

LB&I Concept Unit Knowledge Base - International

Library Level	Number	Title
Shelf	–	Cross-Over
Book	19	Organization / Restructuring
Chapter	19.2	Evaluation of corporate transactions
Section	N/A	N/A
Sub-Section	N/A	N/A

Unit Name	Overview of Entity Classification Regulations (a/k/a Check-the-Box)	
Primary UIL Code	9415.02	Evaluation of Corporate transactions

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General Overview

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

When a business entity is created, a determination must be made as to how the entity should be treated for U.S. income tax purposes (its tax classification). Some entities are treated as flow-throughs; their income, losses, and credits flow through to their owners and are subject to tax at the owner level, whether or not actually distributed. Other entities, such as corporations (also known as associations) are subject to income tax at the entity level and then subsequently at the owner (shareholder) level when income is actually distributed to the owner.

Prior to the entity classification regulations an entity's tax classification as a corporation or flow-through entity was determined by multi-factor *Kintner* regulations that enumerated six characteristics of a corporate venture and the classification turned on possession of more or less of the factors. The application of these regulations was theoretically simple, but practically complex because of uncertainty in determining whether an entity possessed any given factor and the rise of limited liability companies and limited liability partnerships (LLCs and LLPs) which narrowed factor distinctions.

The IRS announced in Notice 95-14 its intention to simplify the entity classification process. Final entity classification regulations under IRC 7701, also known as Check-the-Box or CTB regulations, were generally effective January 1, 1997 for all domestic and foreign eligible entities. The regulations allow an eligible (i.e., *not* automatically classified as a corporation) entity to elect to be classified as a corporate (association) or a flow-through (partnership or an entity disregarded from its owner (DRE)) for U.S. income tax purposes.

An entity is a deemed corporation if it is so formed under federal or state corporate statutes, or is a type of foreign entity found on a comprehensive list found in Treas. Reg. 301.7701-2(b)(8) ("per se" foreign corporations). These entities are automatically classified as corporations and are not eligible to elect their classification. All other business entities are eligible to elect their classification. If no election is made, a default classification will apply, depending on the number of owners, and for a foreign entity, whether the owners have limited or unlimited liability.

One of the results of the elective nature of the CTB regulations is that a foreign entity may be treated differently for U.S. tax purposes than the entity is treated under foreign law. An entity may be classified as a flow-through entity for in the U.S. tax purposes but as a corporation in a foreign tax purposes (commonly referred to as a "hybrid entity") or vice versa (a "reverse hybrid entity"). Issues regarding the use of hybrid entities in the context of the CTB regulations is the subject of future units.

Relevant Key Factors

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

Key Factors

- Default classification if no election is made (Treas. Reg. 301.7701-3(b)):
 1. Domestic eligible entities: (a) a partnership if two or more members [i.e., owners], or (b) a DRE if a single owner (Treas. Reg. 301.7701-3(b)(1))
 2. Foreign eligible entities: (a) a partnership if two or more members and at least one does *not* have limited liability, (b) a corporation if all members have limited liability, or (c) a DRE if a single owner without limited liability (Treas. Reg. 301.7701-3(b)(2))
- To elect an alternative classification, there are two factors needed under the CTB Regulations (Treas. Reg. 301-7701-1 through -3):
 1. Eligible entity (Treas. Reg. 301.7701-3(a)), and
 2. Filed election (Treas. Reg. 301-7701-3(c))
- There are generally three factors for an eligible entity:
 1. Not an individual,
 2. A business entity (Treas. Reg. 301-7701-2(a)), and
 3. Not a “per se” corporation (automatically classified as a corporation) (Treas. Reg. 301.7701-2(b); Treas. Reg. 301.7701-3(a))
- There are generally three requirements to make an election (Treas. Reg. 301.7701-3(c)):
 1. A properly completed and filed Form 8832 (“Entity Classification Election”) (Treas. Reg. 301.7701-3(c)(1)),
 2. Not electing a change in classification within 60 months of the effective date of a prior election to change classification (Treas. Reg. 301.7701-3(c)(1)(iv)), and
 3. Signed by each owner-member or an authorized officer, manager, or member (Treas. Reg. 301.7701-3(c)(2))
- Upon certain entity ownership changes and in elective changes of classification, certain deemed steps take place to effectuate the change (Treas. Reg. 301.7701-3(g))

Detailed Explanation of the Concept

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

The first consideration is whether the entity is domestic or foreign.

