, and 332 to apply. *Id.*

166. Before issuing Rev. Rul. 2003-125, the Service apparently struggled with the question whether to apply doctrines that require it to give effect to transactions based on their substance and came to contradictory conclusions. In one instance, it decided not to apply those doctrines. In I.R.S. Chief Couns. Adv. Mem. 2002-38-025 (June 14, 2002), the Service analyzed the application of § 269(b) to a Check-the-Box election that resulted in a deemed liquidation, thus suggesting that for purposes of applying tax avoidance doctrines the Service would treat an election as it would treat the transaction that the election effects, so the election neither cleanses nor problematizes a transaction. I.R.S. Chief Couns. Adv. 2002-38-025 (June 14, 2002). The Service also refused to "disregard [a company's] check-the-box election and then reallocate to [that company], as a separate entity, the loss recognized . . . on the sale of [its subsidiaries] stock." *Id.* The Service explained that it did not believe it is appropriate to apply section 482 to disregard [the company's] check-the-box election, given that entity classification for Federal income tax purposes does not directly implicate the allocation of items of income between controlled taxpayers. It is not clear, therefore, that section 482 should have application to these facts.

*Id.* However, in Field Service Advice ("FSA") 2002-26-004, issued by the Chief Counsel's Income Tax and Accounting Division, the Service suggested that for purposes of determining whether there has been an identifiable event marking the worthlessness of a subsidiary's stock, checking the box of an foreign entity, which should be treated as a liquidation of the entity, does not have the same effect as actually liquidating the entity. I.R.S. Field Serv. Adv. 2002-26-004 (June 28, 2002). The issuance of FSA 2002-26-004 did not end the study of the matter, and the Treasury's officials continued to discuss the issue publicly. See Sheryl Stratton, *Treasury Officials Clarify Reach of Recent Corporate Guidance*, 97 TAX NOTES 862 (2002). The issue also remained on the 2003 Business Plan. See I.R.S. *Treasury Release 2002-2003 Business Plan*, TAX NOTES TODAY, July 11, 2002, LEXIS, 2002 TNT 133-8; see also Jasper L. Cummings, Jr., *The 2003-2004 Priority Guidance Plan for Chief Counsel (Corporate)*, 100 TAX NOTES 1443 (2003). The issuance of Rev. Rul. 2003-125, which comes to a different conclusion than FSA 2002-26-004, shows that the rule-based approach carried the day.

identify any purpose, business or otherwise, for the transaction and noted that the entity continued to operate as before even after the change. The action that resulted in a deduction was not only taken at the election of the taxpayer but was meaningful only for U.S. tax purposes. Giving effect to such an action is formalistic in the extreme, and while such formalism follows directly from the approach of the Check-the-Box regulations, it makes those instances in which the Service has refused to adhere to that approach (such as in the bankruptcy-remote rulings discussed above), all the more confounding.<sup>167</sup>

#### D. THE CRYSTALS BEGIN TO TURN TO MUD.

Despite its adherence to form and the linear application of the Check-the-Box rules in much of the public guidance it issued, the Service found a transaction that exceeded its tolerance for the linear application of rules in *Dover Corp. v. Commissioner*.<sup>168</sup> *Dover* involved a second tier foreign subsidiary of a U.S. corporation that requested, and obtained, permission to file a retroactive election to check-the-box so that the foreign corporation would become a disregarded entity. The effect of this change in classification was that the foreign corporation was treated as having liquidated into its parent in a § 332 liquidation, and the effect of the § 332 liquidation was to treat the parent as having conducted the business activities of the former subsidiary.<sup>169</sup> The further effect of this in the international context applicable to the transaction was to treat the owner of the disregarded entity as being engaged in a trade or business so that its sale of the assets of that business would not give rise to foreign personal holding company income ("FPHCI").<sup>170</sup> By electing to treat the subsidiary as a disregarded entity, the taxpayer avoided the application of the foreign personal holding company provisions. The Tax Court, in an opinion written by Judge Halpern, indicated that it recognized that the result it was reaching was arguably inconsistent with the policies behind the foreign personal holding company provisions, but laid the blame for that at the

---

167. See *supra* Section III(B).

168. 122 T.C. 324, 327-53 (2004).

169. *Id.* This conclusion followed from Rev. Rul. 75-223, 1975-1 C.B. 109. The Service explained that:

Under section 381 . . . a parent corporation that liquidates a subsidiary under section 332 . . . inherits, among other attributes, the earnings and profits, net operating loss carryovers, and accounting methods of the liquidated subsidiary. These attributes pass to the parent corporation whether the liquidating distribution consists of the operating assets of the subsidiary or the proceeds of a sale of those assets. Section 381, in effect, integrates the past business results of the subsidiary (as represented by its earnings and profits, net operating loss carryovers, etc.) with those of the parent corporation. [Thus], [f]or most practical purposes, the parent corporation, after the liquidation of the subsidiary, is viewed as if it had always operated the business of the liquidated subsidiary.

Rev. Rul. 75-223, 1975-1 C.B. 109.

170. The FPHCI provisions were repealed by the American Jobs Creation Act of 2004, but that repeal does not affect the proposition for which the case is discussed. American Job Creation Act of 2004, Pub. L. 108-357, 118 Stat. 1418 (2004).

Treasury's door, noting that the Treasury could amend the regulations to require "a minimum period of continuous operation of a foreign disregarded entity's business, prior to the disposition of that business, as a condition precedent to treating the owner as having been engaged in the trade or business for purposes of characterizing the gain or loss."<sup>171</sup> The perceived abuse, according to Judge Halpern was "a problem of respondent's own making."<sup>172</sup>

Perhaps not surprisingly, in light of the apparent retreat from the formalistic approach represented by its litigating position in *Dover*, the Service in PLR 2003-15-001<sup>173</sup> retreated from a formalistic, linear application of the Check-the-Box regulations. PLR 2003-15-001 involved a United States parent corporation ("Old Parent") that inverted by merging into a subsidiary of a newly formed corporation ("New Parent"), surviving and then converting into an LLC.<sup>174</sup> Following the conversion, Old Parent became a disregarded entity because it became an LLC whose sole owner was New Parent.<sup>175</sup> The issue the Service was asked to rule on was the effect of the transaction on debt issued by Old Parent.<sup>176</sup> After the inversion and conversion, the debt was, as a matter of state law, still owed by the same legal entity—Old Parent.<sup>177</sup> The problem was that for tax purposes Old Parent was now a single member LLC and therefore did not exist separately from the new entity—New Parent. If the LLC's separate existence were disregarded for tax purposes, as the Check-the-Box regulations command, then for tax purposes the debt would have to be treated as owed by a different obligor—New Parent. As a result of Treas. Reg. § 1.1001-3(c)(1)(i) (part of the so-called *Cottage Savings* regulations),<sup>178</sup> which treats a change in obligor as a modification which triggers realization of gain or loss,<sup>179</sup> applying the Check-the-Box regulations literally

171. *Dover*, 122 T.C. at 352.

172. *Id.* at 352-53 (quoting *CSI Hydrostatic Testers, Inc. v. Comm'r*, 103 T.C. 398, 411 (1994), *aff'd*, 62 F.3d 136 (5th Cir. 1995)). In a prescient but highly controversial move, the Treasury had proposed regulations that would have invalidated Check-the-Box elections made within a time frame that suggested a relationship to an "extraordinary transaction." Those proposals were eventually withdrawn amid vociferous criticism that they undermined the elective nature of the Check-the-Box regulations. After all, what other reason besides tax avoidance would any taxpayer have for making an election that is meaningful *only* for tax purposes? For a description of the rise and demise of the proposed extraordinary transaction regulations, see David L. Click, *Treasury Withdraws Extraordinary Check-the-Box Regulations*, 101 TAX NOTES 95 (2003). For a pithy analysis of *Dover* and the effect of the Check-the-Box Regulations, see Lee A. Sheppard, *The Undead Subpart F*, 103 TAX NOTES 948 (2004). For an equally pithy retort, see Kimberly Blanchard, *Sheppard's Dover Discussion Dismantled*, 103 TAX NOTES 1297 (2004).