Analysis	Resources
<ul style="list-style-type: none">▪ First, determine whether the entity is a domestic or a foreign business entity.<ul style="list-style-type: none">– A business entity is domestic if it is created or organized as any type of entity in the United States or under the laws of the United States or of any State. A business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity.– A business entity is foreign if it is not domestic.▪ A determination of whether a business entity is domestic or foreign is made independently from the proper classification of that entity.<ul style="list-style-type: none">– The domestic vs. foreign determination must be done before the classification determination because it is key to proper classification and election.	<ul style="list-style-type: none">▪ Treas. Reg. 301.7701-5(a)

Detailed Explanation of the Concept (cont'd)

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

If a business entity is domestic, certain classification defaults apply in absence of an election, unless the entity is a “per se” corporation.

Analysis	Resources
<p>If no election is made, a domestic entity’s default classification is determined as follows:</p> <ul style="list-style-type: none"> ▪ A domestic entity which is not a “per se” corporation is an “eligible” entity classified as: <ul style="list-style-type: none"> – A partnership if it has two or more members (i.e., owners), or – A DRE if it has a single owner. ▪ A domestic entity is a “per se” corporation, not eligible to elect, if it is: <ul style="list-style-type: none"> – Organized under a Federal or State statute (or a statute of a federally recognized Indian tribe) if the statute describes or refers to the entity as incorporated, or as a corporation, body corporate, or body politic; a joint-stock company or association; an insurance company; a State-chartered bank; an entity owned by a State, political subdivision, or foreign government; and a business entity that is taxable as a corporation under a provision of the Internal Revenue Code other than IRC 7701(a)(3). An eligible entity that elects or defaults to be an association (corporation under Treas. Reg. 301.7701-2(b)(2)) is not a “per se” corporation. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 301.7701-3(a) ▪ Treas. Reg. 301.7701-3(b)(1) ▪ Treas. Reg. 301.7701-2(b) ▪ Treas. Reg. 301.7701-2(b)(1); (3); (4); (5); (6); (7) ▪)

Detailed Explanation of the Concept (cont'd)

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

If a business entity is foreign, certain classification defaults (different than domestic) apply in absence of an election, unless the entity is a “per se” corporation.

Analysis	Resources
<p> CAUTION: Foreign default rules differ from domestic default rules!</p> <p>If no election is made, a foreign entity’s default classification is determined as follows:</p> <ul style="list-style-type: none"> ▪ A foreign entity which is not a “per se” corporation is an “eligible” entity classified as: <ul style="list-style-type: none"> – A partnership if it has two or more members (i.e., owners) and at least one member does not have limited liability, – A corporation (“association”) if all members have limited liability, or – A DRE if it has a single owner that does not have limited liability. ▪ Limited liability generally means a member has no personal liability for the debts of the entity by reason of being a member. This determination is made under the law of the jurisdiction under which the entity is organized. ▪ A foreign business entity is a “per se” corporation, not eligible to elect, if it is: <ul style="list-style-type: none"> – A specifically enumerated type of foreign entity listed in the regulations dealing with foreign organized entities. <ul style="list-style-type: none"> ▪ Some narrow clarifications and exceptions to this are also specified in the regulations. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 301.7701-3(b)(2)(i) ▪ Treas. Reg. 301.7701-3(b)(2)(ii) ▪ Treas. Reg. 301.7701-3(a) ▪ Treas. Reg. 301.7701-2(b)(8)(i) ▪ Treas. Reg. 301.7701-2(b)(8)(ii)

Detailed Explanation of the Concept (cont'd)

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

A more detailed analysis of entities eligible to elect their classification.

Analysis	Resources
<ul style="list-style-type: none"> ▪ The CTB regulations provide the ability for eligible entities to affirmatively elect their classification for U.S. federal tax purposes. ▪ An eligible entity must not be an individual, must be a business entity, and not be an entity automatically classified as a corporation (“per se”). <ul style="list-style-type: none"> – Separate Entity: Whether an entity is separate from its owner is a matter of federal tax law, not local law. Joint undertakings or contractual arrangements may be separate if used to carry on a trade, business, venture or the like where participants divide the profits therefrom, but mere expense sharing or passive co-ownership will not create a separate entity. – Cost sharing arrangements (Treas. Reg. 1.482-7) are specified as not being separate. ▪ Business Entity: A business entity is any entity recognized for federal tax (including an entity with a single owner that may be a DRE) not properly classified as a trust (Treas. Reg. 301.7701-4) or otherwise subject to special treatment under the IRC. <ul style="list-style-type: none"> – Business trusts are generally not properly classified as trusts. ▪ Not “per se” corporation: A business entity is a “per se” corporation if, for example: (1) it is organized under a federal or state statute, (2) it is an insurance company, (3) it constitutes one of the foreign business entities enumerated in the regulations, and (4) it satisfies certain other requirements listed in the regulations. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 301.7701-1 through -3 ▪ Treas. Reg. 301.7701-1(a) ▪ Treas. Reg. 301.7701-1(c) ▪ Treas. Reg. 301.7701-2(a) ▪ Treas. Reg. 301.7701-4(b) ▪ Treas. Reg. 301.7701-2(b)

Detailed Explanation of the Concept (cont'd)

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

In general, the procedure for filing an entity classification election.

Analysis	Resources
<ul style="list-style-type: none"> ▪ An entity elects a classification by filing a complete Form 8832 (Entity Classification Election), with a designated service center, in accordance with form instructions. <ul style="list-style-type: none"> – An eligible entity with at least two owners can elect to be classified as either an association (i.e., a corporation) or a partnership. – A single owner eligible entity can elect to be classified as a DRE or corporation. ▪ A copy of Form 8832 must be attached to the entity's Federal tax or information return for the year of election, or if none is filed to a return of any direct or indirect owner. ▪ The election is effective on the date specified on Form 8832. If not specified then on the date filed. The effective date cannot be more than 75 days prior to the date the election is filed (retroactive date) and not more than 12 months after the date the election is filed. ▪ Once an entity elects to change its classification, it cannot change its classification by election again during the sixty months succeeding the effective date of the election, unless the Commissioner grants permission after a greater than 50% ownership change. An election by a newly formed eligible entity that is effective on the date of formation is not counted as a change for purposes of the 60-month limitation. ▪ The Form 8832 must be signed by each member of the electing entity who is an owner at the time the election is filed or an authorized officer, manager, or member who will attest to such authorization under penalties of perjury. ▪ The Service Center will mail back an acceptance or non-acceptance letter. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 301.7701-3(a) ▪ Treas. Reg. 301.7701-3(c)(1)(i) and (ii) ▪ Treas. Reg. 301.7701-3(c)(1)(iii) ▪ Treas. Reg. 301.7701-3(c)(1)(iv) ▪ Treas. Reg. 301.7701-3(c)(2)

Detailed Explanation of the Concept (cont'd)

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

Remedial provisions for failing to make an election or failing to make an election properly.

Analysis	Resources
<ul style="list-style-type: none">▪ Failure to attach an election to the appropriate income tax or information return does not invalidate the election, but the non-filer may be subject to penalties.▪ Failure to timely file may be remediated:<ul style="list-style-type: none">– Automatically under certain circumstances within 3 years and 75 days of the requested effective date of the eligible entity's classification election.– Certain foreign entity elections may be automatically corrected where a mistake in the number of owners exists.– “9100 relief” may be available in certain circumstances to extend the time to make intended elections.▪ However, Exam lacks the authority to cure a late filed Form 8832.	<ul style="list-style-type: none">▪ Treas. Reg. 301.7701-3(c)(1)(ii)▪ Rev. Proc. 2009-41, 2009-39 I.R.B. 439 & Form 8832 Part II▪ Rev. Proc. 2010-32, 2010-36 I.R.B. 320▪ Treas. Reg. 301.9100-1 through -3

Detailed Explanation of the Concept (cont'd)

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

The mechanics of deemed steps that may occur if there are changes in the number of owners of an entity.