173. I.R.S. Priv. Ltr. Rul. 2003-15-001 (Sept. 19, 2002).

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. These regulations are referred to as the *Cottage Savings* regulations because they were issued following the decision in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), under which an arguably small change in the attributes of property nevertheless resulted in realization.

179. Treas. Reg. §1.1001-3(b) provides that a "significant modification of a debt instrument" will result "in an exchange of the original debt instrument for a modified instrument

would cause the holders of Old Parent's debt to recognize income.<sup>180</sup>

In PLR 2003-15-1001, the Service did not address the issue of the application of the Check-the-Box regulations directly. Instead, it observed that:

[T]he conversion of [Old Parent] into [LLC] will not affect the legal rights or obligations between the Debt holders and [Old Parent], because, as a matter of State law, [LLC] will remain the same legal entity as [Old Parent]. The Debt holders will continue to have exactly the same legal relationship with [LLC] that they previously had with [Old Parent], viz., as general unsecured recourse claimants having no greater preference than any other creditor.<sup>181</sup>

The Service then concluded that the change in nominal obligor was not a modification under the *Cottage Savings* regulations, so the restructuring did not result in the recognition of gain.

As a matter of substance, the Service's conclusion in PLR 2003-15-1001 is clearly correct. There is no reason to cause realization of gain or loss when the legal obligor remains the same, because as a matter of substance, nothing has changed. In the situation described in the ruling, Old Parent continued to exist and retained its obligation to the debt holders—only its legal form changed. Nevertheless, the problem is that for tax purposes, Old Parent, the original legal obligor, ceased to exist. Under the Check-the-Box regulations a disregarded entity does not exist for federal tax purposes. There is no reasonable construction of those regulations that would allow the Service to resurrect the disregarded entity for purposes of applying the *Cottage Savings* regulations. When for tax purposes Old Parent ceased to exist, New Parent became the obligor. A change in obligor therefore occurred and application of the *Cottage Savings* regulations would result in gain recognition to the debt holders.<sup>182</sup>

---

that differs materially in either kind or extent." Treas. Reg. § 1.1001-3(b) (1996). Such an exchange is a realization event, resulting in gain or loss to the debt holder. If the modification is not "significant," then there is no exchange. Treas. Reg. § 1.1001-3(c) defines "modification," and Treas. Reg. § 1.1001-3(e)-(f) define "significant modification." Treas. Reg. § 1.1001-3(c)-(f).

180. In describing the facts the Service observed that "[t]he current trading price of one or more series of the Debt is substantially less than its respective adjusted issue prices." I.R.S. Priv. Ltr. Rul. 2003-15-001 (Sept. 19, 2002). Therefore, as Jack Cummings observed: the reason Parent wanted the ruling may have been that if the debt securities were treated as exchanged in a § 1001 sale or exchange, and the "new" securities were treated as having an issue price less than the adjusted issue price of the old securities, then the corporate debtor would have to recognize cancellation of indebtedness income. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATION AND SHAREHOLDERS* & 12.27[4][c] (7th ed. 2005); Jasper L. Cummings, Jr., *The Disregarded Entity Is and Isn't (Disregarded)*, 99 TAX NOTES 743, 744 (2003). The *Cottage Savings* regulations contain an exception for new obligors that become so as a result of § 381 transactions or asset acquisitions. Treas. Reg. § 1.1001-3(e)(4)(i)(B), (C); Treas. Reg. § 1.1001-3(g) (Example 7). Nevertheless, although the Service noted the existence of exceptions, apparently none applied to the facts in the ruling.

181. I.R.S. Priv. Ltr. Rul. 2003-15-001.

182. This result follows so long as none of the exceptions in Treas. Reg. § 1.1001-3(e)(4) applies, as apparently they did not in this case. See *supra* note 180.

It is hard to fault the Service for reaching a result that is both substantively correct and favorable to taxpayers, particularly when that result is economically efficient because it removes tax as an impediment to corporate transactions. Nevertheless, the Service only confuses the law and turns crystals into mud when it ignores the implications of its own regulations.<sup>183</sup> The conclusion the Service reached in this situation is the equivalent of saying “we will ignore the separate existence of a disregarded entity for federal tax purposes, except when ignoring that separate existence would reach a substantively incorrect result.” The problem with this view is that disregarding the separate existence of an entity which not only exists under state law but which was almost certainly created because it had a separate existence and thus afforded its owner limited liability, is itself counter-substantive. Given that the single owner of the LLC can choose the tax classification of the entity, it is not unreasonable to follow the logical consequence of that choice. If the single owner does not like the consequences of its choice, it can elect corporate status.<sup>184</sup> The Check-the-Box regulations can achieve their objective of reducing entity classification questions only if they are consistently applied. Because classification is elective, any unfavorable consequence that might result from the consistent application of that classification is of the taxpayer’s own making and can be altered by taxpayer action.

Proposed regulations dealing with allocation of partnership debt show that the Service has not completely retreated from the rule based approach of the Check-the-Box regulations.<sup>185</sup> These proposed regulations address the difficult, and almost certainly unforeseen, questions that arise when a disregarded entity is a partner in a partnership and it is necessary to determine the extent of each partner’s liability for partnership debt that is recourse to the partnership. Mechanical application of the Check-the-Box regulations requires that the separate existence of the LLC be ignored and that the LLC’s owner be treated as the partner. The prob-

---

183. This ruling has prompted sophisticated practitioner commentary that reveals the confusion its conclusion created. See Cummings, *supra* note 180. For further discussion of issues related to ownership of debt by disregarded entities, see Terence F. Cuff, *Indebtedness of a Disregarded Entity*, 81 TAXES 303 (2003) (noting that debt owned by a disregarded entity is treated as non-recourse to the entity’s owner). See also Marc D. Teitelbaum, *A Disregarded Entity Must Be Taken Into Account*, 97 TAX NOTES 1205 (2002). For an analysis of the likely consequences of the acquisition of target debt by a disregarded entity that is the survivor in a tax-free merger, see Elizabeth T. Kessenides & Alison S. Wang, *Taxation of Debtholders in LLC Mergers*, TAX NOTES TODAY, Sept. 28, 2004, LEXIS, 2004 TNT 188-35.

184. If Old Parent had elected corporate status after converting into an LLC, the transactions would have been an “F” reorganization and the nominal change in obligor would not have triggered realization of gain under the *Cottage Savings* regulations. See Cummings, *supra* note 180, at 743 (noting that “[i]f debt securities of a corporation are exchanged for new debt securities of the corporation, the creditors can enjoy an exception to recognition by virtue of a recapitalization/reorganization, and generally will recognize gain only if the principal amount increases,” but also warning that a recapitalization can cause cancellation of indebtedness income to the corporation if the principal amount of the loan drops).

185. Prop. Treas. Reg. § 1.752-2(a), 69 Fed. Reg. 49,832-01 (Aug. 4, 2004).

lem that causes is that the LLC's owner is not legally liable for partnership debts because of the limited liability afforded by the LLC. Therefore, treating partnership level debt as recourse to the single owner, the partner, would misrepresent the nature of the legal relationships.<sup>186</sup>

The Service struggled with the dilemma presented by this situation and debated various approaches, including treating the debt as nonrecourse to a disregarded entity general partner,<sup>187</sup> and characterizing the debt based on the level of economic risk to which the owner of the disregarded entity was subject.<sup>188</sup> The Proposed Regulations follow that approach. They provide that partnership liabilities will be treated as recourse to the extent that the partner bears the economic risk of loss.<sup>189</sup> Under the proposed regulations, a partner will be treated as bearing the economic risk of loss only to the extent of the net value of the disregarded entity, unless the owner of the disregarded entity is otherwise required to satisfy the obligations of the disregarded entity.<sup>190</sup>

The proposed regulations adopt precisely the right approach.<sup>191</sup> They

---

186. A similar problem used to arise under the *Kintner* regulations when limited partnerships have a general partner that is a corporation. See *supra* note 74.