Analysis	Resources
<ul style="list-style-type: none">▪ Classification changes may occur if the number of members/owners change.<ul style="list-style-type: none">– An eligible entity classified as a corporation (association) will not be affected by a change in the number of members of the entity.– An eligible entity classified as a partnership becomes a DRE when the entity's membership is reduced to one member.– A DRE is classified as a partnership if its membership increases to more than one member.– Such changes do not count toward the 60-month limitation rule.	<ul style="list-style-type: none">▪ Treas. Reg. 301.7701-3(f)▪ Treas. Reg. 301.7701-3(f)(1)▪ Treas. Reg. 301.7701-3(f)(2)▪ Treas. Reg. 301.7701-3(f)(3)

Detailed Explanation of the Concept (cont'd)

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

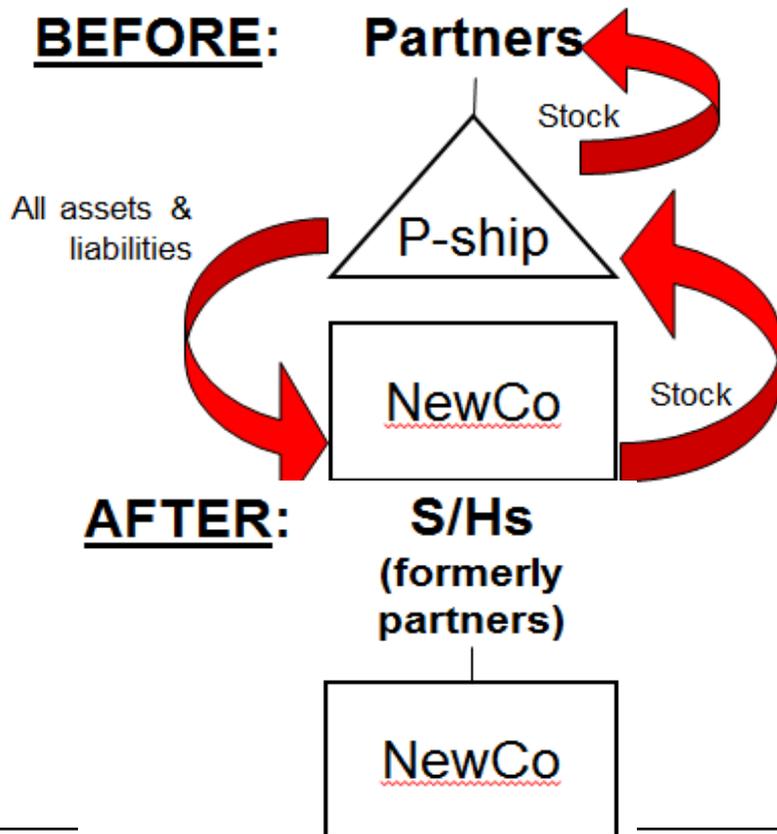
The mechanics of deemed steps that occur when elective changes in classification take place.

Analysis	Resources
<ul style="list-style-type: none">▪ Steps are also deemed to occur when elective changes take place.<ul style="list-style-type: none">– Classified Partnership Elects to Change to Corporation: The partnership is deemed to contribute all of its assets and liabilities to a corporation in exchange for stock of the corporation, and immediately thereafter, the partnership liquidates by distributing the stock to its partners.– Classified Corporation Elects to Change to Partnership: The corporation is deemed to distribute all of its assets and liabilities to its shareholders in liquidation. The shareholders immediately contribute the assets and liabilities to a new partnership.– Classified Corporation Elects to Change to DRE: The corporation is deemed to distribute all of its assets and liabilities to its single owner in liquidation.– Classified DRE Elects to Change to a Corporation: The owner of the DRE is deemed to contribute all of the assets and liabilities of the DRE to the corporation in exchange for stock of the corporation.	<ul style="list-style-type: none">▪ Treas. Reg. 301.7701-3(g)▪ Treas. Reg. 301.7701-3(g)(1)(i) ▪ Treas. Reg. 301.7701-3(g)(1)(ii) ▪ Treas. Reg. 301.7701-3(g)(1)(iii) ▪ Treas. Reg. 301.7701-3(g)(1)(iv)

Examples of the Concept

Example Overview of Entity Classification Regulations (a/k/a Check-the-Box)