187. See *Treasury Official Offers Insight into Business Plan Partnership Items*, TAX NOTES TODAY, Sept. 17, 2003, LEXIS, 2003 TNT 180-4. In addition to simply treating the debt as nonrecourse, the Service considered allocating the debt to the general partner or treating the debt as a pledge of the LLC's assets. *Id.*

188. In April, 2004, the American Bar Association Section of Taxation ("ABA Tax Section") submitted members' comments considering the issues that arise in applying the § 752 regulations when partnership debt is recourse to a general partner but the general partner is an LLC that is a disregarded entity. Richard Shaw, *ABA Comments on Regs on Characterization of Partnership Liabilities*, TAX NOTES TODAY, Apr. 27, 2004, LEXIS, 2004 TNT 81-21. The ABA Tax Section recommended that partnership debt be characterized based on the economic risk of loss to which the owner of the disregarded entity is subject and provided a number of examples applying its proposed paradigm. *Id.*

189. Prop. Treas. Reg. § 1.752-2(a), 69 Fed. Reg. 49,832-01. In the first update to its 2005-2006 Priority Guidance Plan, the Treasury announced that it plans to finalize these proposed regulations in 2006. Press Release, Dept. of the Treas., First Periodic Update of the 2005-2006 Priority Avoidance Plan (Mar. 6, 2006), available at <http://www.treas.gov/press/releases/js4095.htm>.

190. Prop. Treas. Reg. § 1.752-2, 69 Fed. Reg. 49,832-01. The proposed regulations contain a definition of net value that is based on fair market value, excluding the disregarded entity's interest in the partnership. Prop. Treas. Reg. § 1.752-2(k)(2), 69 Fed. Reg. at 49,835. Unless certain triggering events occur, the assets of the disregarded entity will not be revalued, but the Service is considering, and has requested comments on, the question whether the partner should be able to make an election to revalue the disregarded entity's assets even in the absence of a triggering event. It has also sought comments on whether the list of triggering events ought to be expanded. See *IRS Publishes Proposed Regs on Treatment of Disregarded Entities*, TAX NOTES TODAY, Aug. 12, 2004, LEXIS, 2004 TNT 156-6.

191. Although the ABA Tax Section has generally commended the Treasury on the positions taken in the proposed regulations, the AICPA has urged that the proposed regulations not be adopted. Compare Kenneth W. Gideon, *ABA Members Comment on Proposed Regs on Disregarded Entities*, TAX NOTES TODAY, Apr. 7, 2005, LEXIS, 2005 TNT 66-27 with Thomas J. Purcell, *AICPA Seeks Withdrawal of Proposed Regs on Disregarded Entities*, TAX NOTES TODAY, Feb. 1, 2006, LEXIS, 2006 TNT 21-10. For a thoughtful critique of the proposed regulations which the authors characterize as theoretically pure but imposing significant compliance burdens on taxpayers, see Blake D. Rubin & Andrea McIntosh Whiteway, *Disregarded Entities and Partnership Liability Allocations: Proposed Regs Critiqued*, 106 TAX NOTES 321 (2005).

disregard the separate existence of the entity and focus on the economic risk of loss faced by the owner. The key is that the proposed regulations do not treat the LLC as the partner, nor do they treat the debt as being the debt of the LLC. Rather, they look through the LLC to its owner and determine the extent of the owner's economic risk of repayment. To the extent that the owner is at risk, based on the property of the LLC (which is treated as the owner's property), then the debt will be treated as recourse to the owner. The separate existence of the LLC is disregarded, as it should be under the rule adopted in the Check-the-Box regulation.

### E. THE NEED FOR MORE GUIDANCE

The need for guidance on issues involving disregarded entities shows no sign of abating. Two issues which have already received attention from commentators are worth mentioning.

#### 1. Cancellation of Debt

One currently unresolved issue is how § 108 should be applied to debt discharged to a disregarded entity. Some solvent corporations are apparently taking the position that § 108(a) applies to the cancellation of indebtedness income of LLCs in which they are the single member.<sup>192</sup> This position is derived from Tax Court Memorandum decisions in which general partners in partnerships which filed for bankruptcy were granted discharges in bankruptcy.<sup>193</sup> The taxpayer's argument would be that although the taxpayer—the corporate owner of the LLC—has not itself been discharged in bankruptcy, the debts discharged in bankruptcy are, for federal tax purposes, its debts (the debts of the taxpayer/owner) because for federal tax purposes the LLC does not exist as a separate entity. Furthermore, the taxpayer/owner is the only person who could be treated as being before the bankruptcy court, as required by § 108(d)(2), because for federal tax purposes the LLC does not exist as a separate entity.

---

192. Sheryl Stratton, *Officials Highlight Upcoming Consolidated, Corporate Guidance*, TAX NOTES TODAY, Sept. 22, 2004, LEXIS, 2004 TNT 184-3.

193. See, e.g., *Price v. Comm'r*, 87 T.C.M. (CCH) 1426 (2004); *Garcia v. Comm'r*, 87 T.C.M. (CCH) 1423 (2004); *Mirarchi v. Comm'r*, 87 T.C.M. (CCH) 1424 (2004); *Martinez v. Comm'r*, T.C.M. (CCH) 1428 (2004). The Service has stated that it is working on "guidance that would make this position disclosable." Stratton, *supra* note 192. Apparently, some taxpayers are taking the position that if a partner in a partnership can use the § 108(a)(1)(A) exclusion when the partnership files for bankruptcy, as the Tax Court allowed in *Price* and similar cases, the single-member of a bankrupt LLC should be able to do likewise.

Section 108(a)(1)(A) provides an exclusion for amounts discharged in a "Title 11 case." Section 108(d)(2) provides that a "Title 11 case" means a case under Title 11 of the U.S. Bankruptcy Code, "but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." *Price*, 87 T.C.M., at 1406. In *Price*, the opinion of the bankruptcy court explicitly asserted jurisdiction over the general partner, who had also personally guaranteed the partnership's debt, and the partner agreed to contribute additional amounts to the partnership in exchange for the discharge. *Id.* It is the Service's position that it does not follow from cases like *Price* that a single-member LLC whose debts are discharged in bankruptcy is eligible for the benefits of § 108(a).

Such a position should not be sustained. The LLC is not a taxpayer under the Code, and if it is the only entity under the jurisdiction of the bankruptcy court then the requirements for purposes of § 108(d)(2) have not been met. In the Tax Court Memorandum decisions that raise this issue the bankruptcy court asserted jurisdiction over the partner as well as the partnership. If, as in those decisions, the single member owner has personally guaranteed the LLC's debts (as business exigencies might dictate), and if the bankruptcy court asserts jurisdiction over the single member owner, then the taxpayer's argument could succeed, but not otherwise.<sup>194</sup>

It has also been suggested that the insolvency exception of § 108(a)(1)(B) should apply to discharge of indebtedness income of a single member LLC that is insolvent at the time of the discharge, regardless of whether or not its single owner is insolvent.<sup>195</sup> That should not occur. To test the application of § 108(a)(1)(B) at the LLC level contravenes the explicit directive of the Check-the-Box regulations to disregard the existence of the LLC for federal tax purposes. Nevertheless, proponents of this result note that, substantively, testing the solvency of the LLC rather than its single owner best comports with the policies behind § 108. They argue that because the Service has been willing to ignore the Check-the-Box regulations and apply the tax law as if the LLC, and not its single owner, were the taxpayer in other situations, it should do so in this situation as well.<sup>196</sup>

That such arguments are being made underscores the need for the Service's consistent application of the rule-based approach of the Check-the-Box regulations and proves that the clear, administrable world the Treasury tried to create when it promulgated those regulations is in imminent danger of unraveling.<sup>197</sup> A taxpayer should not be able to have it both ways. Having elected to disregard the separate existence of the LLC, the

---

194. This should be true even though § 108(d)(6), which provides that § 108(a) will apply at the partner level, does not apply to a single-member LLC. I.R.C. § 108(d)(7) (2005). Arguably, no provision like § 108(d)(6) is necessary in the case of a single-member LLC, because the Check-the-Box regulations ignore the existence of the entity and treat the owner as the taxpayer, so § 108 could only apply at the owner level.