Classified Partnership Elects to Change to Corporation



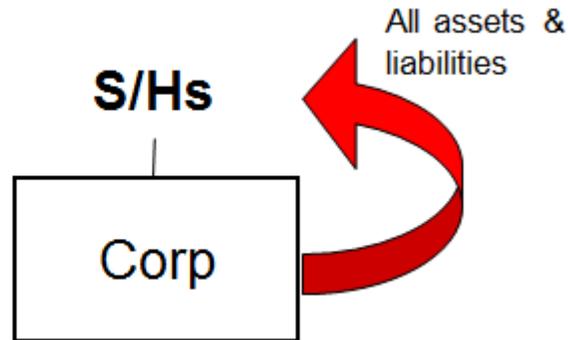
- P-ship is deemed to contribute all of its assets & liabilities to NewCo in exchange for NewCo stock
- P-ship immediately distributes that stock to its partners in liquidation
- Afterwards the former partners, now shareholders, own all of the NewCo stock
- Treas. Reg. 301.7701-3(g)(1)(i)

Examples of the Concept (cont'd)

Example Overview of Entity Classification Regulations (a/k/a Check-the-Box)

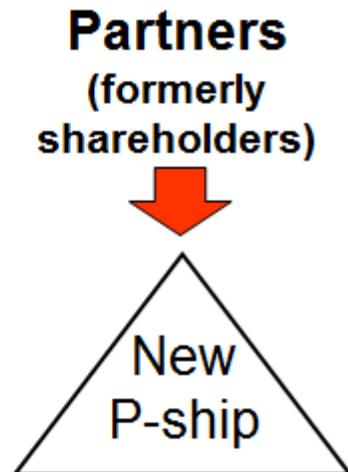
Classified Corporation Elects to Change to Partnership

BEFORE:



- Corp is deemed to distribute all of its assets and liabilities to its S/Hs in liquidation of Corp
- Immediately thereafter, the S/Hs contribute all of the distributed assets and liabilities to newly formed partnership New P-ship and are deemed partners in New P-ship
- Treas. Reg. 301.7701-3(g)(1)(ii)

AFTER:

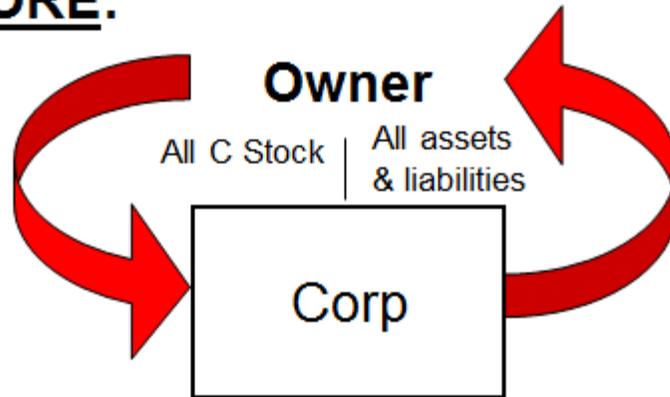


Examples of the Concept (cont'd)

Example Overview of Entity Classification Regulations (a/k/a Check-the-Box)

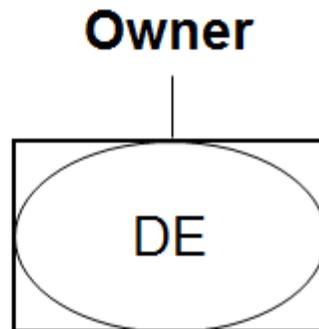
Classified Corporation Elects to Change to DRE

BEFORE:



- Corp is deemed to distribute all of its assets and liabilities to its single owner in liquidation
- Corp must have a single owner to elect to be treated as a DRE
- Afterwards the owner is deemed to directly own the assets and liabilities of DRE as a proprietorship, branch, or division
- Treas. Reg. 301.7701-3(g)(1)(iii)

AFTER:

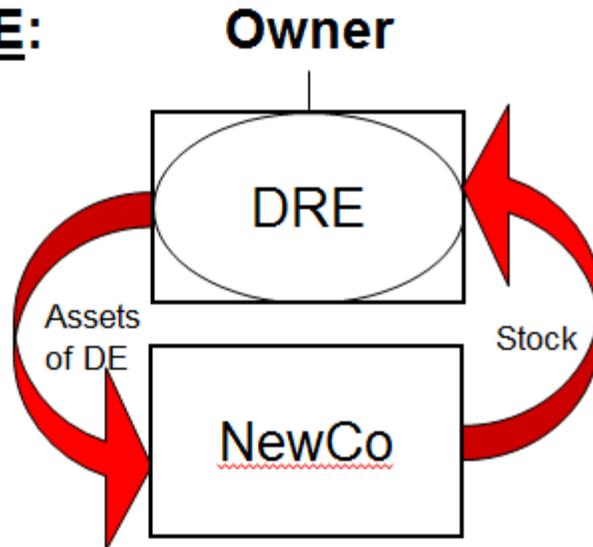


Examples of the Concept (cont'd)

Example Overview of Entity Classification Regulations (a/k/a Check-the-Box)

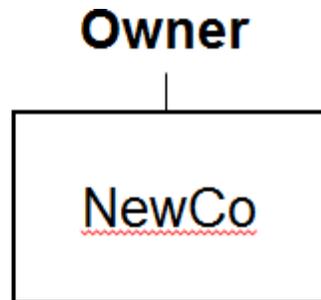
Classified DRE Elects to Change to a Corporation

BEFORE:



- Owner is deemed to contribute all of the assets and liabilities of DRE to NewCo in exchange for stock
- Afterwards Owner is the sole shareholder of NewCo
- Treas. Reg. 301.7701-3(g)(1)(iv)

AFTER:



Index of Referenced Resources

Overview of Entity Classification Regulations (a/k/a Check-the-Box)

Treas. Reg. 301.7701-1 through -5

Rev. Proc. 2009-41, 2009-39 I.R.B. 439 & Form 8832 Part II

Rev. Proc. 2010-32, 2010-36 I.R.B. 320

Training and Additional Resources

[Enter the Unit Name Here]	
Type of Resource	Description(s)
SABA Sessions	<ul style="list-style-type: none"> ▪ FY 2015 IBC Training Non-Recognition Corporate Events https://ve.learning.irs.gov/SiteRoots/main/User/PlaybackOptions.jhtml?s_id=00000114a23e000001507bee8f55ac19&cdurl=null&r_id=00000079ab20000001515f96ffa39cc7 ▪ CPE: Global Tax Organization Chart training, Parts 1 through 5 https://organization.ds.irsnet.gov/sites/lbiintl/SitePages/Organization-Restructuring/Org-StructIPN.aspx ▪ SharePoint website [above] > PN Resources > PN Related Training > Organization/Restructuring [Apply] > PPT for IBC CPE CENTRA Global Tax Org Chart Analysis 2014 > GTOC Units 1 of 5 through 5 of 5
Reference Materials – Treaties	<ul style="list-style-type: none"> ▪ Form 8832 Instructions http://core.publish.no.irs.gov/forms/public/pdf/f8832--2013-12-00.pdf

Glossary of Terms and Acronyms

Term/Acronym	Definition
CTB	Check-the-Box
DRE	Disregarded Entity, i.e., an entity disregarded as separate from its owner(s)
EIN	Employer Identification Number
Eligible Entity	A business entity that is not a “per se” corporation
Hybrid Entity	An entity that is considered to be a pass-through entity for U.S. tax purposes and a taxable corporate entity (association) in the tax jurisdiction of its organization
IRC	Internal Revenue Code
LLC	Limited Liability Company
LLP	Limited Liability Partnership
“Per se” Corporation	A domestic or foreign business entity automatically classified as a taxable corporate entity (association) as specified in Treas. Reg. 301.7701-2(b)
Reverse Hybrid Entity	An entity that is considered to be a corporate entity (association) for U.S. tax purposes and a pass-through entity in the tax jurisdiction of its organization
S/Hs	Shareholders

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
▪ 9415	Worthless Stock Loss	▪ To Be Developed
▪ 9414	Corporate Reorganizations Overview	▪ To Be Developed
▪ 9414	The Use of Hybrid Entities in Business Organization / Restructuring	▪ To Be Developed