195. Stephanie R. Hoffer, *Give Them My Regards: A Proposal For Applying The COD Rules To Disregarded Entities*, 107 TAX NOTES 327 (2005).

196. *Id.* at 330.

197. *Id.* at 330-33. Ms. Hoffer not only proposed that § 108 apply at the LLC level, but supported her argument by pointing out that the Service itself has regarded disregarded entities when "state property laws or basic tax principles require it." *Id.* at 333. As she explained in introducing her proposal:

To support its proposal, this article first examines the section's treatment of partnerships and S corporations, comparing those entities to disregarded entities. Next, the article discusses the tax evolution of disregarded entities, focusing primarily on instances in which the IRS has respected them as separate from their owners. The article then explores the difficulty of applying current section 108 to bankrupt or insolvent disregarded entities and finally concludes that all state law entities possessing distinct property rights should be respected as such when assessing the tax results of forgiveness of indebtedness under section 108.

*Id.* at 327-28.



taxpayer should suffer *all* of the consequences of that decision, not just those that are favorable.<sup>198</sup> If the taxpayer wants to have § 108 apply at the entity level, it can easily change its elections. If the taxpayer is willing to suffer the tax consequences of such revocation, should it be entitled to have the separate existence of the entity respected for tax purposes.

## 2. *Administrative Dissolution*

Another area in need of clarification is the effect of the administrative dissolution of a corporation. The problem arises when a corporation fails to comply, usually inadvertently, with a state-imposed requirement, and under state law that failure results in the involuntary dissolution of the corporation.<sup>199</sup> In most of the cases that have come before the Service, when the fact of dissolution is discovered the corporation takes the necessary steps to be reinstated as such under state law. Under the laws of some, but not all, states, the reinstatement relates back to the initial dissolution. If the administrative dissolution causes the corporation to cease to be a corporation under state law, strict application of the Check-the-Box regulations would cause the dissolution to be treated as a liquidation for tax purposes, after which the entity will be treated as a disregarded entity if it has only one owner, or as a partnership if it has multiple owners.<sup>200</sup> If the state law problem is subsequently cured and corporate status under state law is restored, the Check-the-Box regulations would treat that restoration as an incorporation transaction to which § 351 or the liq-

---

Ms. Hoffer used *Dover v. Comm'r*, 122 T.C. 324 (2004) and I.R.S. Priv. Ltr. Rul. 2003-15-001 (Sept. 19, 2002) as I do, but she also pointed to Prop. Treas. Reg. § 1.752-2(a), 69 Fed. Reg. 49,832-01 (Aug. 12, 2004) as an example of the government's regarding disregarded entities. As explained above, I disagree with that assessment of those proposed regulations. See *supra* notes 181-91 and accompanying text.

198. Ms. Hoffer argued that:

Failing to apply *section 108* to disregarded entities at the entity level results in federal tax distortion of the state law business arrangement as well as a potential reduction in government revenue. These are problems the code should avoid in the interests of federalism, equity, and taxpayer ease of use. Failing to regard a disregarded entity in debt situations fails to respect the state law rights of the entity and is an approach that should be rejected.

*Id.* at 338. I disagree because disregarding single-member LLCs as entities separate from their owners itself provides a significant "distortion of state law business arrangement[s] as well as a potential reduction in government revenue." *Id.* Yet, that is what the Treasury and the IRS chose to do in promulgating the Check-the-Box regulations. I see no reason to depart from that approach when the entity's debt, which was treated as the owner's debt for tax purposes, presumably entitling the owner to interest deductions, is forgiven. I am simply calling for consistency.

199. See John E. Bragonje, *The Rise and Fall of the Check-the-Box Regime: A Solution to Recent Private Letter Rulings' Troubling Use of the De Facto Corporation Doctrine*, TAX NOTES TODAY, May 6, 2005, LEXIS, 2005 TNT 87-45.

200. Although the Check-the-Box regulations would permit such an entity to elect corporate status, that is not meaningful in these cases. By hypothesis, these are cases in which no one connected with the entity knows that the entity has been administratively dissolved under state law, so there is no one to make a Check-the-Box election. Furthermore, although the rescission doctrine would allow a taxpayer to ignore the dissolution if it was discovered in the same year it occurred, in many of the cases that have caused examination of the issue, the dissolution was not discovered until after the year in which it occurred.

liquidation reincorporation doctrine could apply.<sup>201</sup> Both the liquidation and the reincorporation could result in the recognition of gain or loss.

The Service has not so analyzed these situations. Instead, when asked to rule on the tax consequences of administrative dissolutions the Service has merely noted that the determination of whether an organization is taxed as a corporation is a matter of federal law and that if the affairs of the corporation continue after the termination of its existence, the organization becomes an association taxable as a corporation.<sup>202</sup> Although the Service is correct in its apparent conclusion that administrative dissolution should not be treated as a liquidation, it has confused the application of the Check-the-Box regulations by not setting forth an analysis that is consistent with the application of those regulations.

Instead of ignoring the existence of the Check-the-Box regulations, the Service could, for example, allow the entities to make retroactive elections to be treated as corporations during the time of dissolution.<sup>203</sup> Alternatively, Treasury and the Service could amend the Check-the-Box regulations to provide that administrative dissolution will not alter the status of the entity as one incorporated under state law for federal tax purposes, or the Service might even issue a Ruling publicly announcing such an interpretation of the term "corporation" in the Check-the-Box regulations. The point is that the Service should consistently apply the Check-the-Box regulations and not just ignore them when such application is inconvenient or reaches a substantively unwarranted result. If application of the regulations is not warranted, the Service should so state and then should create an appropriate exception. Doing otherwise only creates confusion and leaves taxpayers to wonder whether the regulations will apply in any given case.

Otherwise, if this were an area of the tax law where substance mattered, perhaps I would feel differently. But in the area of entity classification, substance no longer matters.<sup>204</sup> The Treasury decided that when it issued the Check-the-Box regulations and made classification elective.

---

201. See BITTKER & EUSTICE, *supra* note 180, ¶ 12.64; Richard W. Bailine, *The Elucidation of the Liquidation-Reincorporation Doctrine*, 30 J. CORP. TAX'N 34 (2003). The current corporate priority guidance plan includes promulgating regulations concerning the liquidation-reincorporation doctrine in the context of section 336(e). See Jasper L. Cummings, *Treasury's 2005-2006 Corporate Priority Guidance Plan*, 108 TAX NOTES 1195 (2005). See OFFICE OF TAX POLICY AND INTERNAL REVENUE SERVICE: 2005-2006 PRIORITY GUIDANCE PLAN, available at <http://www.treas.gov/press/releases/reports/20052006%20gpl1st%20update-revised1.pdf>.

202. See I.R.S. Priv. Ltr. Rul. 2001-14-029 (Jan. 8, 2001); I.R.S. Priv. Ltr. Rul. 2001-23-058 (Mar. 13, 2001); I.R.S. Priv. Ltr. Rul. 2002-52-033 (Aug. 27, 2003); I.R.S. Priv. Ltr. Rul. 2003-15-20 (Jan. 6, 2003); I.R.S. Priv. Ltr. Rul. 2005-35-017 (May 26, 2005); I.R.S. Priv. Ltr. Rul. 2005-39-005 (June 17, 2005).

203. This solution is suggested by Bragonje, *supra* note 199. Under this analysis, neither the dissolution nor the reinstatement would have any tax consequences because, even if the state law corporation and the elected corporation were seen as different, the conversion from one into the other would qualify as an "F" reorganization, resulting in no gain or loss at either the corporate or shareholder levels.

204. Whether it should is, of course, a separate question, beyond the scope of this article.

Having struck a blow for administrability in so doing, it should not squander the gains it made by letting substance creep back into the analysis.

While creating an exception to the application of the Check-the-Box regulations in the case of administrative dissolution might be construed as surrendering to the lure of substance and muddying the rules, that need not be the result. Mud results when the edges of the rules become unclear. However, what I am suggesting here is creating a more complex rule, not converting a rule into a standard.<sup>205</sup> The creation of a more complex rule to deal with administrative dissolution casts a blow for administrability, removing the uncertainty that now exists and the need for the Service to issue a multitude of PLRs permitting retroactive elections. It is entirely consistent with the rationale behind the issuance of the Check-the-Box regulations.

#### F. PAYMENT AND COLLECTIONS—THE PLACE FOR A STANDARD

Using a rule to determine the tax consequences of transactions involving disregarded entities ensures that the Check-the-Box regulations accomplish their objective of providing certainty in an area of the tax law that affects many taxpayers. Because the classification is elective, taxpayers can avoid any consequences they do not want by changing their elective classification.<sup>206</sup> Consistent application of the default rule established by the Check-the-Box regulations will ensure that the goal of increased administrability in this area is achieved.

But one rule does not fit all circumstances. Consistently disregarding the separate existence of the entity for federal tax purposes is feasible because only federal tax law is involved in the determination of federal tax liability. Therefore, federal tax law can choose to ignore the substance of state law attributes if doing so promotes a higher goal, such as, in this case, certainty and predictability in the administration of the tax laws. However, when it comes to collecting the amount of tax due, federal law cannot override state law.<sup>207</sup> Therefore, in matters of assessment, collection, and payment a standard should apply.

The Check-the-Box regulations were designed to allow taxpayers to elect pass-through taxation regardless of the attributes of their non-corporate entity, and to provide certainty in that determination regardless of

---

205. As Louis Kaplow has pointed out, rules need not be either simple or simplistic. Kaplow, *supra* note 12, at 565-66. Constitutive rules, which themselves create a regime, like the rules of games and the rule adopted in the Check-the-Box regulations, are particularly apt subjects for complexity, particularly if the complexity breeds clarity and administrability. See SCHAUER, *supra* note 12, at 6-7.

206. The taxpayer's power to change elective classification is not unlimited, as the regulations require consent for any change within five years of a previous change. Treas. Reg. § 301.7701-3(c)(1)(iv) prohibits an entity from changing its classification within sixty months of the initial effective date, unless it obtains permission from the IRS. Treas. Reg. § 301.7701-3(c)(1)(iv) (as amended in 2005). In practice, taxpayers have found this to be a relatively easy hurdle to overcome, but that is a topic beyond the scope of this piece.

207. See discussion of *Drye v. United States*, 528 U.S. 49 (1999) and *infra* note 208-09 and accompanying text.

the specific attributes of the entity. Nothing in those objectives suggests that the government's ability to collect the tax due should be constrained. The certainty taxpayers expect can be provided by a rule that allows taxpayers to determine the tax consequences of transactions *ex ante*. Those are the situations in which taxpayers are most likely to seek legal advice before choosing a course of action and in which the promulgation of rules is most efficient.<sup>208</sup>

*Ex post* determinations involve different considerations and should be made by using a standard to determine who is the legal owner of the property that gave rise to the tax liabilities in question. The goal of administrability is not hampered by the government's application of a standard in this context. Not only are these not situations in which taxpayers tend to seek legal advice before acting, but allowing the government to enforce payment from whoever has legal control over the assets that gave rise to the liability—even if the person who controls the assets is not the same as the person who is the taxpayer for purposes of determining the tax consequences of transactions—simply ensures that all taxpayers are treated equitably by allowing enforcement of tax liabilities attributable to their activities.

In matters of collection, there is no need to disregard the separate existence of the entity. For years, the Service has struggled with the problems that arise when assets are owned by a legal entity that for tax purposes did not exist and was therefore not the taxpayer whose assets could be levied or seized. Although disregarding the separate existence of the entity has allowed the Service to collect from the single owner,<sup>209</sup> by not treating the entity as the taxpayer the Service loses the ability to collect from the entity itself. As the Service has explained in Chief Counsel Advice:

In *Drye v. United States*, 528 U.S. 49 (1999), the Supreme Court articulated a two-prong test to determine a taxpayer's property and rights to property. . . . First, a taxpayer's interests or rights must be determined under state law. Second, one must determine whether such interests or rights are property or rights to property under the Internal Revenue Code. If under the first prong, a taxpayer has no interest in or rights to particular property under state law, it follows that the IRS has no right to levy the particular property under the Internal Revenue Code.

Under the first prong of the Drye test, one looks to state law to determine a taxpayer's interest. Under state law, the taxpayer/single member owner has no interest in the LLC's property. Thus, as a general rule, even though an LLC is disregarded as an entity separate from the single member owner, and its activities are treated in the

---

208. Kaplow, *supra* note 12, at 568-579.

209. Indeed, this was the situation that led to the challenge to the validity of the regulations. See *Littriello v. United States*, No. 3:04CV143H, 2005 U.S. Dist. LEXIS 9813 (W.D. Ky. May 18, 2005). The Service's litigating position in *Littriello* was consistent with that which it had previously taken in Chief Counsel Advice. See I.R.S. Chief Couns. Adv. Mem. 1999-22-053 (June 15, 1999).

same manner as a sole proprietorship, branch, or division of its single member owner, for federal tax liability purposes, the IRS cannot satisfy the single member owner's tax liability from the disregarded LLC's assets.<sup>210</sup>

Although concluding that it could not levy against the assets of the LLC directly did not leave the Service without remedy,<sup>211</sup> it unquestionably hampered collection efforts. The problems included determining who should receive a collection due process notice,<sup>212</sup> whether assessment notices issued in the name of the LLC were valid,<sup>213</sup> whether single member

---

210. I.R.S. Chief Couns. Adv. Mem. 2003-38-012 (Sept. 19, 2003), *reprinted in LLC Not "Other Person" for Employment Tax Purposes*, TAX NOTES TODAY, Sept. 24, 2003, LEXIS, 2003 TNT 185-19. Prior Chief Counsel Advice was to the same effect; in CCA 1999-30-013, Kathryn Zuba, the Chief of Branch 2 (General Litigation), concluded that although a single-member LLC is a disregarded entity for federal tax purposes, it is an entity separate from its owner for state law purposes, and that the Service *cannot* collect from the LLC's property in order to satisfy the single owner's federal tax liability. I.R.S. Chief Couns. Adv. Mem. 1999-30-013 (July 30, 1999). Ms. Zuba reached this conclusion by reasoning that §§ 6321 and 6331 only permit collection from the property of the person liable for the tax and that the person liable for the tax was the individual owner, who does not own the property of the LLC under state law. *Id.* She concluded that:

[W]e do not believe that it is inconsistent to disregard an LLC entity for purposes of determining federal tax liability, but to recognize the LLC as a valid entity for determining what property the taxpayer has an ownership interest in under state law. This result follows from the general principal [sic] that state law determines what property a taxpayer has an interest in for purposes of tax collection.

*Id.* See also *Memorandum for Associate Area Counsel, SB/SE:2 (Washington, DC)*, TAX NOTES TODAY, Sept. 3, 2002, LEXIS, 2002 TNT 170-19 (bearing a June 28, 2002 date but released on August 30, 2002).

211. As Zuba explained in CCA 1999-30-013, the Service could levy on the LLC to reach distributions due to the owner, which is property of the owner under state law. I.R.S. Chief Couns. Adv. Mem. 199-22-053 (July 15, 1999). In addition, the Service could "file alter ego liens in reliance on state law principles permitting a creditor to disregard a business entity" under the concept of piercing the corporate veil. *Id.* The CCA noted that at least one court has applied corporate piercing principles to LLCs, (*Hollowell v. Orleans Regional Hospital*, No. 95-4029, 1998 U.S. Dist. Lexis 8184 (E.D. La. May 29, 1998)), and cites Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143 (1994) for a discussion of when courts will allow piercing. *Id.* In general, piercing principles apply to LLCs. Michael G. Schinner, *IRS Rulings Expand Opportunities for Using Single-Member LLCs in 1031 Exchanges*, J. TAX'N 286, 292-93 (1998) (citing Cox and Woods, *Piercing the Veil in Limited Liability Companies*, 4 J. LIMITED LIABILITY COS. 83 (1997)). See also I.R.S. Chief Couns. Adv. Mem. 2002-16-028 (Mar. 20, 2002), (discussing the alter ego, or "piercing the corporate veil" argument and the difficulties of applying it, but also explores other possibilities, such as asserting nominee or transferee liability).

212. In CCA 2002-16-028, Mitchel S. Hyman, Senior Technical Reviewer for Branch 1, concluded that when the Service makes an assessment against a single-member LLC it should issue a separate collection due process ("CDP") notice to the owner even if the owner received the LLC's CDP notice, and thus had actual notice of the assessment because "[i]ts approach ensures that a single-member owner will receive the CDP safeguards that Congress enacted." I.R.S. Chief Couns. Adv. Mem. 2002-16-028 (Mar. 20, 2002). For analysis and commentary on this Chief Counsel Advice, see Nicholas J. Fiore, *Single-Member Owners of Disregarded LLCs Should Receive Separate Due Process Notices*, 7 THE TAX ADVISER 476 (2002).

213. In FSA 2001-14-006 and FSA 2001-05-045, two Assistant Chief Counsels concluded that assessments in the name and taxpayer identification number of a single-member LLC were valid when the employment tax returns were filed with the address of the sole owner as the address for the LLC, and that, even if the assessments were technically erroneous because not issued in the name of the sole owner, the sole owner was neither

LLCs should report and pay employment taxes under the name and taxpayer identification number of the LLC or of the owner,<sup>214</sup> and whether any changes in name or taxpayer identification number needed to be made when a disregarded entity acquired additional owners and became a partnership, or vice versa.<sup>215</sup> In most of its struggle over collections, the Service assumed that it would be bound by its decision to disregard the separate existence of the entity. The exception was Notice 99-6, where, in providing a choice with respect to employment taxes, the Service seemed to acknowledge the difficulties posed by the dual nature of such entities, which exist as separate entities for state law purposes such as opening bank accounts and depositing and paying state taxes.<sup>216</sup>

Eventually, the Treasury issued proposed regulations providing that a disregarded entity could be separately liable for federal taxes and would be subject to assessment, lien, and levy, and entitled to refunds or credits, when the liability arose from a time when the entity was not disregarded.<sup>217</sup> Although treating disregarded entities as separate entities in such circumstances could be justified as an application of a relation-back doctrine, the proposed regulations nevertheless departed from the lan-

---

prejudiced nor misled by the error so that the assessments would still be valid against the sole owner. I.R.S. Field Serv. Adv. Mem. 2001-14-006 (Apr. 2001); I.R.S. Field Serv. Adv. Mem. 2001-05-045 (Feb. 2, 2001). The FSAs relied on several cases in which courts had found that technical errors that did not deprive the taxpayers of notice would not operate to invalidate the assessments. One such case was *Marvel v. United States*, 719 F.2d 1507 (10th Cir. 1983), where the court upheld assessments made in the trade name of an unincorporated business rather than in the names of the individual owners of the business.

214. I.R.S. Notice 99-6, 1999-1 C.B. 321. See *infra* note 216.

215. In Rev. Rul. 2001-61, the Service ruled that if a disregarded entity that chose to calculate, report and pay its employment tax obligations under its own name and taxpayer identification number, as permitted by Notice 99-6, acquires additional owners and thus becomes a partnership as provided by Rev. Rul. 99-6, it must continue to use that taxpayer identification number to so report. Rev. Rul. 2001-61, 2001-2 C.B. 573. In Rev. Rul. 2001-61, the Service also ruled that if a partnership becomes a disregarded entity because it retains only one former partner, as provided by Treas. Reg. § 301.7701-3(f)(2) and Rev. Rul. 99-6, and if the disregarded entity has chosen to calculate, report and pay its employment tax obligations under its own name and taxpayer identification number, as permitted by Notice 99-6, the disregarded entity must continue to use the partnership's taxpayer identification number. *Id.* Nevertheless, the Service made it clear that for all other federal tax purposes, the disregarded entity must use the taxpayer identification number of its owner pursuant to Treas. Reg. § 301.6109-1(h)(2)(i). *Id.*

216. In Notice 99-6, the Service announced that it would accept calculation, reporting and payment of employment taxes with respect to employees of disregarded entities made in either in the name and taxpayer identification number of the owner, or under the name and taxpayer identification number of the entity. I.R.S. Notice 99-6, 1999-1 C. B. 321. The Service explained that if a taxpayer chose the second method, the owner of the disregarded entity would retain ultimate responsibility for the employment tax obligations and that it would respect that method even if the timing or amount of payments differed from what would have been the result if the first method had been chosen. *Id.* Notice 99-6 has been criticized as failing to include qualified subsidiaries of exempt title holding corporations or trusts, as defined in § 501(c)(25)(E)(i), and for not specifically preserving the ability of those types of subsidiaries to obtain separate taxpayer identification numbers when necessary for state law purposes. Emily W. Mao, *Attorney Notes Omission in Notice on Reporting and Payment by Disregarded Entities*, 83 TAX NOTES 831 (1999).

217. I.R.S., *IRS Clarifies Treatment of Disregarded Entities as Separate from Owners*, TAX NOTES TODAY, Apr. 5, 2004, LEXIS, 2004 TNT 65-70.

guage of the Check-the-Box regulations.<sup>218</sup> The speed with which those proposed regulations were finalized,<sup>219</sup> and the issuance of another set of proposed regulations in the same year that also recognized the separate existence of single member LLCs for purposes of payment of employment and excise taxes,<sup>220</sup> suggest that the Treasury might be having a change of heart with respect to the breadth of the rule it announced in the Check-the-Box regulations in the case of assessment, collection, and payment.<sup>221</sup>

The Treasury should have just such a change of heart, and it should announce that change by amending the Check-the-Box regulations. The Treasury should amend the Check-the-Box regulations to limit the application of the rule it announced there to *ex ante* determinations of the consequences of transactions. It should further announce that for purposes of assessment, collection, and payment of tax liabilities pertaining to the property or transactions undertaken by the LLC, the separate identity of the LLC will be respected when that is necessary to permit proper administration of the tax laws. Adoption of such a standard will allow assessment, collection or payment from the assets that gave rise to the liability in light of the constraints placed by the actual existence, under state law, of the LLC as separate entity. The Service can then im-

---

218. If a disregarded entity's separate legal existence were to be disregarded for all purposes under the Code, the proposed regulations would have provided that the single owner of the disregarded entity was the proper party to consent to extensions of time or against whom assessment and collection would proceed, regardless of whether the liability arose from a time when the entity was not disregarded.

219. The regulations were proposed on April 1, 2004 and finalized less than a year later, on February 25, 2005. T.D. 9183, 2004-32 I.R.B. 160.

220. On October 18, 2005, the Treasury issued proposed regulations that would treat disregarded entities as separate entities for employment tax and related reporting requirement purposes. Prop. Rul., 70 Fed. Reg. 60,475 (Oct. 18, 2005). These proposed regulations have not been warmly received by taxpayers, whose representatives have commented that they will impose significant administrative hardships. See, e.g., Kenneth Klein, *Attorney Raises Concerns With Proposed Regs on Employment Taxation of Disregarded Entities*, TAX NOTES TODAY, Jan. 13, 2006, LEXIS, 2006 TNT 16-20; Ray McCarty, *Institute Criticizes Proposed Regs on Employment Taxation of Disregarded Entities*, TAX NOTES TODAY, Dec. 30, 2005, LEXIS, 2006 TNT 28-23; Deborah Walker, *Deloitte Tax Comments on Proposed Regs on Employment, Excise Taxation of Disregarded Entities*, TAX NOTES TODAY, Jan. 19, 2006, LEXIS, 2006 TNT 16-21.

221. The Treasury might well have a change of heart more broadly, as the Service continues to have to cope with situations that were almost certainly unforeseen when the Check-the-Box regulations were issued. For example, the collections problems involving LLCs are not limited to disregarded entities. In Rev. Rul. 2004-41, the Service examined the question of whether it could collect employment tax liabilities from the members of an LLC that was treated as a partnership. Rev. Rul. 2004-41, 2004-18 I.R.B. 846. Although the Service acknowledged that it could collect against partners in a partnership, it noted that such a result followed because partners in a partnership were jointly and severally liable for the debts of the partnership. *Id.* In the case of an LLC treated for federal income tax purposes as a partnership, however, state law contains no such provision; on the contrary, state law provides that the members of the LLC are not liable for the debts of the LLC. *Id.* Therefore, the Service concluded that in the absence of fraud, it would not be able to proceed against the members of the LLC or their assets to satisfy unpaid employment tax liabilities of the LLC even if the members of the LLC had sufficient assets to satisfy the liability. *Id.*

plement the standard by the issuance of specific rules as it deems appropriate.

## VI. A PLACE FOR CRYSTALS AND A PLACE FOR MUD

Adoption of the model I have suggested would provide certainty to taxpayers *ex ante*, flexibility to the Service *ex post*, and bring transparency to the guidance process. It would free the Service to reach results such as those it reached in Revenue Ruling 2004-88,<sup>222</sup> while preventing the confusion that arises when the regulations seem to say one thing, but the Service seems to do another. Revenue Ruling 2004-88 illustrates the point. In that Ruling, the Service held that a partnership that had a single member LLC as a partner had a pass-through entity partner, and therefore could not be treated as a small partnership for purposes of the Tax Equity Fiscal Responsibility Act (“TEFRA”) partnership audit provisions. It also held that the single owner of the LLC could not serve as the tax matters partner.<sup>223</sup> Neither of these conclusions follow from the application of the Check-the-Box regulations, but both involve the *ex post* audit process. The Service seems to have reached these conclusions in the interest of administrability of the TEFRA provisions, but in the process, it reached conclusions that conflict with the Check-the-Box regulations because it failed to disregard the separate existence of the single member LLCs.

If the separate identity of the single member LLC partner that was the subject of Revenue Ruling 2004-88 were disregarded, its owner would be the partner for tax purposes. Only if that owner were a pass-through entity should the partnership be ineligible for treatment as a small partnership under the TEFRA audit procedures.<sup>224</sup> This result is inconsistent with the reason for the rule; only if the single owner of the LLC is itself a pass-through entity would the actual number of taxpayers whose returns are affected by partnership items differ from the nominal number of partners, thus permitting an end-run around the ten partner limitation of § 6231(a)(1)(B)(i). It also satisfies the requirement of § 6231(g), that the Service should be able to determine the application of the TEFRA provisions from the face of the partnership return because since the single member is the partner for tax purposes, the single member should be listed as the partner on the return.<sup>225</sup> Such a construction would also

---

222. Rev. Rul. 2004-88, 2004-32 I.R.B. 165.

223. *Id.* The TEFRA partnership provisions are codified in I.R.C. §§ 6221-6234 (2005).

224. Treas. Reg. §§ 301.6231(a)(1)-(2) provides that a partnership that has a pass-through partner, as defined in § 6231(a)(9), cannot be treated as a small partnership. Treas. Reg. §§ 301.6231(a)(1)-(2) (2001). Section 6231(a)(9) defines a pass-through partner as “a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which proceedings under this subchapter are conducted.” *Id.* § 301.6231(a)(9).

225. In Chief Couns. Adv. Mem. 2002-50-012, the Service listed § 6231(g) in support of its conclusion that a single-member LLC should be treated as a pass-thru partner, apparently assuming that the LLC, and not its single owner would be listed as the partner on the return. It did not explain why that should be the case. I.R.S. Chief Couns. Adv. Mem.



comport with the statutory definition of a pass-through partner, which is a “partnership, estate, trust, S corporation, nominee, or similar person” (emphasis added).<sup>226</sup> If the LLC is disregarded as an entity separate from its owner, as provided by the Check-the-Box regulations, it is not only *not* similar to a partnership, estate, trust, S corporation or nominee, but it is not a person at all for tax purposes.<sup>227</sup> Treating the LLC as a pass-through *partner* is patently inconsistent with the Check-the-Box regulations and calls into question the manner in which the Service will apply those regulations.<sup>228</sup> Inconsistency creates uncertainty and will ultimately return the law to its pre-Check-the-Box chaotic state. Paradise will have been lost.

Paradise, however need not be lost. If the Service finds it useful in the audit process to restrict exemption from the TEFRA partnership audit rules to situations where the legal partner is also the person in whose return the partnership items are taken into account, the Service should be able to regard the existence of the LLC for that purpose.<sup>229</sup> It will be able to do so without confusing the law on the Check-the-Box regulations if it has announced, as I suggest, that for purposes of assessment, collection, and payment it will respect the separate identity of the LLC insofar as necessary to permit proper administration of the tax laws. Announcing such a standard will allow the Service to reach conclusions such as the

---

2002-50-012 (Aug. 30, 2002), *reprinted in Disregarded Entity Rules Applied to TEFRA Small Partnership Exception*, TAX NOTES TODAY, Dec. 16, 2002, LEXIS, 2002 TNT 241-52. The instructions to Form 1065 provide that if a single-member LLC owns an interest in the partnership, and the LLC is treated as a disregarded entity, then the name and address of the owner of the disregarded entity should be listed on the Schedule K-1 where it asks for the partner's name, address, and other identifying information. I.R.S. INSTRUCTIONS TO FORM 106522, (bottom of the middle column), *available at* <http://www.irs.gov/pub/irs-pdf/i1065.pdf>. The Service should therefore have no trouble identifying the true partner for tax purposes.

226. Chief Couns. Adv. Mem. 2002-50-012.

227. A disregarded entity also differs from a grantor trust because although income and deductions of a grantor trust are taxed as if earned or incurred by the grantor, the Service does not take the position that the existence of the trust should be disregarded for tax purposes. A grantor trust exists, but it is a pass-through entity. By contrast, under the Check-the-Box regulations, a disregarded entity does not exist for tax purposes. The Check-the-Box regulations do not say that a single-member LLC will be treated as a pass-through. Instead, they specifically say that it will be treated as a branch or proprietorship.

228. The Service seems to have acknowledged that it was reaching a result inconsistent with disregarding the separate identity of the LLC when it noted in Chief Couns. Adv. Mem. 2002-50-012 that “the disregarded entity regulations did not even exist when Congress enacted sections 6231(a)(1)(B) and 6231(a)(9).” Chief Couns. Adv. Mem. 2002-50-012. My claim is not that the Service was wrong in reaching the conclusion it did in the Chief Couns. Adv. Mem. and in Rev. Rul. 2004-88. Rather, my claim is that the Service ought to be able to reach a result that it feels is administratively sensible without trying to fit that result within the parameters of the Check-the-Box regulations.

229. That is precisely what the Service did in Chief Couns. Adv. Mem. 2002-50-012. The Service gave administrability as the reason it was concluding that the single-member LLC would be a pass-thru partner. Chief Couns. Adv. Mem. 2002-50-012. My point is not that the Service was wrong to want to regard the disregarded entity for purposes of administering the TEFRA audit provisions. My point is that the Service should be able to state that for return filing and other audit purposes, it will not ignore the separate existence of the LLC and not have to justify its decision in ways that are inconsistent with the position taken in the Check-the-Box regulations.

one it reached in Revenue Ruling 2004-88 without contorting the application of the Check-the-Box regulations.

Adoption of the bifurcated analysis that I propose is supported by the scholarship that addresses the operation of rules and standards. First, that scholarship shows that the development of the Check-the-Box regulation followed a well worn pattern of evolution from crystals to mud and back again. Carol Rose's work explores this pattern by showing that several important areas of property law have cycled between crystalline rules and muddy standards.<sup>230</sup> She posits that as an area of the law becomes more important to more people, its very ubiquity demands clear rules with high predictive capability. The crystalline rules clear away the mud, but the mud returns as decision makers blunt the hard edges of the rule to effect justice in particular cases. Eventually the crystal again becomes mud, and the cycle starts all over again.

That pattern is starkly evident in the development of the tax law that attempted to define what types of entities should be treated as corporations for tax purposes. As Part I of this article has shown, the law on entity classification has cycled between muddy standards and crystalline rules from the inception of the income tax. Indeed, it was the muddied state of the law that led Treasury to propose incrementally crystalline rules designed to allow both the Service and taxpayers to determine the tax characterization of an unincorporated entity. The Treasury's efforts did not stem the devolution into mud until 1996, when in frustration over its inability to function in the mud created by the application of the *Kintner* regulations, the Treasury promulgated the seemingly crystalline Check-the-Box regulations. Now, the Service's fledgling attempts to apply the rule created by those regulations threaten to muddy the field again. Guidance that sometimes regards, and other times disregards, the separate existence of an entity without setting forth a theoretical framework to explain the difference can only serve to muddy the crystalline edges of the Check-the-Box regulations. Mud is soft. Sinking into it, like taking a bite of the serpent's apple, can seem like the only thing to do. This article is an attempt to stop the cycling between crystals and mud by showing that given the promulgation of the Check-the-Box regulations, when it comes to entity classification *ex ante* crystals are better than mud, no matter how seductive the latter.

A crystalline rule is especially apt for entity classification *ex ante* not only for all of the reasons that make rules especially efficient *ex ante*,<sup>231</sup> but also because the adoption of a crystalline rule here does not mean that substance has to be forsaken forever. As discussed in Part III(B), above, the Check-the-Box regulations only provide a first-cut answer to the question "For federal tax purposes, what kind of entity are you?"

---

230. See Rose, *supra* note 12.

231. Rules offer certainty and predictability at a time when taxpayers are most likely to seek legal advice before acting and, in this case, before deciding whether to make an election. Kaplow, *supra* note 12, at 568-81.

That first cut answer is very important and in many cases will be the only answer necessary, but it need not be determinative of the way in which an entity's transactions will be treated any more than concluding that an entity is unquestionably a corporation determines that all actions that it undertakes are given effect for federal income tax purposes. That Monitor was a corporation did not mean that Mrs. Gregory's desired tax result came to pass.<sup>232</sup> Furthermore, in matters of assessment, collection, and payment, where the efficiency and administrability gains of rules do not obtain, a standard can be announced to preserve the government's ability to collect the amount of revenue properly due from each taxpayer whose property gives rise to that liability.

The soundness of the bifurcated approach I suggest maximizes the benefits of using rules as well as standards. As Kaplow has pointed out, rules are most effective when the subject matter has wide applicability and involves matters in which legal advice is likely to be sought before action is taken—*ex ante* creation of the law.<sup>233</sup> By contrast, standards are best suited for *ex post* application of the law, where action has taken place, typically without the benefit of prior legal advice, and the task for the law is to determine the legal consequences of that action.<sup>234</sup> Kaplow's analysis suggests that while the Treasury may have been wise to have adopted a rule disregarding the separate existence of single member LLCs in the Check-the-Box regulations, it would not be wise to apply that rule both *ex ante* and *ex post*. The difficulties the Service is having in applying the rule in the audit and collection process show that Kaplow was right to have distinguished *ex ante* from *ex post* applications, and that it is sound for the Service to do likewise.

This bifurcated approach to the adoption of rules and standards is further supported by Duncan Kennedy's observation that "individualism seems to harmonize with an insistence on rigid rules rigidly applied."<sup>235</sup> In promulgating the Check-the-Box regulations and allowing owners of unincorporated entities to elect the tax treatment of those entities, the Treasury maximized individual choice; rigidly applying the rule of Check-the-Box regulations preserves that choice. The Service and the Treasury adopted a rule to provide certainty and administrability, and only consistent application of the rule in situations where the determination is important *ex ante* will allow the Treasury and the Service to achieve the administrability gains of letting taxpayers decide. However, the reasons for adopting a rule *ex ante* do not apply to determinations in matters of assessment, collection, and payment, *ex post*. Individualism is not the concern there—sound administration of the tax laws is. A different approach to problems of assessment, collection, and payment, which is re-

---

232. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

233. Kaplow, *supra* note 12 at 597-98.

234. *Id.*

235. Kennedy, *supra* note 12, at 1685.

sponsive to the constraints placed on the Service by state law concepts of ownership, is therefore appropriate.

## V. CONCLUSION

The creation of disregarded entities nearly a decade ago marked the end of administrative attempts to determine entity classification as a matter of substance. By providing for elective classification in the Check-the-Box regulations, the Treasury and the Service promised to usher in an era of simplicity and predictability. Experience has shown how easy it is to blur the seemingly clear lines drawn in those regulations. The Treasury and the Service are returning the law to its pre-Check-the-Box confused state because they lack a principled way of distinguishing between situations where the clear rule of those regulations should apply and situations where a more nuanced determination is desirable. This article has not only canvassed and evaluated the administrative experience with the domestic implementation of the Check-the-Box regulations, but it has also suggested an analytical approach designed to retain the crystalline approach where it will serve the goals of certainty and predictability, while allowing for a more nuanced approach where necessary to permit the sound administration of the tax laws.

The Treasury and the Service might take their cue from the Tony award winning play and Oscar-winning motion picture *Chicago*, which illustrates the pitfalls of oscillating between regarding and disregarding without a principled analysis to determine when to do what. In *Chicago*, Amos, the husband of the female lead, Roxie Hart, is so often ignored that he sings what could well be the anthem of disregarded entities. Amos proclaims:

Cellophane,  
Mr. Cellophane,  
should have been my name,  
Mr. Cellophane,  
'cause you can look right through me,  
walk right by me, and never know I'm there.

The inconsistency with which Roxie treats Amos threatens to undo her. Roxie ignores Amos and has an affair, but relies on him to be there and take the blame for the murder she commits. He asserts himself when he discovers she's cheated on him, and that gets her arrested. She then ignores him while she is in jail, but is forced to confront his existence when she alleges pregnancy. Although she wants to ignore his existence, the legal system recognizes him as her husband, so ignoring him is actually impossible. At her trial, she sees the wisdom of regarding him as her husband and thereby delights the jury, which acquits her. While the analogy is not perfect and the legal system depicted in the show is certainly not a *desideratum*, Roxie's relationship to Mr. Cellophane nevertheless serves as a cautionary tale. When the existence of a disregarded entity is acknowledged by substantive law, even those who would prefer to disre-

gard may have little practical choice but to concur, particularly if they need to get the property that the disregarded entity has. If an entity must be regarded some of the time, principle should guide what those times are. This article has attempted to suggest such a principle.